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Grantor Trusts

1. Overview. Grantor trusts are trusts portions of the property of which for income tax purposes are treated as if owned by the grantor of the trust, under the rules contained in IRC §§ 672-677. There are further rules which similarly treat a person other than the grantor as the owner of trust assets for income tax purposes. IRC § 678. The classic case under IRC § 678 is a Mallinckrodt demand trust where a person such as a grandparent sets up a trust for grandchildren and the parents of the grandchildren have (or release) a power to take income or corpus to themselves; here the parents are treated as owning the assets for tax purposes. See *Mallinckrodt v. Nanan*, 146 F.2d 1 (8th Cir.), cert. denied, 324 U.S. 871 (1945). If both the rules under IRC §§671-677 and the rules under IRC § 678 would apply, the rules of IRC §§ 671-677 will trump IRC § 678 so the grantor will be treated as the owner. IRC § 678(b). There are also rules which treat a U.S. grantor to a foreign trust with a U.S. beneficiary as the owner of the assets transferred for income tax purposes. IRC § 679. We will focus here on the grantor trust provisions of IRC §§ 672-677 and mostly ignore IRC §§ 678 and 679.

The grantor trust rules supersede the normal trust taxation rules which, in general, tax the trust on undistributed distributable net income (DNI) and tax the beneficiaries to the extent they receive a portion of the DNI. The trust receives a deduction for the distributed DNI. IRC § 641 et. seq.

For planning purposes, it may be desirable that the grantor not be taxed on the trust income, and in that case the grantor trust rules need to be carefully navigated to avoid tax-triggering interests and powers. On the other hand, it may be desirable that the grantor will be taxed on trust income, in which event the grantor trust rules can provide a planning tool to accomplish this goal, by retaining one or more tax-triggering powers, particularly powers that do not cause gross estate inclusion for estate tax purposes.

2. Grantor. The grantor trust rules (where applicable) treat a grantor as the owner of the assets he or she gratuitously transferred into the trust. The person who established the trust may or may not be a grantor to it (other than for possibly having a duty to report the creation of a foreign trust when it is still unfunded; Reg. § 1.671-2(e)(11)). Gratuitous transfers can include the below market portion of a bargain sale to a trust. Reg. § 1-671-2(e)(6), Ex. 7. The assets transferred may be only a portion of all the assets held in the trust, and, thus, an allocation of income may be needed between the grantor and non-grantor portions of the trust. IRC § 671.

a. Exclusive. The grantor trust rules are also exclusive. IRC § 671 (last sentence). Before the codification of the rules under the 1954 Code, case law had applied IRC § 61 (general definition of gross income) to trust schemes which could, under all the facts and circumstances, result in an unrealistic shift among persons of taxable income. Using IRC § 61, the courts could impose the tax obligation where it most realistically belonged, to the person with "dominion and control." *Helvering v. Clifford*, 309 U.S. 331 (1940). Now, under IRC § 671, IRC § 61 no longer can be so used.

b. Reciprocal Trusts. The reciprocal trust doctrine may apply to treat the grantor of one trust as actually being the grantor of another trust which is reciprocal to the first trust, in that, although separate trusts, the grantors of each end up in approximately the same economic position as if they had set up their trusts to name themselves as beneficiaries. *U.S. v. Grace's Est.*, 395 U.S. 316 (1969) (gross estate inclusion issue); *Krause v. Comm'n*, 51 T.C. 890 (1973), aff'd 497 F. 2d 1109 (6^{th} Cir. 1974), cert denied, 419 U.S. 1108 (1975) (income tax issue).

c. Spouse. A grantor is treated as holding any power or interest held by an individual who was the spouse of the grantor *at the time* of the creation of the power or interest or who later became the grantor's spouse, but only after the individual became the spouse. IRC § 672(e)(1)(B). A divorce or separate maintenance decree causes a marriage to be treated as if it did not exist under this rule relating to a person who was a spouse at the time the power or interest was created. However, for a person who became a spouse *after* the creation of the power, a later divorce does not end the attribution of powers or interests to the grantor. IRC § 672(e)(2). As we will see, there are other rules relating to spouses as well. Although a sprinkling power held by the grantor's spouse will cause grantor trust treatment for the portion affected, this power alone will not be sufficient to cause inclusion in the grantor's gross estate.

3. Avoiding Grantor Trust Status. How can treatment as a grantor trust be avoided? All the trapdoors in the rules need to be avoided. These trapdoors are:

a. No Reversion. The grantor must not possess a reversionary interest in corpus or income which as of the inception of that portion of the trust exceeds 5% of the value of that portion. IRC § 673. There is an exception for reversions arising from the death before age 21 of a lineal descendant holding all present interests in any portion of the trust. IRC § 673(b).

b. No Right to Revoke. Neither the grantor nor any non-adverse party can have any right to revoke the trust. IRC § 676. Such a power may be held prior to the occurrence of an event triggering the power (e.g., a future death) where the period would not cause a 5% reversion under IRC § 673 if the power were a reversionary interest; but after the triggering event, the power will cause grantor trust status unless the power is relinquished. IRC § 676(b).

c. No Income Benefit to Grantor. The trust income must not be distributable without the consent of an adverse party to the grantor or the grantor's spouse, either presently or accumulated for future distribution. Also, no income may be used or the purchase of insurance on the life of the grantor or the grantor's spouse. IRC § 677(a). Such a power may be held, however, prior to the occurrence of an event triggering the power where the period would not cause a 5% reversion under IRC § 673 if it were a reversionary interest but after the occurrence of the triggering event grantor trust status will be created unless the power is relinquished. Nor may the income be distributable and distributed for supporting persons (other than the spouse) whom grantor is obligated to support. The unexercised discretion of another person, the trustee (which can include the grantor as trustee or co-trustee), to distribute to benefit persons the grantor is obligated to support does not cause taxation to the grantor. Further, amounts of principal actually so used are treated as distributions of DNI taxable to the grantor. IRC § 677(b).

d. No Power Over Beneficial Enjoyment. The grantor and any non-adverse party, without the consent of any adverse party, must not have powers over the beneficial enjoyment of corpus or income, with certain specified exceptions. IRC § 674(a). Note that mandatory distributions of income or principal are not proscribed, but would possibly cause estate inclusion for a grantor holding such a power which may be treated as a general power of appointment unless its use to discharge the grantor's obligations is prohibited under the trust. See Reg. § 20.2036-1(b)(2). Some of the exceptions to IRC § 674(a) relate to specific powers, others are broader and relate to the powers of an independent trustee or to powers which are limited by a reasonably definite external standard.

i. Specific Power Exceptions. The specific powers which a grantor or non-adverse party may hold are:

1. Support Dependent. The power to apply income to a dependent allowable under IRC § 677(b) without causing tax to the grantor (i.e., unexercised discretion by a trustee). IRC § 674(b)(1).

2. Enjoyment After an Event. The power affecting beneficial enjoyment only after the occurrence of an event which would not cause tax under IRC § 673 if it were a reversionary interest; but after the event occurs, the grantor will be subject to tax unless the power is relinquished. This exception seldom applies. IRC § 674(b)(2).

3. Only by Will. A power exercisable only by will, other than a power to appoint accumulated income (or where income is or could be accumulated by the grantor or non-adverse party) without the consent of an adverse party. IRC § 674(b)(3).

4. Among Charities. A power to allocate corpus or income where income or corpus is irrevocably payable among charities (e.g., choosing recipients of an annuity from a charitable lead trust) or an ESOP (Employee Stock Ownership Plan) in a qualified gratuitous transfer of employer securities. IRC § 674(b)(4).

5. Distribute Corpus. A power to distribute corpus to any beneficiary (whether or not an income beneficiary) where limited by a reasonably definite standard. IRC § 674(b)(5)(A). If such a standard is not desired, there is an exception to allow grantor or a non-adverse party to distribute corpus to a current income beneficiary where the distribution of corpus is chargeable against the proportionate share of corpus held in trust for the payment of income to the beneficiary as if the corpus was a separate trust. For example, if A has an income interest only, with a remainder in B, the grantor could have the power to have the entire corpus distributed to A. Reg. § 1.671(b)-1(b)(5)(iii), Ex. 3 (equal shares for two sons for ten years, then to grandchildren; grantor may distribute half to a son in the ten years where this reduces the son's share so all income then becomes payable to other son). IRC § 674(b)(5)(B). The exception for these corpus distributions do not apply if anyone can add to beneficiaries other than after born or after adopted children. IRC§ 674(b)(5).

6. Withhold Income Temporarily. A power to withhold income temporarily may be held where the accumulated income must be paid (i) either to the beneficiary, the beneficiary's estate, or appointees of the beneficiary where the class is unlimited except to avoid being a general power (i.e., can exclude the beneficiary, her estate, and the creditors of her estate), or else, (ii) on trust termination or on a corpus distribution augmented by the accumulated income, to the current income beneficiaries where shares have been irrevocably specified (i.e., there will be no changes in shares of income). Again, the exception is destroyed if anyone can add to beneficiaries other than after born or after adopted children. IRC § 674(b)(6).

7. Withhold Income During Disability. A power may be held to withhold income and add the accumulated income to corpus during the legal disability of a current income beneficiary or while any beneficiary is under age 21. Again, no one can be able to add beneficiaries other than after-born or after-adopted children. IRC § 674(b)(7).

8. Principal and Income Allocation. A power may be held to allocate receipts and disbursements between income and principal even though expressed in broad language. IRC § 674(b)(8). This exception is designed to allow a grantor as trustee to have "a power which is normally vested in the trustee for purposes of conforming to appropriate trust accounting principles." S. Rep. 1622, 83d Cong., 2d Sess. 369 (1954). Given this intent, it would be best not to allow too much power to the grantor.

ii. Independent Trustees Exception. There is also a broad exception to the holding of powers by a non-adverse party over the beneficial enjoyment of income or principal. A power may be held over income (distribute, apportion, or accumulate) or principal (pay out for beneficiaries, whether or not income beneficiaries) where the power is solely exercisable (without the consent of anyone) by a trustee or trustees none of whom is the grantor and no more than half of whom are related or subordinate parties who are subservient to the wishes of grantor. This exception is also destroyed if anyone can add beneficiaries other than after born or after adopted children. Since a person who is the spouse of the grantor is treated as the grantor, the spouse can't be a trustee and neither can anyone related to or subservient to the spouse. IRC § 674(c). Who is related or subordinate to a grantor or spouse is discussed further below.

iii. Limited by Standard Exception. A power solely exercisable (without anyone's consent) by a trustee or trustees none of whom is the grantor or spouse living with the grantor, may be held to distribute, apportion, or accumulate income to or for beneficiaries where the power is limited by a reasonably definite external standard. This exception applies whether or not the conditions of the exceptions relating to the power to withhold income temporarily or for a disabled beneficiary are met (i.e., of IRC § 674(b)(6) and (7)). The exception is destroyed if anyone can add beneficiaries of income or principal, except to provide for after born or after adopted children. IRC § 674(d).

e. No Specified Administrative Powers. The grantor or certain others must not hold proscribed administrative powers. These are:

i. Power to Deal for Less than Adequate Consideration. Neither the grantor nor a non-adverse party, without the consent of an adverse party, may deal with income or principal for less than adequate consideration in money or money's worth. IRC § 675(1).

ii. Power to Borrow Without Adequate Interest in Security. Neither the grantor nor a non-adverse party may have power to borrow income or principal, directly or indirectly, without adequate interest or without security except where a trustee (other than grantor) is authorized under a general lending power to make loans to any person without regard to interest or security. IRC § 675(2).

iii. Borrowing. The grantor must not actually borrow income or principal, and will be treated as owning the portion not completely repaid (including interest) before the beginning of the tax year. In the view of the Tax Court, in determining the portion to be taxed to the grantor, the loan could cause the entire trust to be taxed to the grantor if circumstances show the grantor to have significant dominion and control over the trust. See *Benson v. Comm'r,* 76 TC 1040 (1981); *Rothstein v. U.S.,* 735 F.2d 704 (2d Cir. 1984). But this borrowing rule has an exception where the loan bears adequate interest and has adequate security and is made by a trustee other than the grantor or a related or subordinate trustee subservient to the grantor. While a person is a spouse of the grantor, the term grantor includes the spouse, so the spouse cannot borrow or be the lending trustee. IRC § 675(3).

iv. General Powers of Administration. The grantor is treated as owning a portion of the trust subject to certain powers exercisable in a non-fiduciary capacity by any person without the consent of a person in a fiduciary capacity. IRC § 675(4). These powers are:

1. Vote Where Control Significant. The power to vote stock or other securities of a corporation in which the holdings of the grantor and of the trust are significant from the viewpoint of voting control.

2. Direct Investments Where Control Significant. The power to direct investments of the trust or veto investments to the extent trust funds consist of stock or securities of a corporation in which the holdings of the grantor and the trust are significant from the viewpoint of control.

3. Reacquire Assets. A power to reacquire the trust corpus by substituting other property of equivalent value. This is the power which is often retained by a grantor where grantor trust treatment is desired with minimal risk of gross estate inclusion for estate tax purposes.

v. Adverse and Non-Adverse Parties. An adverse party is a person having a substantial beneficial interest in a trust that will be adversely affected by the exercise or non-exercise of a power. A person with a general power of appointment is treated as a person with an interest in the trust. IRC § 672(a). A non-adverse party is anyone not an adverse party. IRC § 672(b). Powers held by an adverse party are not imputed to the grantor. If there are several adverse parties, say four remainder holders, if the grantor retains the right to get the property back with the consent of only one of the remainder holders (although all four lose their interests), the grantor is not taxed under the grantor trust rules. The holder of an income interest would be adverse (because adversely affected) by a power to terminate the income interest, but not by a power to change a remainder holder. Also, a remainder holder is not adversely affected by a change in the income interest. Even relatives and close friends can be adverse parties. *See Laganas v. Comm'r*, 281 F.2d 731, 735-736 (1st Cir. 1960). The matter of relatives and friends is dealt with by the "related or subordinate party" rules.

vi. Related and Subordinate Parties. As we have seen, no more than half of the trustees may be related or subordinate parties subservient to the grantor. Some persons who are not adverse parties because lacking an interest in the trust nevertheless can still hold certain limited powers which will not be imputed to the grantor if the person, although a related or subordinate party, is not subservient to the grantor. IRC § 672(c).

1. Categories of Parties. A related or subordinate party is:

a. Spouse living with the grantor;

b. Parent, descendant, sibling, or employee of the grantor;

c. A corporation in which the trust and grantor hold voting rights significant from the viewpoint of control, or any employee of that corporation; or

d. A subordinate employee of a corporation in which the grantor is an executive.

2. Subordinate. These related or subordinate persons are presumed to be subservient to the grantor with respect to any power held by the person to control beneficial enjoyment (i.e., under IRC § 674) or administrative powers (under IRC § 675). The presumption can be overcome by preponderance of the evidence. IRC § 672(c). It is best to use a sufficient number of truly independent trustees and not rely on overcoming the presumption by trying to prove the trustee is not following the grantor's wishes. Most business associates, lawyers (See *Zand v. Comm'r,* TC Memo 1996-19, aff'd 143 F.3d 1393 (11th Cir. 1998)), and relatives will not be related or subordinate. For example, uncles and aunts, nephews and nieces, cousins, etc. are relatives not in the tainted group.

vii. Summary Chart. The following chart may help to recall key provisions in planning a trust.

Who May Hold Powers Without Causing Grantor Trust Treatment
and Without Causing Gross Estate Inclusion:

Power	**Who May Exercise**			
	Grantor	**Non-Adverse Party**	**Independent Trustee**	**Adverse Party Trustee**
Selecting and voting investments not significant from viewpoint of control	X	X	X	X
Make mandatory distributions (but not to discharge grantor obligations)	X	X	X	X
Distribute principal under definite standard where no one can add to beneficiaries (other than after-born or after-adopted children)	X	X	X	X
Control benefits during period it would be okay if it was a reversion (Note: on vesting of the power, grantor status begins)		X	X	X
Control beneficial enjoyment under power exercisable by will (but not to accumulate income for disposition at own death)		X	X	X
Allocate income among charities, ESOP		X	X	X
Distribute principal to income beneficiary with charge against beneficiary's separate share		X	X	X
Withhold income if it must be payable to beneficiary or beneficiary's estate, under broad limited power, or in stated shares to income beneficiaries where no one can add to beneficiaries (other than after-born or after-adopted)		X	X	X
Withhold income during disability or minority of beneficiary		X	X	X

Withhold income temporarily where no one can add beneficiary (other than after-born or after-adopted)		X	X	X
Allocating receipts and disbursements between income and principal		X	X	X
Revoking trust after period not causing 5% reversion (will be grantor trust after that)		X	X	X
Paying trust income to or accumulating it for grantor or spouse after period not causing 5% reversion (will be grantor trust after that)		X	X	X
Allocating income among beneficiaries under reasonably definite standard, where trustee is not grantor or spouse and no one can add beneficiaries (other than after-born or after-adopted)		X	X	X
Lend funds to grantor without adequate interest and security if trustee empowered and loan repaid before taxable year			X	X
Revoke trust to revest in grantor				X
Pay or accumulate income for grantor or grantor's spouse				X
Use income to pay premiums on policy on life of grantor or grantor's spouse				X

Chart derived from Zaritsky, Tax Planning for Family Wealth Transfers During Life: Analysis with Forms, Appendix C, Checkpoint online 2017.

4. <u>Triggering Grantor Trust Treatment</u>. How best to trigger grantor trust status when desired? The trust could be a grantor trust as to income, or as to gains and losses (typically principal), or both depending on the powers retained. Since the grantor trust rules apply to applicable portions or interests, it may be important that both accounting income and accounting principal (capital gains) be treated as owned by the grantor, for example, to allow sales to the grantor trust to avoid gain recognition. An interest in income and an interest in principal are treated as two different portions of a trust. Reg. § 1.671-3(b)(1). The Service will not give an advance ruling on whether the trust is a grantor trust due to retained powers. Let's compare some possible powers that could be used.

a. Premium Payments. Under IRC § 677(a)(3), the power of the grantor or a non-adverse party to apply income to pay premiums on life insurance on the lives of the grantor or the grantor's spouse would create grantor trust status for a portion of the trust. Is the portion limited by the portion the income of which was necessary to pay premiums? See older cases limiting the portion, *Iverson v. Comm'r*, 3 TC 756 (1944), and *Weil v. Comm'r*, 3 TC 579 (1944) acq. 1944 CB 29; compare to PLR 8118051 and PLR 8126047 which found the entire trust to be a grantor trust. If income and principal can be used to pay premiums, perhaps the entire trust will be a grantor trust if it holds life insurance.

b. A Sprinkling Power in a Non-Adverse Trustee. Under IRC § 674, a power of disposition as to beneficial enjoyment of principal or income exercisable by the grantor or non-adverse party, without the consent of anyone else, will trigger grantor trust treatment. However, the grantor will not want to risk gross estate inclusion under IRC § 2036 and thus must not control, even indirectly, the trustee's decision. Perhaps the sprinkling power could be limited to income only to help reduce this risk. This may still cause the entire trust to be treated as a grantor trust. See PLR 8103074.

c. Non-Adverse Party's Power to Add Beneficiaries. Under IRC § 674(b)(5) and (6) provides grantor trust treatment if a non-adverse party (such as a trustee, or indeed any non-adverse person), can add beneficiaries (other than after born or after adopted children) where the non-adverse party also has discretion to distribute income and principal. This would appear to make the trust a grantor trust both as to income and principal (e.g., gain on asset sale). This power appears to be relatively safe against estate inclusion where there is no control over the trustee.

d. Right to Substitute Assets. The use of a power of substitution of assets at equivalent value under IRC § 675(4) is a relatively safe way to have the entire trust treated as a grantor trust, perhaps coupled with the discretion to add beneficiaries as described above. However, life insurance should not be subject to the power in order to avoid an incident of ownership which could cause estate inclusion. There is no gain or loss recognized on the exercise of the substitution power. PLRs 200846001, 200842007, 200606006, 200603040. The substitution power must be held in a non-fiduciary capacity, thus it would be best not to have it held by a trustee, or perhaps even by a trust protector. A nonfiduciary power will not likely cause estate inclusion. See *Jordahl Est. v. Comm'r*, 65 TC 92 (1975), acq. 1977 1 CB 1 (no estate inclusion where grantor as trustee (fiduciary capacity) had power to substitute); Rev. Rul. 2008-22, 2008-1CB796 (no estate inclusion of power held in nonfiduciary capacity if trustee has fiduciary duty to assure exercise at equivalent value without shifting benefits for beneficiaries).

e. Payment of Income to Spouse or Grantor. A non-adverse party's power to pay trust income to or for the benefit of the spouse of the grantor causes grantor trust status under IRC § 677(a)(1) but perhaps only as to the income portion, and has the risk of having the grantor trust status end on the death of the spouse. The discretion of a non-adverse trustee to pay income to the grantor will cause grantor trust treatment whether or not the payments are made. The power runs the risk of causing estate inclusion under IRC §§ 2036 or 2038 if any implied agreement can be found, and runs the risk of making the trust available to the grantor's creditors. These powers are usually best not used.

5. Some Planning Issues. Let's look at some planning issues and techniques where grantor trusts are used.

a. Retained Powers Generally. Retained powers or interests need to be reviewed from various perspectives.

i. Tax. In planning with irrevocable trusts, the grantor must decide whether the trust should be treated as a grantor trust or else as either a simple or complex trust under the trust income tax rules. If grantor trust treatment is desired, one or more powers or interests described above would be retained or granted to a non-adverse party; otherwise such powers or interests will be avoided.

The grantor must also decide whether the transfer is intended to be a completed gift or an incomplete gift. If the trust is to constitute a completed gift, for example to use the annual exclusion (if available for a present interest, for example, by providing Crummy withdrawal powers to beneficiaries) or to use the unified credit during life, to reduce the donor's gross estate, then certain retained rights and powers in the donor will be avoided, such as any rights or powers to get the property back or any rights or powers to modify beneficial interests (e.g., a retained limited power of appointment). As part of this decision, the donor will also decide whether the trust assets are to be included and excluded from the donor's gross estate, and certain powers (e.g., to revoke or amend) will be avoided to keep the property out of the donor's gross estate.

In granting Crummy withdrawal powers to beneficiaries, the grantor should bear in mind that a lapsed withdrawal power (as a lapse of a general power of appointment) will cause the beneficiary to be treated as a grantor of the trust of the portion over which the power lapsed. This may be ameliorated by a lapse limited by the 5 and 5 ($5,000 or 5%) exception to general power treatment. IRC § 2514(e).

Each of these decisions turns on powers held or given up by the grantor or donor, but the treatment of powers under different tax regimes are not fully compatible with each other, so that a trust may well be a grantor trust taxable for income tax purposes to the grantor, yet be a completed gift for the benefit of the beneficiaries and excluded from the grantor's gross estate for estate tax purposes. However, while a transfer which will not be includable in the donor's gross estate is generally going to be a completed gift, it is also quite possible that a modest power to change beneficial interests could bring a property into the donor's gross estate but result in a completed gift for gift tax purposes. It helps to impose fixed, ascertainable standards to a grantor's discretion held as trustee, in order that the gift be treated as completed yet reduce the risk it will be includable in the donor's gross estate. In all cases a good deal of care should be used where a grantor is to have any retained powers, whether as trustee, holder of a power of appointment, or otherwise. A power which may cause desirable grantor trust treatment could cause undesired estate and gift tax treatment.

ii. Creditors. A further concern with powers or interests held by the grantor or related persons is the effect of the powers on creditor access to a trust, under the self-settled trust doctrine (*Leach v. Anderson,* 535 P.2d 1241 (UT 1975), fraudulent transfer (now, in Utah, voidable transaction) rules (UCA §§ 25-6-101 et seq.), the Utah Asset Protection Trust rules (UCA § 25-6-502), divorce equitable division (*Dahl v. Dahl*, 2015 UT 79, 2015 WL 509 S2 49 (UT 2015)), and similar rules.

iii. Flexibility. The grantor trust power which many planners find the least risky is the power to substitute property at equivalent value described in IRC § 675(4) clause (C). If this is the only such power, it becomes relatively easy to toggle between grantor and non-grantor trust treatment. For example, the grantor may desire grantor trust treatment in order to enhance the gift to the beneficiaries by making the trust income payable to the beneficiaries not taxable to them at a time when the trust income was modest; however, at a later time when the trust income could be quite large (e.g., on sale of an appreciated business interest), the grantor may give up the substitution power to avoid the larger income tax liability. Adding such a power to a non-grantor trust to make it a grantor trust is not treated as a transfer of property. PLR 201730018; Rev. Rul. 85-13, 1985-1 C.B. 184. Also, a trust protector could be given the power to eliminate or restrict powers of the grantor or the grantor's spouse in order to turn-off grantor trust treatment. Naturally, the tax effect of terminating grantor Trust treatment should be considered. See further discussion below.

b. Sales to Grantor Trusts. Some planners use sales to grantor trusts (sometimes called "intentionally defective grantor trusts") as an estate freezing technique. For example, a grantor sells closely held business stock to a trust created by the grantor treated as a grantor trust, under which the income is payable to or for the children of the grantor and the trust principal is eventually distributed to the children. The price for the stock is payable over time, interest only for nine years (for the mid-term applicable federal rate) with a balloon payment at the end of the term under a promissory note bearing at least the minimal interest, secured by the stock and perhaps guaranteed by the beneficiaries or perhaps the trust could hold some other assets, e.g., 10% of the price. The guaranty or other assets are so that the debt will not be deemed illusory. The results generally will be, no income tax on the sale (the grantor sold the stock to herself), no interest income to the seller and no interest deduction to the buyer on note payments (PLR 9535026), no gift tax (it was a sale at full value), and estate tax inclusion for only the value of the note at death (using low interest rates, usually the applicable federal rate, the value will be less), the tax paid by the grantor on the income of the trust is not a gift (it is the grantor's own tax liability being paid) (to avoid estate inclusion there must be no mandatory reimbursement or preexisting agreement for reimbursement of the grantor for such taxes; see Rev. Rul. 2004-64, 2004-27, IRB 7). This example assumes the stock and other trust assets produce cash flow sufficient to make the payments. The value of the income tax paid and any growth on the stock will be removed from the grantor's estate, all without a taxable gift.

However, there are significant issues that create risk for this strategy. Is there an income taxable event on grantor's death when grantor trust status ends? See *Madorin v. Comm'r,* 84 T.C. 667 (1985) and Reg. § 1.1001-2(c) Ex. (5) (recognition) and compare *Crane v. Comm'r,* 331 U.S. 1 (1947) (implies death is not a gain recognition event); Blattmachr, Gans, and Johnson, *Income Tax Effects of Termination of Grantor Trust Status by Reason of Grantor's*

Death, Journal of Taxation, Sept. 2002, Vol. 97, p. 149. Also, related to this, what is the basis of the stock? No recognition event occurred while a grantor trust, and there was no estate inclusion. Does the gift (carry over basis) or sale (new basis) rule apply while a grantor trust? Does the sale rule apply when no longer a grantor trust? As noted below, in the discussion of terminating grantor trust status, there would be a deemed transfer if grantor trust status ended during grantor's life; does something similar apply at death?

6. Useful Features of Grantor Trusts. Grantor trusts have a number of features useful in planning. The main feature is that the grantor and the owned portion of the trust are not treated as separate in many tax situations such as IRC § 121 principal home ownership requirements to avoid gains on sale, IRC § 1033 like kind exchange reinvestment requirements, IRC § 1042 gain deferral on sale of stock by an ESOP, whether a transfer has occurred for purposes of IRC § 691 income in respect of a decedent, and so on.

Irrevocable life insurance trusts are generally grantor trusts; this is almost assured under the insurance premium payment rule of IRC § 677(a)(3). This makes the trust able to make transfers of the insurance to another trust without incurring tax under the insurance transfer for value rules of IRC § 101(a)(1) and (2). See *Swanson v. Comm'r,* 518 F.2d 59 (8th Cir. 1975).

Grantor trusts can own S-corporation stock. Typically, this is a standard revocable trust, but can also be an irrevocable trust which is treated as a grantor trust. Without grantor trust treatment, the trust would need to elect to be a Qualified Subchapter S Trust (QSST) or an Electing Small Business Trust (ESBT) under IRC § 1961(d) and (e) if the S-election is to be allowed or is to continue. IRC § 1361(c)(2) (only certain trusts can be shareholders).

With a grantor trust, net operating losses or other deductions can pass through to the grantor's tax return (even if the deduction exceeds the income of the portion owned), rather than being stuck at the trust level (IRC § 642(d) allows trusts to use the NOL deduction) when the losses may not be useable to offset income as quickly or to offset income of the taxpayer best able to use the loss. If the grantor is not treated as the owner of the trust, the beneficiaries who may be taxable on the trust income will be unable to use the trust's deductions except to the extent the deductions have reduced the DNI. Unused losses, carryovers, and most deductions typically can be used by beneficiaries in trust termination, however. IRC § 642(h).

A grantor trust may be useful in corporate liquidations where assets are sold for an installment obligation. To facilitate payments to the many stockholders, the stockholders can create a liquidating trust treated as a grantor trust as to each seller's portion, and then transfer the note to the trust without triggering gain recognition on disposition of the note. See IRC § 453B(a); Rev. Rul. 74-613, 1974-2 C.B. 153. There will, however, be a taxable transfer if the trust ceases to be a grantor trust.

7. Tax Reporting. The grantor trust need not obtain a separate tax identification number as long as the grantor is taxed as the owner of the entire trust. Otherwise the trust will need a tax identification number, and must obtain one when no longer deemed owned by only one person (e.g., on death of grantor). Reg. 301.6109-1(a)(2). There are tax reporting

differences where the grantor trust is treated as owned by only one grantor and where the grantor trust is treated as owned only partly by the grantor.

a. Grantor Owns Portion. Where only a portion is owned by the grantor, the trust files form 1041 but does not include on it the items of income, deduction, or credit of the grantor. Rather, these items are shown on a separate statement attached to form 1041. Reg. § 1.671-4(a).

b. Grantor Owns All. Where all the trust is treated as owned by the grantor, the trustee can use the general method described above (separate statement where a portion is owned by the grantor) or may choose between two other reporting methods (with some exceptions). Under the first alternative method, the trust does not have a taxpayer identification number and does not itself file returns; rather, it uses the grantor's tax number (after having it certified to the trustee by the grantor on form W-9). Except where the trustee is the grantor, the trustee provides a detailed statement to the grantor also stating that the information must be reported on the grantor's return. Reg. § 671-4(b)(2).

Under the second alternative method, the trust obtains a tax number and provides it to payors who send their 1099s to the trustee. The trustee then separately aggregates all of each type of 1099s (e.g., all 1099 INT, all 1099 DIV, etc.), and provides a statement to the grantor which includes all the 1099 reported items as well as non-1099 items (e.g., partnership K-1 items).

One important exception to the alternative reporting methods are QSSTs holding S-corporation stock. They are treated as grantor trusts but are required to have a tax number and file a separate return under the general reporting rule rather than either alternative. See IRC § 1361(d).

c. Two or More Grantors. Where two or more persons are grantors of the grantor trust, the trustee provides the trust tax number to all payors and then aggregates the various types of 1099s, etc. and creates new forms 1099 of the various types for each grantor. Thus, there may be a dozen 1099 DIVs received by the trustee; the trustee will aggregate them and make a new 1099 DIV for each grantor showing that grantor's share of the dividend income received by the trust. Reg. § 671-4(b)(3).

8. Terminating Grantor Trust Treatment. There is a deemed transfer by the grantor of trust assets when the trust is no longer a grantor trust. A termination during the life of the grantor would cause the same tax consequences as if the grantor directly transferred the assets. If the liabilities exceed the basis of assets, this could cause gain recognition. Reg. § 1.1002-2(c) (Ex. 5); Rev. Rul. 77-402, 1977 C.B. 222.

Where the death of the grantor ends grantor trust status it is not clear if there is a basis step-up on the trust assets not includable in the estate of the grantor. The Service's position is that there is none. CCH 200937028. Some tax advisors disagree. Blattmachr, Gans, and Johnson, Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor's Death, 97 J. Tax'n 149 (2002). What if liabilities exceed basis? Would the gain be treated as being recognized just prior to death and be reportable on the grantor's final return, or would the gain be taxed to the grantor's estate in a manner similar to self-cancelling promissory notes? (See *Est. of Frane v. Comm'r*, 988 F.2d 567 (8th Cir. 1993) (death terminating installment note taxable as a transfer by the estate under IRC § 691(a)(2) not as a disposition of the obligation by the deceased grantor under IRC § 453B).