Trust Education Forum

Issues That Arise With Grantor Trusts

Tuesday, February 26, 2019
8:00 a.m. – 9:30 am

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ISSUES THAT ARISE WITH GRANTOR TRUSTS

I. Introduction.

A. The grantor trust rules, found in Code Sections 671-679 and the regulations thereunder, were developed in response to taxpayers' attempts to shift income to individuals in lower tax brackets through the use of trusts.

B. When the grantor trust rules were enacted as part of the Internal Revenue Code of 1954, tax rates for trusts were basically the same as they were for an unmarried individual. There were many more tax brackets and a much larger spread in tax rates in our progressive tax system at that time. In fact, at the time of enactment, there were 24 tax brackets and rates ranging from 20% to 91%. Therefore, there was a significant opportunity to shift income to lower rates through placing income producing property into trusts that were separate taxpayers.

1. Congress enacted the grantor trust rules to curtail the practice in those situations where the taxpayer or related parties, retained certain beneficial interests in or powers over the trust. In those cases where Code Section 671-679 caused the trust to be a grantor trust, the trust income would be taxed to the grantor.

2. The high number of brackets and significant spread in rates continued through 1986. Throughout this period, a non-grantor trust was almost always desirable, so much so that a trust that was categorized as a grantor trust was often referred to as "defective."

3. Congress then began to compress the tax brackets for all taxpayers, and in particular for trusts and estates. For 2019, a trust or estate pays federal income tax on its ordinary income at a rate of 37 percent for taxable income in excess of $12,750 In contrast, an unmarried individual's income tax rate does not increase to 37 percent until his or her taxable income exceeds $510,300.

C. As these materials discuss in more detail, this change in the way trusts are taxed has shifted the paradigm. Grantor trusts are no longer defective; they are often highly desirable, and a key part of transfer tax planning.

II. Trust Income Taxation

A. Separate taxpaying trusts

1. Generally, a trust is considered a separate taxpayer for federal income tax purposes and is taxed under subparts A through D and F of subchapter J of the Code (Sections 641 to 668 and 681 to 685).

2. Such trusts ordinarily must apply for a taxpayer identification number and file annual federal income tax returns.

3. Items of trust income, deduction, and credit generally are reported on Form 1041, and any tax liability is paid by the trust. To the extent that the trust makes distributions during the taxable year, however, those items may be allocable, in whole or in part, among the beneficiaries of the trust.

B. Grantor trusts

1. However, when one or more of the grantor trust rules of subpart E of subchapter J (sections 671 to 679) are satisfied, the trust is not treated as a separate taxpayer.

2. In the case of a grantor trust, items of trust income, deduction, and credit are attributed to the grantor (or in some cases, to a third person). As discussed below, a grantor trust may but often not need, file a separate federal income tax return.

3. During a trust's existence, it may be a grantor trust at some times and a nongrantor trust at others. For example, a revocable living trust is a grantor trust during the grantor's lifetime and ordinarily becomes a nongrantor trust at the grantor's death.

4. A trust can be partially a grantor trust if the retained powers that cause it to be a grantor trust apply only to certain assets or to a fractional share of all trust assets.

5. In addition, a trust may be a grantor trust as to its accounting income but not as to its principal, which for accounting purposes usually includes capital gains and other taxable receipts such as employee benefit payments. For example, if the grantor retains the right to receive trust accounting income, the trust will be a grantor trust as to that income, but absent the retention of additional powers, capital gains would be subject to the regular, nongrantor rules. Capital gains thus would be reported on Form 1041 and be subject to income tax under the rules applicable to nongrantor trusts.

C. Overview of the grantor trust rules

1. Code Section 671 provides that when the grantor or another person is treated as the "owner" of any portion of a trust (under the rules prescribed in Code Sections 672-679), that person must include on his or her federal income tax return those items of income, deduction, and credit that are attributable to that portion of the trust.

   a. For this purpose, the "grantor" is not necessarily the creator of the trust. It is the person who funds the trust via a gratuitous transfer. A trust may have more than one grantor. This occurs for example if the person who created the trust funds the trust, and then another person makes a gratuitous transfer to it.

b. This also means that the party who decants a trust, or who creates the trust instrument into which a trust is decanted, is not necessarily the grantor. The grantor will be the person who funded the original trust.

2. Code Section 672 defines certain terms and general rules. Those defined terms and rules include the following:

   a. "Adverse party" means any person having a substantial beneficial interest that would be adversely affected by the exercise or nonexercise of a power. A person holding a general power of appointment over trust property is treated as having a beneficial interest in the trust. A trustee is not an adverse party solely by virtue of being trustee.

   b. "Nonadverse party" means any person who is not an adverse party. An independent trustee or a trustee who is family member but not a beneficiary of the trust would be a nonadverse party.

   c. "Related or subordinate party" means the grantor's spouse (if living with the grantor), parents, descendants, siblings, or employees; a corporation (or employee thereof) over which the grantor has voting control; or a subordinate employee of a corporation in which the grantor is an executive.

   d. A grantor is treated as holding any power or interest held by the grantor's spouse. IRC §672(e). There is some uncertainty about the scope of this provision, given that other provisions in Section 674 refer in certain places to powers held by the grantor or the grantor's spouse and in others to powers held by the grantor (implying that a power held by the spouse is different).

3. Code Section 673 provides that a grantor will be treated as the owner of any portion of a trust in which the grantor's reversionary interest in trust income or principal exceeds five percent of the value of that portion.

   a. The value of the grantor's reversionary interest will be determined assuming the maximum exercise of discretion in favor of the grantor.

   b. The IRS applies standard actuarial principles and the applicable federal rate under Code Section 7520 for purposes of determining the grantor's reversionary interest.

   c. Code Section 673 renders the so-called "<u>Clifford</u> trust" obsolete. A typical <u>Clifford</u> trust paid income to a designated beneficiary for a fixed period in excess of 10 years. After the expiration of the income term, the trust corpus would revert to grantor. Under prior

law, the income would be taxed to the beneficiary, not to the grantor. If the beneficiary occupied a lower income tax bracket than the grantor, then the arrangement was beneficial from an income tax standpoint. The Tax Reform Act of 1986 eliminated the 10-year rule and replaced it with the current five-percent rule of Code Section 673.

4. Under Code Section 674, the grantor is treated as the owner of any portion of a trust for which the beneficial enjoyment of corpus or income is subject to a power of disposition that is exercisable by the grantor or a nonadverse party, or both, without the consent of an adverse party.

   a. Code Section 674 lists eight specific exceptions to this general rule. Powers that will not trigger grantor trust status include:

      (1) The power to apply income to support a dependent (IRC §674(b)(1));

      (2) The power to affect beneficial enjoyment that only arises after the occurrence of an event, and Section 673 would not apply if the power were a reversionary interest (IRC §674(b)(2));

      (3) A power exercisable only by will, other than a power in the grantor to appoint accumulated trust income where the grantor or a nonadverse party (without the consent of an adverse party) had discretion to accumulate the income (IRC §674(b)(3));

      (4) The power to allocate corpus or income among charitable beneficiaries (IRC §674(b)(4));

      (5) The power to distribute corpus among beneficiaries subject to a reasonably definite standard or where any distribution is an advancement on that beneficiary's share (IRC §674(b)(5));

      (6) A power to withhold income where that income ultimately will pass to the beneficiary(ies) or be under their control as specified in the section (IRC §674(b)(6)); and

      (7) The power to allocate receipts and disbursements between income and principal. IRC §674(b)(7).

   b. In addition, the grantor generally will not be treated as owner when an independent trustee has the power (without the consent of another) to distribute, apportion, or accumulate income, or to

distribute corpus, among the trust beneficiaries (other than the grantor or the grantor's spouse). IRC §674(c).

c. Finally, a nonadverse trustee (other than the grantor or the grantor's spouse) can have the power to distribute or accumulate income if limited by a reasonably definite standard. IRC §674(d).

d. The Sections 674(b)(5) to (7), 674(c) and 674(d) exceptions do not apply if a person has a power to add beneficiaries to the trust or add to a class of beneficiaries (other than to include after-born or after adopted children).

5. Code Section 675 provides that the grantor will be treated as the owner of any portion of a trust over which:

   a. The grantor or a nonadverse party has the power (exercisable without the consent of an adverse party) to dispose of trust property for less than full and adequate consideration (thereby effectively revoking the trust as to that property) (IRC §675(1));

   b. The grantor or a nonadverse party has the power (exercisable without the consent of an adverse party) to borrow without adequate interest or security. A general power of the trustee to lend without regard to interest or security is not sufficient to invoke this provision (IRC §675(2));

   c. The grantor borrowed trust income or corpus, other than pursuant to a loan with adequate interest and security made by an independent or adverse trustee, and has not completely repaid the borrowed funds before the beginning of the next taxable year (IRC § 675(3)); or

   d. A person in a nonfiduciary capacity (without the consent of a fiduciary) has the power to (i) vote securities of a corporation in which the holdings of the grantor and the trust are significant; (ii) control the investment of the trust, if the trust's assets consist of securities of corporations in which the holdings of the grantor and the trust are significant; or (iii) reacquire trust corpus by substituting other property of equivalent value. IRC §675(4).

6. Under Code Section 676, the grantor is treated as owner of any portion of a trust over which the grantor or a nonadverse party has the power to revest title to that portion in the grantor. Thus, for example, a revocable living trust ordinarily will be a grantor trust during the grantor's lifetime.

7. Code Section 677 provides that the grantor is treated as owner of any portion of a trust the income from which (without the consent of an adverse party) is or may be (i) distributed to, or held for future distribution to, the grantor or the grantor's spouse, or (ii) applied to the payment of premiums on an

insurance policy on the life of the grantor or the grantor's spouse. This provision usually causes an irrevocable life insurance trust to be a grantor trust during the grantor's life.

8. In Mallinckrodt v. Nunan, 146 F.2d 1 (8th Cir.), cert. denied, 324 U.S. 871 (1945), the Eighth Circuit held that a person other than the grantor may be treated as owner of a trust for federal income tax purposes if that person holds certain powers. Nine years later, Congress enacted Code Section 678, which codifies when a third person will be taxed as an owner of a trust.

    a. Under Code Section 678, a person who is not the grantor will be treated as the owner of any portion of a trust over which that person:

        (1) Has a power, exercisable alone, to vest corpus or income in himself or herself; or

        (2) Has partially released or otherwise modified such a power, and after that release or modification, has retained such control as would subject a grantor to treatment as owner under Code Sections 671-677.

    b. The most common application of this provision is to a trust over which a beneficiary has acquired a right of withdrawal. The beneficiary will be treated for income tax purposes as owner of that portion of the trust. This is why a Section 2503(c) minor's trust becomes a grantor trust as to the beneficiary when he or she turns age 21.

    c. Note that the third person need not be a designated beneficiary of the trust to be treated as owner under Code Section 678. For example, a trustee who has the power to use trust income or corpus to discharge a legal obligation of support could be treated as owner of all or part of the trust.

    d. Grantor trust status as to a beneficiary does not apply during the period the grantor is treated as owner of the trust. IRC §678(b). The statute references only a power over income, implying that this provision does not apply to a power over trust principal such as a power of withdrawal. However, the IRS has consistently ruled that grantor trust status as to the owner will trump application of Section 678 in all respects. See, e.g., Priv. Ltr. Ruls. 200840025; 200606006.

9. Code Section 679 provides rules for treating the grantor as owner of a foreign trust that has one or more U.S. beneficiaries.

D. Selected rulings and observations.

1. A grantor trust and its grantor are treated as a single taxpayer for federal income tax purposes. For example:

   a. A grantor may take advantage of the Code Section 121 $250,000 exclusion when selling a principal residence held in a grantor trust. See Rev. Rul. 85-45, 1985-1 C.B. 183, and Priv. Ltr. Rul. 1999 12026 (March 26, 1999). Likewise, the grantor can treat real estate taxes paid on a residence in a grantor trust as a deduction of the grantor.

   b. A transfer of property from a husband's revocable trust to his wife's revocable trust is not a taxable event because of the nonrecognition of gain on interspousal transactions under Code Section 1041. See Priv. Ltr. Rul. 8644012 (July 31, 1986).

   c. A grantor retained annuity trust always will be treated as a grantor trust if trust income and principal may be used to satisfy the annuity payment. Priv. Ltr. Rul. 9504021 (Jan. 27, 1995). As a result the transfer of trust corpus from a grantor retained annuity trust to the grantor in partial satisfaction of the annual payout requirement is not a taxable sale or exchange. See Priv. Ltr. Rul. 9146025 (Aug. 14, 1991).

2. As a general rule, under Code Section 664(c), a charitable remainder trust is not subject to tax on its income. Furthermore, Section 1.671-1(d) of the Regulations provides that the grantor trust rules do not apply to charitable remainder trusts.

3. The IRS has ruled privately that lapsing rights of withdrawal, like those found in Crummey trusts, will cause Section 678 to apply, even after the powers have lapsed. See, e.g., Priv. Ltr. Rul. 9034004 (Aug. 24, 1990). The Service's conclusion is not free from doubt. Section 678 states it applies if the beneficiary "has partially released or otherwise modified" the power. It does not mention a power that lapses by its own terms. Section 2041 states that a lapse will be considered a release only to the extent it exceeds the greater of $5,000 or 5% of the trust property.

   a. Some practitioners and tax preparers conclude that, in the absence of a public ruling or regulation on this question, it is reasonable to continue to report the trust as a separate taxpayer. This avoids the complications of reporting for a trust with multiple Section 678 grantors (all the Crummey power holders).

   b. During the life of the grantor, the best way to void the issue entirely is to have the trust be a grantor trust as to the grantor, and report it as such pursuant to Section 678(b).

4. The Service has implied in the past that when a grantor pays the income tax liability attributable to a grantor trust, that payment constituted a gift to the remainder persons of the trust (at least to the extent that the tax otherwise would be payable out of trust corpus). Priv. Ltr. Rul. 9444033 (Nov. 4, 1994)). The Treasury did not pursue the gift theory in any organized way, and in Revenue Ruling 2004-64, 2004-2 C.B. 7 (July 6, 2004), it formally acknowledged that a grantor does not make a gift when he or she pays the income tax attributable to inclusion of the trust's income or grantor's tax return.

5. In Revenue Ruling 2004-64, the Treasury also ruled that a discretionary reimbursement payment by a trustee to a grantor for the tax owed on trust income will not cause the trust to be includible in the grantor's gross estate for estate tax purposes.

   a. In explaining its position, the IRS set forth three different factual situations.

      (1) Under the first situation, neither state law nor the governing instrument of the trust contain any provision requiring or permitting the trustee to reimburse the grantor for income tax attributable to the trust. In this situation, the grantor pays the additional tax liability from his or her own funds. Because the grantor is liable for the taxes, and not the trust, the grantor has not made a gift to the trust beneficiaries. In addition, the trust is not includable in the grantor's gross estate.

      (2) In the second situation, the trust document requires the trustee to repay the grantor for the income tax attributable to the trust. Since the trust mandates repayment to the grantor, there is no taxable gift. However, the fact that the grantor retained the right to have the trust discharge the grantor's legal obligations means the trust will be included in the grantor's gross estate. The ruling states that the IRS will not apply this aspect of the ruling to trusts created before October 4, 2004.

      (3) In the last situation, the trust document gives the trustee discretion to reimburse the grantor for income tax, but such reimbursement is not required. Neither the grantor's payment of the tax nor the trustee's decision to reimburse the grantor will be considered a gift.

   b. In addition, the Ruling states that the existence of the trustee's discretionary power to reimburse the grantor will not, by itself, cause the trust assets to be included in the grantor's estate. But, here

the IRS warns that other factors could change that result. Those factors include, (1) a pre-existing arrangement or understanding between the grantor and the trustee, (2) a power in the grantor to remove the trustee and appoint a successor trustee, or (3) local law regarding what retained powers cause a trust to be subject to the claims of creditors.

c. The second factor suggests that, at a minimum, the power to reimburse the grantor should be held by an independent trustee (not related or subordinate party), to fall within the safe harbor of Rev. Rul. 95-58, 1995-2 C.B. 191. Since Rev. Rul. 2004-64 does not incorporate this safe harbor specifically, an even better approach is not to give the grantor both a power to remove and a power to appoint successors.

d. The third factor is the dangerous one, because state law often is not well defined on this issue. If a creditor of the grantor can reach the trust assets under state law because of the reimbursement provision, then the IRS could claim that Section 2036 does apply.

III. Powers Used to Create Grantor Trust Status

A. Certain trusts automatically will have grantor trust status and will remain that way as long as the grantor is alive.

1. A revocable trust will be a grantor trust under Section 676.

2. Similarly, but much less common, a trust in which the grantor retains a reversionary interest greater than 5 percent will be a grantor trust under Section 673.

3. A trust over which the beneficiary possesses a full power of withdrawal will be a grantor trust as to that beneficiary.

B. Many other powers that cause grantor trust status under Subpart E are dependent on the identity of the trustee or other powerholders and his or her relationship to the grantor. Because either the identity of the trustee or the relationship could change, these powers are not reliable for ensuring that a trust will be, and continue to be, a grantor trust.

1. For example, the change in trustee from a nonadverse party to someone who is independent or an adverse party could change grantor trust status under Section 674.

2. Likewise, if a person who is acting as trustee is related or subordinate party by reason of being an employee of the grantor's company, and that person retires, the tax status of the trust could change.

3. A trust that is a grantor trust because income may be distributed to the spouse (Section 677) would cease to be a grantor trust when the spouse dies. Section 677 also may not apply to a spousal limited access trust (discretionary income for spouse) or an irrevocable income trust (income may pay premium on insurance on life of grantor or spouse) if a child who is a beneficiary becomes the trustee. The child would be an adverse party.

C. For this reason, a practitioner who wants to be sure that the trust will continue as a grantor trust as long as the grantor is alive most often relies on one of the administrative powers under Section 675 of the Code. There are several options that usually can be used without also creating the risk of inclusion of the trust in the grantor's estate.

1. Grantor power to borrow without security (§ 675(2)). The provision refers to a power to borrow without adequate interest or security. Practitioners generally just rely on the security part of this provision because a power to borrow without adequate interest could have estate inclusion and/or gift implications.

   SAMPLE POWER: At any time during my life, I may borrow principal or income of the trust without security, but this shall not relieve the trustee of any fiduciary obligation with respect to the other terms of the loan, including the obligation to confirm that a promissory note or other evidence of indebtedness given to the trust is of sufficient value. I may irrevocably release the power granted to me in this paragraph at any time by written instrument delivered to the trustee. A guardian, conservator or personal representative may exercise my rights under this paragraph on my behalf during any period in which I am disabled.

2. Trustee power to lend without security (§ 675(2)). Section 675(2) states "A power exercisable by the grantor or nonadverse party, or both [that] enable the grantor to borrow…" Thus, the power could be framed as a power in an independent trustee to lend. There may be concern, however, about the effectiveness of this power if the trust does not require an independent trustee to be acting at all times.

   SAMPLE POWER: At any time during my life, the independent trustee may lend to me principal or income of the trust without security, but this shall not relieve the independent trustee of any fiduciary obligation with respect to the other terms of the loan.

3. Power to Substitute Property (Section 675(4)(c)). This is the power exercisable "in a nonfiduciary capacity by any person without the approval or consent of any person in a fiduciary capacity… to reacquire the trust corpus by substituting other property of an equivalent value." It is by far the most popular power to use, in part because it provides other planning benefits. It is discussed in more detail below.

SAMPLE POWER: At any time during my life, I may reacquire any part or all of the trust principal by substituting other property of an equivalent value upon written notice to the trustee, which power shall be exercisable for my personal benefit in a nonfiduciary capacity and without the approval or consent of any person in a fiduciary capacity, subject to the requirement that property of an equivalent value be substituted (and the trustee shall have the obligation to confirm that the substituted property has equivalent value). I may irrevocably release the power granted to me in this paragraph at any time by written instrument delivered to the trustee. A guardian, conservator or personal representative may exercise my rights under this paragraph on my behalf during any period in which I am disabled.

D. Power to Substitute Property

1. This power is a right to initiate an arm's length exchange of trust property for other property for adequate and full consideration. Because it is arm's length, the view of many practitioners for a long time has been that the power does not present estate inclusion problems if held by the grantor.

2. The provision does refer to the power being held by "any person." Sometimes, practitioners would give the power to a spouse or other nonfiduciary in order to eliminate any possible risk of Section 2036 or 2038 applying if the grantor held the power. However, other practitioners shy away from this approach because Section 675(4)(c) refers to a power to "reacquire the trust corpus" which implies that only a grantor with respect to the property can exercise the power.

3. The IRS significantly reduced concerns about the possible estate tax consequences of the power to substitute in Revenue Ruling 2008-22, 2008-1 C.B. 796. The holding of Revenue Ruling 2008-22 is

   "A grantor's retained power, exercisable in a nonfiduciary capacity, to acquire property held in trust by substituting property of equivalent value will not, by itself, cause the value of the trust corpus to be includible under §2036 or 2038..."

   a. The Revenue Ruling imposes limitations on this treatment. Non-inclusion applies only if the trustee has a fiduciary obligation to ensure the grantor's compliance with the requirement that property of equivalent value be substituted. In addition, the substitution power cannot be exercised in a way that can shift beneficial interests among beneficiaries. This could happen, for example, if the grantor substituted non-income growth producing property for income-producing property, and the trustee was prohibited under the trust terms for selling the property so substituted.

b. Interestingly, the IRS does not create any exception in the Ruling based on the types of property exchanged in the substitution. Specifically, it does not distinguish or create an exception for Section 2036(b), the provision requiring inclusion of closely stock in the grantor's estate if the grantor retains the right to vote the stock. It would seem therefore that the grantor could transfer closely held voting stock to an irrevocable trust, and retain the Section 675(4)(C) power of substitution. Even though the grantor could re-acquire the vote, because it is only by substituting property of equivalent value, Section 2036(b) would not appear to apply.

c. Not everyone is convinced of this result, and some practitioners will exclude closely held stock from a substitution power. In that case, if the goal is grantor trust status for the entire trust, another power must be used.

4. The IRS provided additional comfort about the Section 675 power to substitute in Revenue Ruling 2011-28, 2011-48 C.B. 380. Here, the IRS confirmed the Revenue Ruling 2008-22 applies to a power to substitute insurance policies, and that the power will not be treated as an incident of ownership under Code Section 2042.

E. Power to Add Beneficiaries

1. One other power that can be used to ensure that a trust will be a grantor trust is the power under Section 674 to add a beneficiary or beneficiaries or to a class of beneficiaries.

2. In Section 674, it is referred to in several places as something that negates exception powers that otherwise are delineated in Section 674. Thus, even if the trust has an independent trustee who has discretion to distribute income or principal (the Section 674(c) exception to the grantor trust rules), the trust will be a grantor trust if it contains the power to add beneficiaries.

<u>SAMPLE POWER</u>: During my lifetime, the independent trustee may add or delete one or more charitable organizations as beneficiaries of the trust, and the independent trustee may distribute such amounts of income and principal to them, in such proportions, as the independent trustee believes to be desirable.

3. The major reason this power is not used is that the grantor may not want another party to be able to have such broad authority. The sample above is limited to the ability to add charitable beneficiaries. That may be more acceptable to some grantors.

IV. Tax Reporting for Grantor Trusts

A. Regulation § 1.671-4 governs the tax reporting requirements for grantor trusts. The current regulation was put in place effective January 1, 1996 with the expressed intent of reducing the number of situations in which it is necessary to file a Form 1041 for a grantor trust.

B. Under the previous regulation, an individual who was both grantor and trustee or co-trustee of a revocable trust was not required to obtain a taxpayer identification number (TIN) for the trust or file a Form 1041. Instead, the grantor could furnish his or her social security number to all payors of income and report all items of trust income, deduction and credit directly on his or her personal return. For all other grantor trusts it was necessary to obtain a TIN and file a Form 1041, with a separate statement attached showing the items of income, deduction and credit that will be reported by the grantor (the so-called "grantor trust letter").

C. This option of filing a Form 1041 with a separate statement is still available in all cases under the regulations. However, Section 1.671-4 provides the following alternate reporting methods:

1. For a person who is grantor or Section 678 owner, whether or not he or she is also a trustee, the trustee can use the social security number of that grantor or owner and items of income, deduction and credit are reported directly on that person's return. By April 15 of the year following the taxable year in question, the trustee must provide that person with a statement showing all items of income, deduction, and credit of the trust for the year and identifying the payors of each of those items. The statement must inform the grantor or other owner that these items must be included on his or her personal return. No Form 1041 has to be filed.

2. Where one person is the grantor or other owner of the trust, the trustee may, and where multiple persons are grantors or other owners, the trustee must, use the TIN of the trust. The trustee then would file a Form 1041 and provide the appropriate grantor trust letters. But the regulations provide another alternative.

3. Instead of filing the Form 1041, the trustee can file Form 1099s under the trust TIN with the IRS showing items of income and gross proceeds allocable to each grantor. The trustee then must furnish a statement to each grantor with the same information described above. The 1099's are due by February 28 of the year following the taxable year in question, and the statements must be provided to each owner by April 15 of that following year.

D. Certain grantor trusts are required to report income by obtaining a TIN and filing a return, including:

1. A trust with situs or assets outside the United States;

2. A qualified subchapter S trust that is treated as owned by an individual; and

3. A trust that is treated as owned in whole or in part by a person who is not a U.S. person.

E. The regulations do permit a trustee to change reporting methods and contain instructions on how to notify the IRS that it is doing so. Treas. Reg. § 1.671-4(g).

F. Section 301.6109-1 provides that trustee who is reporting a grantor under one of the methods using a trust TIN must obtain a new TIN upon the death of the grantor, or the death of the last grantor or owner where there are multiple grantors and/or owners. See Treas. Reg. §301.6109-1(a)(2) and (3). The regulations do not address this question of obtaining a new TIN where the grantor trust status ceases other than be reason of a grantor's death.

V. Transfer Tax and Gift Planning with Grantor Trusts

A. Grantor trust status has become one of the most important and powerful tools in transfer tax planning. It is a key component in many important technique

1. Section 2503(c) Minor's Exclusion Trust. A Section 2503(c) Minor's Exclusion Trust can be structured as either a grantor or a non-grantor trust for income tax purposes. Structuring the trust as a grantor trust for income tax purposes may or may not be appropriate depending upon the exposure of the unearned income of the minor to the kiddie tax

2. Grantor Retained Annuity Trust (GRAT). As noted earlier, a GRAT will be a grantor trust under Section 677 by virtue of the grantor's retained annuity. This means that the assets used to fund the GRAT (stock, interests in an LLC or partnership, or real estate) can be paid to the grantor in satisfaction of the annuity without the distribution being treated as a sale of the asset.

3. Irrevocable Perpetuities Trust. An irrevocable perpetuities trust for the benefit of one or more of the grantor's spouse and children and funded with gifts using some or all of the grantor's $11,400,000 applicable exclusion amount can be structured as a grantor trust for income tax purposes. The grantor's payment of the income taxes (both ordinary and capital gains) is an additional gift to the trust.

4. Sale to a Grantor Trust. The sale of an asset to a trust designed to be a grantor trust combines the long-recognized advantages of selling a growth asset for a promissory note with the tax efficiency of the grantor trust. The use of a grantor trust eliminates the gain on the sale. In addition, interest paid on the note is not taxable to the grantor, since for income tax purposes, the trust and the grantor are one in the same. Note principal payments can be made in kind with trust assets without recognizing gain.

5. Loans. Likewise if the grantor makes a low-interest AFR loan to a grantor trust, the interest is not taxable, and note repayments in kind have no tax consequences.

6. Qualified Personal Residence Trusts. As noted earlier, the grantor is treated as the owner of the residence for income tax purposes in a grantor trust, making Section 121 available and real estate taxes deductible by the grantor.

B. In any irrevocable trust that is a grantor trust, the grantor's payment of income tax or trust income allows the trust to accumulate more funds and appreciate more rapidly over time.

1. The impact is very significant over a long period of time, in particular if there is a sale of a highly appreciated asset. For example, assume an irrevocable grantor trust hold an interest in a family business with a basis of $100,000. The family business is sold and the trust receives $20,000,000. If one assumes a 30% combined federal and state capital gains tax rate, the trust is able to retain an additional $5,970,000 that otherwise would go to income tax payments. Compounded at 4% annually for 20 years, that savings would grow to $13,080,000.

2. Any irrevocable trust can take advantage of this, if the grantor is still alive. Ordinarily, a Code Section 2503(c) trust (also known as a minor's trust) is a separate taxpayer for income tax purposes. If income will be accumulated in the trust, the current compressed income tax brackets for trusts make grantor trust status highly desirable in many cases.

a. An irrevocable trust can be converted into a grantor trust by drafting it to include one of the Section 675 administrative powers, such as giving the grantor the power to replace trust assets with property of equivalent value.

b. Payment of the trust's income tax liability by the grantor provides an additional benefit that otherwise would be absorbed by the trust. It also simplifies tax reporting. The trust does not need to file a separate Form 1041.

C. Under Code Section 1361(c)(2)(A)(i), a trust that is treated as wholly owned by a U.S. citizen or resident under the grantor trust rules may own shares of stock in an S corporation. A grantor retained annuity trust cannot qualify as a qualified subchapter S trust under Section 1361(d), so grantor trust status is essential for a GRAT that will hold S corporation stock.

D. Swap Powers Used for Other Tax and Estate Planning

1. The existence of a grantor trust and the Section 675 swap power can provide a number of potential planning benefits.

2. The most significant of these is the ability of the grantor to take a low basis asset out of the trust in exchange for a high basis asset and/or cash or cash equivalents.

   a. If the asset would not otherwise be sold before the grantor's death, this allows the family to achieve a step-up in basis for the asset. The asset would not otherwise have received a step-up if it remained in the trust and the trust is excluded from the grantor's estate.

   b. For example, assume that the grantor previously had gifted stock in a family business with a basis of $10,000 to the trust, and the stock many years later, having appreciated significantly since the gift, has a value of $5,000,000. The grantor could exchange the stock for $5,000,000 of cash. At the grantor's death, the stock receives a basis step-up.

   c. It is not always possible to plan for this possibility. The grantor could die unexpectedly before a planned swap. But many times, there is an opportunity to do this kind of planning with an elderly grantor.

   d. It is important that the exchange be for equivalent value. With a closely held asset, it may be appropriate to obtain a current appraisal.

3. Swap planning also can be used to avoid a step-down in basis at death under Section 1014 for a depreciated asset owned by the grantor. The grantor can swap the asset into the trust, and allow it to retain its higher basis.

4. Swaps also are used in GRATs to lock in appreciation in value. For example, assume a grantor transfer stock to a 4-year GRAT and after two years the stock has appreciated by a cumulative 40%. The GRAT will be a great success unless the stock depreciates before the end of the term. The grantor can swap bonds and cash into the GRAT and take back the stock (and possibly fund a new GRAT with it, because it could continue to appreciate).

5. If the trust is a grantor trust, even if it does not have a swap power, the grantor arguably could engage in an exchange of equal value assets with the trust. The swap power, however, gives the grantor the right to do it, as opposed to needing the trustee's full agreement.

   a. That being said, the trustee does have a fiduciary obligation to confirm that it is an exchange of equivalent value

   b. In <u>Benson v. Rosenthal</u>, 2016 WL 2855456 (E.D. La. 2016) (slip opinion), <u>mot. for partial summary judgment denied</u> 2016 WL 6649199 (E.D. La. Nov. 10, 2016) (slip opinion), the court considered a refusal of a trustee to allow Tom Benson to make an

exchange of assets in the grantor trust in exchange for promissory notes. The assets in question were interests included interest in the New Orleans Saints and Pelicans that Benson wished to reacquire in connection with a change of his succession plans for the teams. The exchange eventually was approved.

c. In Mark V. Condiotti Irrevocable GDT Trust, No. 14CA0969 (Col. Ap..July 9, 2015) both the Colorado Probate Court and then the Colorado Court of Appeals upheld the refusal of the trustees to accept a note that the grantor offered in exchange for the property in an irrevocable grantor trust. The trustees offered two reasons for their refusal. The first was that the note was not of equivalent value because the interest rate was set at the applicable federal rate that made the note difficult to sell. The second was that the note was in fact a loan and loans were forbidden by the terms of the note. The Court of Appeals did not address the equivalency issue and upheld the refusal of the trustees to substitute assets finding that the note was a loan and the trust document prohibited loands.

E. Transfer in Value

1. Grantor trusts play an important role in the transfer of life insurance policies. The trustee of an irrevocable life insurance trust holding an insurance policy with undesirable terms is limited in its options as to how to move the policy to a trust with more advantageous terms. The problem is that if the policy is simply purchased by another trust, a transfer for value would occur and this would subject the proceeds when received to income tax under IRC § 101(a)(2).

2. However, if the new trust is a grantor trust, the purchase is treated for income tax purposes as if the insured had purchased the policy from the original trust. Therefore, the purchase of the policy by the grantor trust would not be a transfer for value. The IRS specifically acknowledged the grantor trust to grantor trust transaction as an exception to the transfer for value rule in Rev. Rul. 2007-13, 2007-1 C.B. 684.

3. The same exception can be employed to avoid the three-year rule if the insured wants to acquire an insurance policy on his life from a family business that owns the policy. The insured can form and fund an irrevocable grantor trust that purchases the policy, avoiding both inclusion in the insured's estate and the transfer for value rule.

F. Code Section 170(b), an individual's income tax charitable deduction for a given taxable year is limited to a specified percentage of the individual's contribution base (which generally equals adjusted gross income) for that year. Any excess contributions must be carried forward to subsequent taxable years. Because a grantor trust's income is attributed to the grantor, that grantor's contribution base

will be higher, allowing a potentially greater charitable deduction in the current year.

G. Incomplete Gift Non-Grantor Trusts

1. This is not a grantor trust strategy but rather a strategy requiring one to thread the needle in creating a separate taxpayer trust. An incomplete gift, non-grantor trust is a trust structured to be a non-grantor trust for income tax purposes that is funded by transfers from the grantor that are incomplete gifts for gift tax purposes. These trusts are commonly referred to as a Delaware incomplete gift non-grantor trust or "DING," if created under Delaware law, or a Nevada incomplete gift non-grantor trust or "NING," if created under Nevada law.)

2. Assuming the trust is established in a state that doesn't tax the income accumulated in the trust (like Delaware or Nevada), the trust will avoid state income taxes as long as the state of residence of the grantor or beneficiaries doesn't subject the trust's income (or accumulated income) to tax. Moreover, if structured and administered properly, the trust property should be protected from the grantor's creditors.

3. The DING or the NING allows a grantor to achieve these benefits while still being able to receive discretionary distributions of trust property and without paying gift tax (or using any gift tax exemption) on the transfer of property to the trust. A gift from the grantor will be complete upon a subsequent distribution from the trust to a beneficiary other than the grantor, and whatever property remains in the trust will be subject to estate tax at the grantor's death.

4. A DING or NING is particularly attractive for a highly appreciated asset in anticipation of sale of that asset. For example, the founder of a business that is going to be sold may face hundreds of thousands or even hundreds of millions of dollars of capital gain because he or she has so little basis. Avoiding state income tax on those gains can be a significant benefit.

5. The IRS has issued multiple rulings approving these kind of trusts. See, e.g. Ltr. Ruls. 201440008 – 201440012 (Oct. 3, 2014); Ltr. Ruls 201436008 – 201436032 (Sept. 5, 2014); Ltr. Ruls. 201430003 – 201430007 (July 26, 2014); Ltr. Ruls. 201410001 – 201410010 (March 7, 2014).

6. The Service may view these trusts as beneficial to the bottom line. A non-grantor trust may pay slightly more tax than an individual taxpayer. States are that the ones that lose tax dollars from these trusts. New York passed legislation, effective for income earned on or after January 1, 2014 (unless the trust was liquidated before June 1, 2014) to treat such trusts as grantor trusts for New York income tax purposes.

7. The key in creating an effective DING or NING is to structure distribution provisions that leave the grantor with enough control so that the initial transfer to the trust is not a completed gift, but there is sufficient involvement of parties adverse to the grantor to avoid the grantor trust rules. For example, the trust would permit distributions to the grantor or the other designated beneficiaries as follows:

   a. The trustee must distribute to the grantor or a beneficiary at the direction of a majority of a distribution committee, with the grantor's written consent;

   b. The trustee must distribute to the grantor or a beneficiary at the unanimous direction of the distribution committee;

   c. The grantor, in a non-fiduciary capacity, may distribute to any beneficiary for health, maintenance, support or education.

8. The initial distribution committee was the grantor, her children and her stepchildren. The committee always must have at least two members other than the grantor.

VI. Implications of Turning Off or On Grantor Trust Status.

A. Turning Off Grantor Trust Status

1. For all the advantages of grantor trust status, a grantor may decide at a certain point that he or she no longer wishes to pay the income tax liability of the trust. This may be because the burden has become too great, and too much of a draw on the grantor's assets. It may be because the grantor feels that the resources of the trusts, together with other assets set aside for descendants, are sufficient; that the children "have enough."

2. The trust agreement for an irrevocable trust that will be a grantor trust should contain mechanisms for turning off grantor trust status. The sample clauses for the Section 675 administrative powers discussed above contain examples of a provision to relinquish the powers.

3. The instrument also may give the trustee an independent power to renounce certain powers that could be applied to eliminate grantor trust status.

4. Another option is to use a trust protector power. The trust protector could have authority to modify the trust to add powers to cause it to be a grantor trust, or to eliminate grantor trust powers. If the trust protector's authority to make substantive changes to the beneficial interests in the trust is otherwise limited, the trust protector provisions could state "an amendment that changes the tax characteristics of the trust (including, but not limited to, an amendment that causes the trust to be or not to be a grantor trust) shall not be deemed a significant change in a beneficiary's beneficial interests."

B. Income Tax Consequences of Turning Off Grantor Trust Status

1. When grantor trust status is turned off during the life of the grantor, the grantor is deemed to have transferred to the trust all of the assets and liabilities of the trust. This potentially creates a taxable event, depending on the make-up of the assets. See Treas. Reg. §1.1001-2(c), Example 5; Madorin v. Comm'r., 84 T.C. 667 (1985); Rev. Rul. 77-402, 1977-2 C.B. 222.

2. One way this occurs is if the liabilities deemed transferred to the trust exceed the basis of the assets deemed transferred. Under Treas. Reg. §1.1001-2(a)(1), the "amount realized from a sale or other disposition of property includes the amount of liabilities from which the transferor is discharged as a result of the sale or disposition."

3. In addition, transactions after grantor trust status is off now would have tax consequences. Interest payments on a note payable to the grantor now will be taxable. A transfer of an appreciated asset to the grantor, in repayment of a note or for other consideration, will result in capital gain.

4. There is not specific guidance on how a note with respect to an outstanding sale to a grantor trust should be treated if grantor trust status ends. Is it a new sale, as of the date grantor trust status ceases? Or, better stated, does the original sale, at the original value becomes "complete" for income tax purposes? If so, can the grantor elect installment treatment if available and thereafter recognize gain only as principal payments are made by the trust? If some principal payments were made before grantor trust status ended, there is nothing specific in the Code which suggests gain would have to be recognized on those prior payments.

5. The best approach is not to let grantor trust status terminate during the life of the grantor while the note is still outstanding.

C. Multiple Changes in Grantor Trust Status

1. There may be situations where grantor trust status for a trust has been turned off, and the grantor now wishes to turn it back on. There are no specific prohibitions on "toggling off and on the grantor trust status of a trust, and the IRS has not ruled adversely on it as a general concept.

2. Nevertheless, grantors and trustees should exercise caution in light of the actual facts of the situation. In Notice 2007-73, 2007-2 C.B. 545, the IRS did list two types of toggling transactions as potentially abusive tax avoidance transactions under the reportable transaction rules. Both involved turning off and on grantor trust status, timed around particular transactions with the goal creating tax losses or avoiding gains. While these were very specific types of transactions, the Notice indicates a willingness

by the IRS to take action in the case of any changes in status close in time that result in income tax benefits.

3. In addition, the IRS could treat repeated toggling as an indication of an unwritten agreement with the grantor, on the grounds that no trustee would take actions with respect to something that has a meaningful impact on the grantor's income tax reporting except pursuant to the consent, if not at the direction of, the grantor. The IRS then could argue the grantor had an implied retained interest in the trust under Section 2036.

D. Grantor Trust Status at the Grantor's Death

1. The death of the grantor is an unavoidable termination of grantor trust status. But the tax treatment at death is much less clear. Many practitioners believe that different rules apply at death, such that the death of the grantor itself should never be a recognition event. The leading article that advances this argument is Blattmachr, Gans, and Jacobson, "*Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor's Death*", 97 J. Tax'n 149 (Sept. 2002) (hereafter "*Income Tax Effects of Termination*").

2. There are indications that the IRS agrees to at least some extent. Chief Counsel Advice 2009-23024 (Dec. 31, 2008)), addressed a transaction when a nongrantor trust was converted to a grantor trust. The CCA reviews the authorities on termination of grantor trust status during life and then states: "We would also note that the rule set forth in these authorities is narrow, insofar as it only affects inter vivos lapses of grantor trust status, not that caused by the death of the owner *which is generally not treated as an income tax event* [emphasis added]."

3. In its 2015-2016 Priority Guidance Plan, the Treasury identified a project to promulgate guidance on the basis of grantor trust assets at death under Section 1014. It was one of the few estate and trust related projects on the 2018-2019 Priority Guidance Plan, issued November 8, 2018. Until guidance is forthcoming, practitioners can consider following one of three primary theories.

4. Two of the theories follow the reasoning of the *Income Tax Effects of Termination* article that death does not trigger a taxable event. The argument is based on the conclusion that Section 1001 does not apply at death because there is no amount realized on any transfer occurring as a result of death. For income tax purposes, one could equate the transfer from the grantor to the trust at death as equivalent to a bequest. Like a bequest, the decedent does not receive any consideration, so there can be no gain.

5. The authors of *Income Tax Effects of Termination* go on to argue that Section 1014 also should apply to cause the basis of the property transferred to equal the value on the date of death. Many fewer people agree with this

conclusion and instead believe the grantor's death should be treated as a nonrecognition event for all purposes, meaning a carryover basis should apply. Thereafter, payments on the note are IRD to the extent they would have been income in the hands of grantor as a taxpayer in a sale to a nongrantor trust.

6. The third theory is that there is no basis step-up but there should be recognition of gain to the extent that liabilities exceed the basis of assets in the trust. This is based on the general principle that relief from liability is a taxable event. Assuming the deemed transfer is treated as taking place the moment before death, the grantor would recognize the gain on his her final income tax return. See Dunn and Handler, *Tax Consequences of Outstanding Trust Liabilities When Grantor Trust Status Terminates*," 95 J. Tax'n 49 (2001).

VII. Beneficiary Grantor Trust Status under Section 678

A. Grantor trust status can be so advantageous that there is an increasing focus on how to make it last longer, by creating trusts that will be grantor trusts as to the beneficiary.

B. Supercharged Credit Shelter Trust[1]

1. The goal behind a supercharged credit shelter trust is to increase the effectiveness of a credit shelter trust for transfer tax purposes by making it a grantor trust as to the surviving spouse.

2. This allows the trust to continue to have the same benefits that a grantor trust does during the life of the grantor.

3. The supercharged credit shelter trust starts as a lifetime QTIP trust created by one spouse in a couple for the other spouse.

a. During the life of the beneficiary spouse, the trust operates as a marital trust, paying all the income to that spouse.

b. The trust is treated as a grantor trust for income tax purposes because the spouse is a beneficiary. IRC § 677.

4. On the death of the beneficiary, the trust is included in that spouse's estate and the trust property (or that portion equal to the deceased spouse's remaining applicable exclusion amount) can pass to a credit shelter trust for

[1] The "Supercharged Credit Shelter Trust" is a service mark of Jonathan G. Blattmachr, Mitchell M. Gans, and Diana S. C. Zeydel. They first advanced the concept in various articles and presentations.

the grantor spouse. The trust continues as a grantor trust for that grantor spouse. See Treas. Reg. § 1.671-2(e)(5).

5. The goal of course is to have the spouse most likely to survive create the lifetime QTIP trust. Each spouse could create a lifetime trust for the other, and vary the terms sufficiently to avoid possible application of the reciprocal trust principles. In that case, only one trust ultimately will be supercharged.

B. Beneficiary Irrevocable Grantor Trust

1. A Beneficiary Irrevocable Grantor Trust ("BING) is designed to take advantage of the provisions of Section 678 of the Code which make the beneficiary of a trust the grantor for income tax purposes under certain circumstances. It is sometimes referred to as a Beneficiary Deemed Owner Trust ("BDOT").

2. As previously discussed, the IRS has repeatedly applied Section 678 to the Crummey trusts, and maintained the position that the beneficiary becomes the grantor of the trust for income tax purposes to the extent of the portion of the trust attributable to lapsed Crummey powers.

3. A wealthy taxpayer can take advantage of these rules by having a parent or other family member create a Crummey trust for the taxpayer. The trust can be funded over a few years with $5,000 gifts, subject to a Crummey power in the wealthy beneficiary. The Crummey power lapses, and the beneficiary treats the trust as taxable to him or her.

   EXAMPLE. John is an entrepreneur with a significant estate. John's mother creates a trust for John and his descendants in November and funds it with $5,000 gifts in November and January of the following year. The gifts are subject to a Crummey right of withdrawal in John. The trust is treated as subject to Section 678, and the income is reportable by John on his Form 1040.

4. John now can sell property to the trust in an installment sale, with the tax attributes being identical to any sale to an irrevocable grantor trust. However, John also maintains a beneficial interest in trust. Furthermore, the trust continues as a grantor trust as to him for his life, long after his mother is deceased.

   EXAMPLE. In June of year two of the trust, John sells $5,000,000 of stock in a venture capital entity to the trust in exchange for a $5,000,000 note. The sale is treated as a sale to a grantor trust. The entity liquidates 5 years later and pays out $10,000,000 to the trust. The trust repays the note.

5. The transaction is possibly subject to IRS attack because the trust is under-capitalized at the time of the sale. Guarantees would need to be provided to address this risk.

6. In addition, there is much greater risk to the transaction if the IRS is successful in arguing that the property transferred has a greater value. If John is treated as making a gift to the trust, Section 2036 will apply because he also is a beneficiary.

C. New Twist on the BING or BDOT

1. Recently, practitioners have focused on a different method for achieving Section 678 beneficiary grantor status. Instead of using a Crummey type power, the trust could give the beneficiary the right to withdraw all the income of the trust in any given year.

2. Section 678 states "(a) . . . A person other than the grantor shall be treated as the owner of any portion of the trust with respect to which: . . . (1) such person has a power exercisable solely by himself to vest the corpus *or the income* therefrom in himself" (emphasis added).

3. If the withdrawal power exists over all the taxable income (including gains), the trust should be a grantor trust as to the beneficiary for all purposes. There is no need for the grantor to limit the initial funding of the trust, as there is in the Crummey power approach.

4. Letter Ruling 201633021 (Aug. 12, 2016) supports this tax treatment. There the IRS examined the tax consequences of one trust which had a right to withdraw all the income from the second trust. The IRS concluded that trust 1 would be treated as the owner of trust 2 for income tax purposes.

5. The idea is discussed by Steve Akers in the 2018 Recent Development materials from the Heckerling Institute on Estate Planning. See Recent Developments – 2017, 52nd Annual Heckerling Institute on Estate Planning, pgs 75-81. Steve cites to several other existing and pending papers on the topic.

6. The summary by Steve Akers notes that one of the possible issues with this technique is the impact of the annual lapse of the power if the income is not withdrawn. He suggests that if it clear in the trust instrument that the withdrawal right can be satisfied from the income and corpus of the trust, then the lapse should fall within the 5-and-5 rule as long as the income in a year does not exceed 5% of the value of the trust property. The danger is that it could exceed 5% in a year that there is a large capital gain. In that case, the beneficiary would want to withdraw the excess to avoid a taxable lapse of the power.

VIII. Recent Minnesota Supreme Court Case Misinterpreting Grantor Trusts

A. In Fielding v. Commissioner, ____ Minn. ___ (July 18, 2018), the attempt of Minnesota to tax irrevocable non-grantor trusts as resident trusts for state income tax purposes was found to be unconstitutional under the due process clauses of United States and Minnesota Constitutions. In this case, the Minnesota Supreme showed that it did not understand the rules governing when a trust ceases to be a grantor trust.

B. Reid MacDonald, who was then domiciled in Minnesota, created four GST trusts on June 25, 2009. Each trust was initially funded with shares of nonvoting common stock in Faribault Foods, Inc. a Minnesota S Corporation. The original trustee for all four trusts was Edmund MacDonald, a California domiciliary. Reid MacDonald retained the power to substitute assets in the trusts. Consequently for the first thirty months of their existence, the trusts were "grantor type trusts". On December 31, 2011, Reid MacDonald relinquished his power to substitute assets in the trusts and the trusts ceased to be "grantor type trusts" and became irrevocable on December 31, 2011 (according to the court). Reid MacDonald was a resident of Minnesota at the time the trusts became irrevocable. As a result, each trust was then classified as a "resident trust" under Minn. Stat. § 290.01, subd. 7b(a)(2). Katherine Boone, a Colorado domiciliary, became the sole trustee for each trust on January 1, 2012.

C. Subsequently, the trusts filed Minnesota income tax returns as resident trusts, without protest, in 2012 and 2013. On July 24, 2014, William Fielding, a Texas domiciliary, became trustee of the trusts. Shortly thereafter, all of the shareholders, including the trusts, sold their shares in Faribault Foods, Inc. Because the trusts were defined to be Minnesota residents as a result of Reid MacDonald's Minnesota domicile in 2011, the trusts were subject to tax on the full amount of the gain from the 2014 sale of the stock as well as the full amount of income from other investments. The trusts filed their 2014 Minnesota income tax returns under protest, asserting that the Minnesota statute classifying them as resident trusts was unconstitutional as applied to them. The trusts then filed amended tax returns claiming refunds for the difference between the tax owed as resident trusts and the tax owed as non-resident trusts – a tax savings of more than $250,000 for each trust.

D. The Minnesota Commissioner of Revenue denied the refund claims and the trusts appealed the Commissioner's decision to the Minnesota Tax Court on the grounds that the Minnesota statute violated the due process and commerce clauses of the United States and Minnesota constitutions. The trusts and the Commissioner each moved for summary judgment. The Minnesota Tax Court ultimately concluded that defining the trust as a resident trust based upon Reid MacDonald's Minnesota residency at the time the trusts became irrevocable violated the due process provisions of the Minnesota and United States constitutions. The Minnesota Tax Court stated that the grantor's domicile at the time the trust becomes irrevocable was not "a connection of sufficient substance" to support taxing the trusts. Having decided the case on due process grounds, the Minnesota Tax Court did not reach the Commerce Clause.

E. The Minnesota Tax Court noted that a state's tax will satisfy the due process clause if there is some minimum connection between the state and the entity subject to the tax and a "rational relationship" between the income that the state seeks to tax and the protections and benefits conferred by the state citing Luther v. Commissioner of Revenue, 588 N.W. 2d 502 (Minn. 1999).

F. The Minnesota Supreme Court framed the issue as whether Minnesota may permissibly tax all sources of income to the irrevocable trusts simply because it had classified the trusts as residents based on events that predated the tax year at issue.

G. The Minnesota Tax Commissioner cited the following as factors requiring taxation:

1. Reid MacDonald was a Minnesota resident when the trusts were created;
2. Reid MacDonald was domiciled in Minnesota when the trusts became irrevocable and was still domiciled in Minnesota in 2014;
3. The trusts were created in Minnesota with the assistance of a Minnesota law firm which drafted the trust documents and until 2014 retained the trust documents;
4. The trusts held stock in a Minnesota S Corporation;
5. The trust documents provided that questions of law arising out of the trust documents were to be determined in accordance with Minnesota law; and
6. One beneficiary had been a Minnesota resident through the tax years in question.

H. The trusts, on the other hand, noted that:

1. No trustee had been a Minnesota resident;
2. The trusts had not been administered in Minnesota;
3. The records of the trust assets and income were maintained outside of Minnesota;
4. Some of the trusts' income was derived from investments with no direct connection to Minnesota; and
5. Three of the four beneficiaries of the trusts lived outside of Minnesota.

I. The Minnesota Supreme Court concluded that the contacts on which the Tax Commissioner relied were either irrelevant or too attenuated to establish that Minnesota's tax on the trusts income from all sources complied with due process requirements. It first noted the grantor's connections to Minnesota were irrelevant.

The relevant connections were Minnesota's connection with the trustee and not the grantor who established the trusts years earlier.

J. It noted also that the stock was an intangible asset and cited cases holding that states cannot impose an income tax on trust property because possession or control of these assets was held by trusts that were not residents of or domiciled in a state. In addition, the Minnesota residency of one beneficiary did not establish the necessary minimum connection to justify taxing the trusts income. The grantor's decision to use a Minnesota law firm and the contacts with Minnesota predating 2014 were irrelevant.

K. As a result, the contacts between the trusts and Minnesota from 2014 on were tenuous. The trusts had no contact with Minnesota during the applicable tax year. All trust administration activities by the trustees occurred outside Minnesota.

L. The Court also noted that these trusts were inter vivos trusts that had not been probated in Minnesota courts and had no existing relationship to the Minnesota courts distinct from that of the trusts and the trust assets unlike other cases which involved testamentary trusts such as District of Columbia v. Chase Manhattan Bank, 689 A. 2d. 539 (DC 1997).

M. Attributing all income, regardless of source, to Minnesota for tax purposes would not bear a rational relationship with the limited benefits received by the trusts from Minnesota during 2014.

N. The repeated references by the courts to the trusts becoming irrevocable in 2014, when grantor trust status ended, not in 2011 when they actually become irrevocable, show that non-tax professionals can struggle with the concept of grantor trusts. It did not seem to impact the outcome, and it may have just been poorly worded short-hand by the courts for when the trusts become separate taxpayers. But it is a reminder that these concepts are not intuitive to most people.

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