

**Fiduciary Education Foundation**

# **Issues With Grantor Trusts**

Presented by:

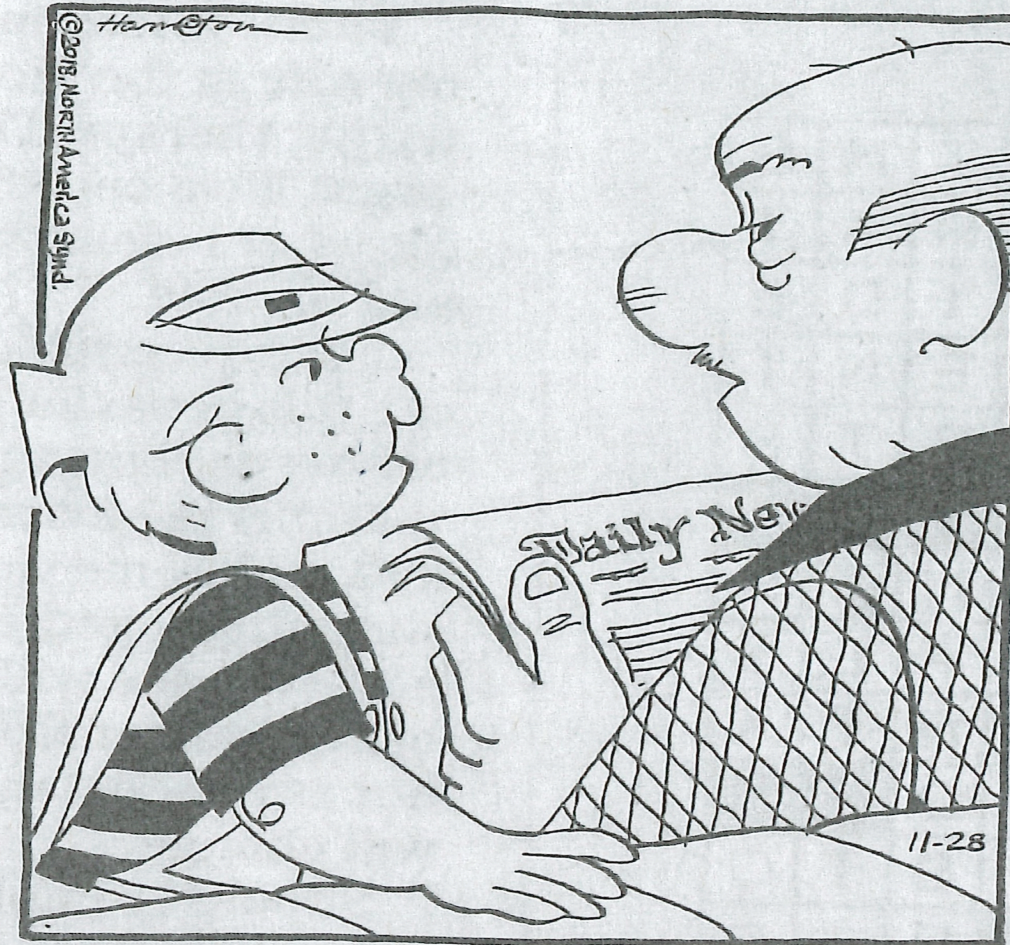
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# DENNIS THE MENACE

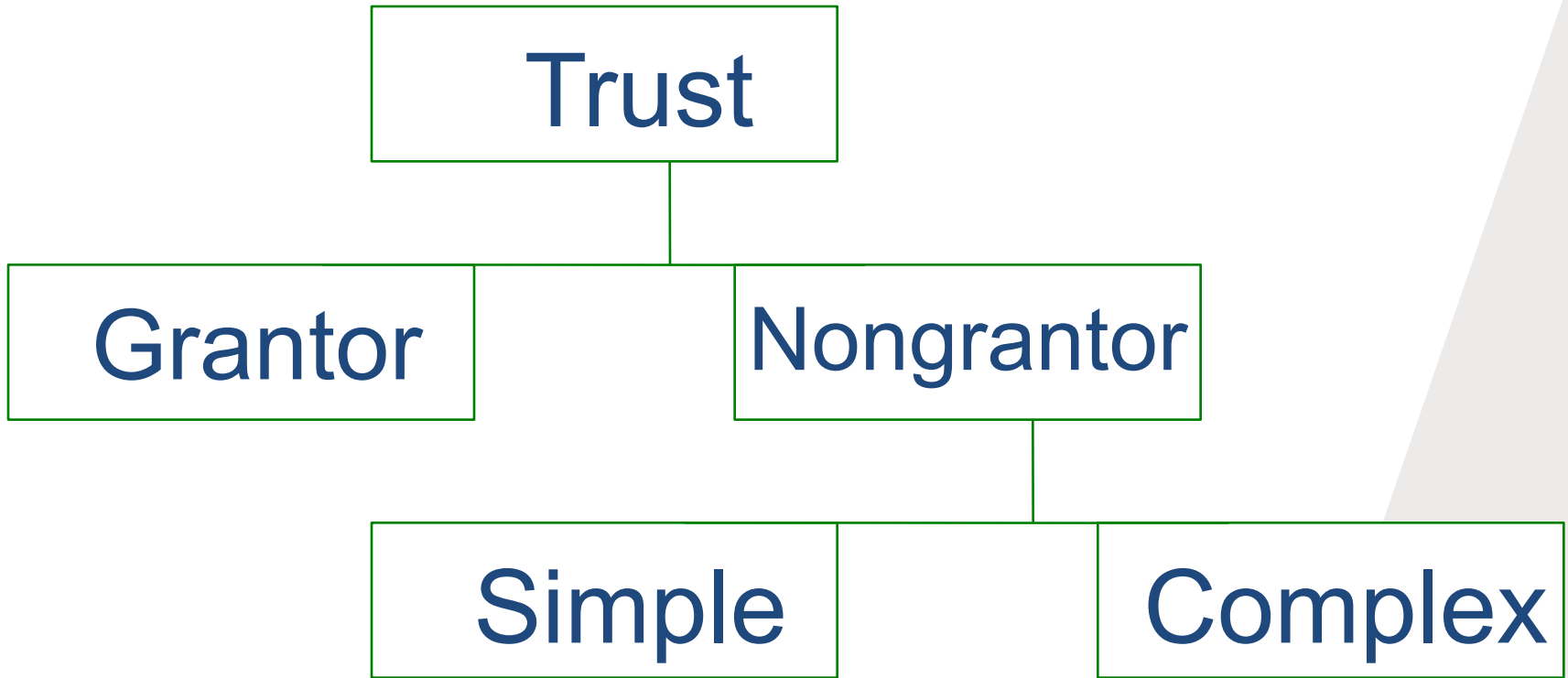
H. KETCHAM



"MY DAD SAYS I MIGHT  
GO TO LAW SCHOOL  
SOMEDAY."

"WELL, AT LEAST YOU'LL  
KNOW HOW TO GET  
OUT OF TROUBLE."

# Decision Tree



# Introduction

- Importance
- Grantor trust rules developed in response to attempts to shift income
- Developed when tax rates for trusts were the same as tax rates for an unmarried individual

# Introduction (continued)

- “Defective”



- Compression of tax brackets in 1986 Tax Act

# Trust Income Taxation

- Separate taxpaying trusts
- Grantor trusts
- Overview of the grantor trust rules

# Trust Income Taxation

- Grantor trust rules apply when grantor or another person is treated as the “owner” of:

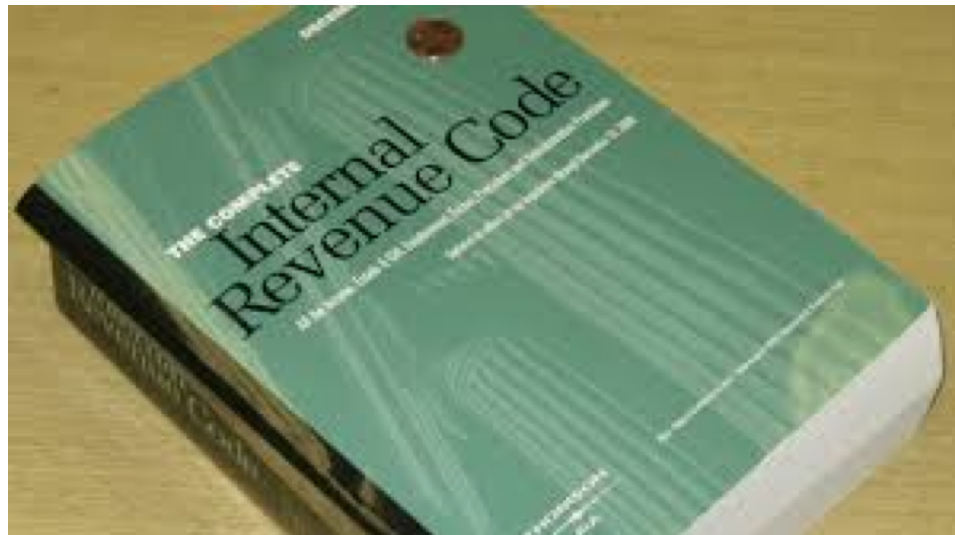
- Entire trust
- Part of a trust



# Terms in Taxation of Grantor Trusts

- Adverse party
- Non-adverse party
- Related or subordinate party

# Grantor Trust Rules Found in Sections 671 to 679 of Internal Revenue Code



# Section 673—Reversionary Interests

# **Section 674-Power to Control Beneficial Enjoyment**

Grantor treated as owner of any power of disposition exercised by the grantor or non-adverse party without the consent of an adverse party



## Exceptions to General Rule in Section 674

- Power to apply income to support a dependent
- Power to allocate corpus or income among charitable beneficiaries
- Power to distribute corpus pursuant to a reasonably definite standard

# Exceptions to Specific Rules in 674

- Power to withhold income when income will ultimately pass to one or more beneficiaries
- Power to allocate receipts and disbursements between income and principal

# Exceptions to Specific Rules in 674

- Presence of independent trustee with power to distribute income or principal
  - Non-adverse trustee can have power to distribute or accumulate income

# Exceptions to Specific Rules in 674

- Exceptions do not apply if person has power to add beneficiaries



## Section 675 – Administrative Provisions

- Power to deal for less than adequate and full consideration
- Power to borrow without adequate interest or security
- Borrowing of trust funds

# Section 675 – Administrative Provisions

## General Powers:

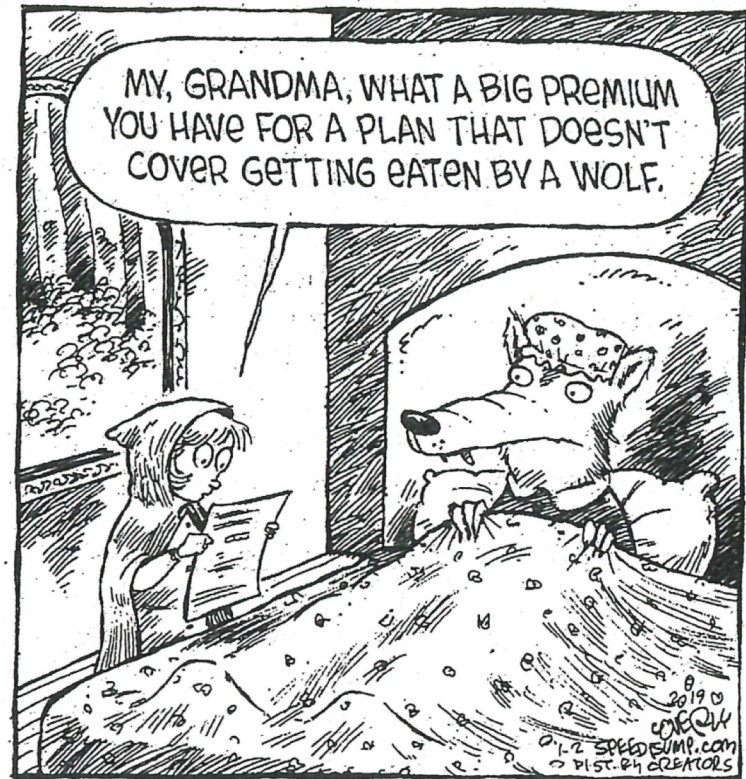
- Vote
- Control Investments
- Substitute Property of Equivalent Value



# Section 676 – Power to Revest Title



# Section 677 – Power to Use Income for Payment of Premiums on Insurance



# Section 678 – Third-Party Treated as Grantor

## Section 679 – Foreign Trusts



# Selected Rulings and Observations

# Grantor Trust and Grantor Treated as Single Taxpayer



# Charitable Remainder Trust

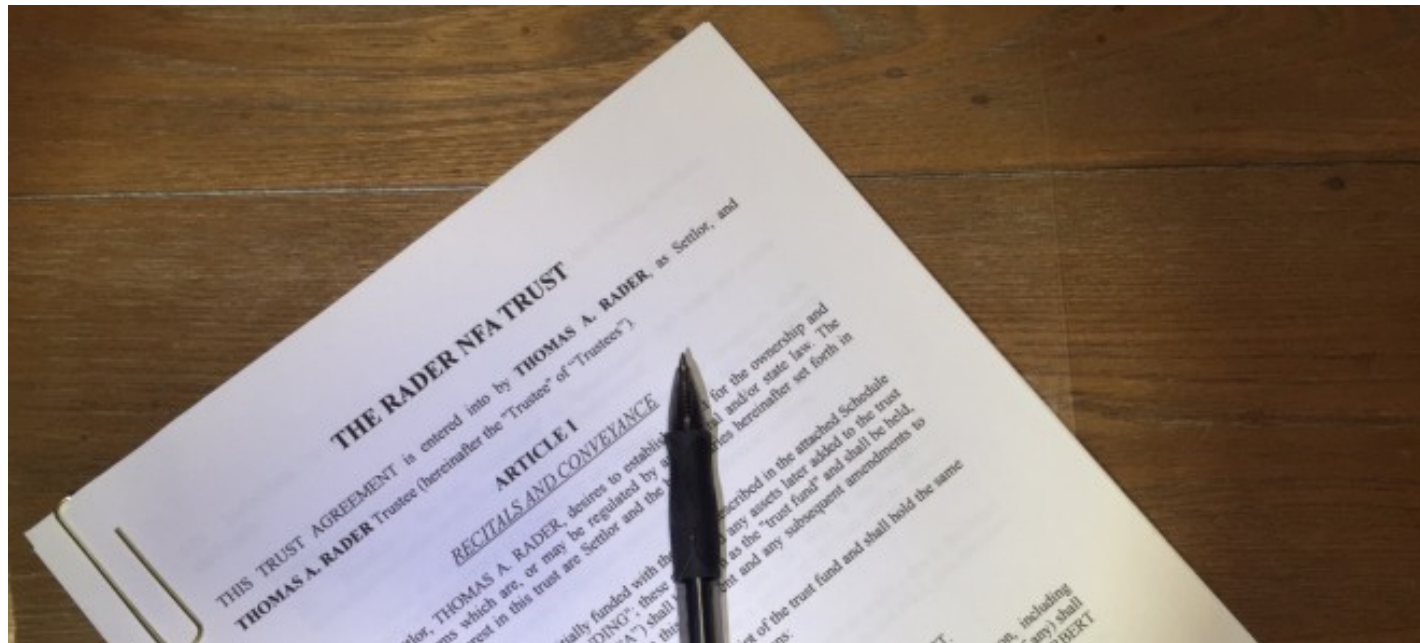
# Lapsing Rights of Withdrawal

# **Revenue Ruling 2004-64**

## **Section 2036 Consequences of Tax Reimbursement Provisions**

- Trustee not permitted to reimburse grantor for income taxes paid
- Trustee required to reimburse grantor
- Optional with Trustee

# Powers to Make Trust Grantor for Income Tax Purposes, but Not Cause Inclusion in Grantor's Estate



# Power to Borrow Without Security

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.

# Power to Lend Without Security

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.

# Power to Substitute Property

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.

# Power to Substitute Property

- Revenue Ruling 2008-22
- Avoid adverse estate tax consequences if:
  - Grantor's power is non-fiduciary power
  - Trustee has fiduciary obligation to insure substitution of property of equivalent value

# Power to Add Beneficiaries

- Appears in several places in Section 674

# Power to Add Beneficiaries

**SAMPLE POWER:** 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.

# Tax Reporting for Grantor Trust

- Option of filing Form 1041
- Some grantor trusts must file returns
  - Trust with situs or assets outside the United States
  - Qualified Subchapter S
  - Trust partly or wholly owned by non U.S. person

# Transfer Tax and Gift Planning with Grantor Trusts

- Minors Exclusion Trust
- Irrevocable Perpetuities Trust
- Grantor Retained Annuity Trust
- Sale to a Grantor Trust
- Loans
- Qualified Personal Residence Trust

# Impact of Payment by Grantor of Income Tax



# Use of Swap Powers for Tax and Other Planning

**Advantage: Exchange low basis asset in trust for high basis asset or cash**

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.

# Use of Swap Powers for Tax and Other Planning

- Used to avoid step-down in basis at death under Section 1014 for a depreciated asset.
- Lock in appreciation in GRATS

# Insuring Exchange of Equal Value of Assets

In Benson v. Rosenthal, 2016 WL 2855456 (E.D. La. 2016) (slip opinion), mot. for partial summary judgment denied 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.



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 loans.

# **Transfer for Value Rules for Life Insurance (Irrevocable Life Insurance Trust)**

# Incomplete Non-Grantor Trusts

# Implications of Turning Off or On Grantor Trust Status

- Turning off grantor trust status
- Income tax consequences
- Multiple changes in grantor trust status
- Grantor trust status at grantor's death

# Beneficiary Grantor Trust Status under Section 678

- Supercharged Credit Shelter Trust
- Beneficiary Irrevocable Grantor Trust

# Beneficiary Grantor Trust Status under Section 678

**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.

# Beneficiary Grantor Trust Status under Section 678

**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.

# New Twist on Beneficiary Grantor Trust

# State Court Decision

## Fielding v. Commissioner, \_\_\_\_\_ Minn. \_\_\_\_\_ (July 18, 2018)

