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GRANTOR TRUSTS

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I. Introduction.

Estate planning is an interesting practice that is governed by an ever changing body of law. As new ideas and new law emerge, the practitioner is encouraged to stay abreast of the changing landscape. An area of law that has experienced changes through the years is the area of taxation of trusts and owners of trusts. This outline is designed to explain what grantor trusts are and how they are triggered from a tax standpoint. Having a trust taxed as a grantor trust has many implications that estate planners need to understand as they draft trusts for their clients.

II. History.

In the post Great Depression and WWII era, progressive income tax rates could exceed 80% and filing jointly with your spouse was not permitted.[1] Motivated by high tax rates, taxpayers attempted to shift some of their income to other individuals, such as their spouses, who fell within a lower tax bracket.[2] One way taxpayers shifted income was to establish and fund a trust with income producing assets for the benefit of their spouses, so that income produced would not be taxed

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[1] See the Revenue Act of 1942. Pub. L. No. 77-753, §§ 102-103, 56 Stat. 798, 802 (1942) (superseded 1944), available at http://constitution.org/tax/us-ic/hist/RevAct1942.pdf.

[2] See e.g., Lucas v. Earl, 281 U.S. 111 (1930). In Lucas, a husband and wife entered into a contractual arrangement where their earnings would be held as joint tenants with rights of survivorship. Each spouse reported half of the income on their tax returns, resulting in both spouses falling within lower tax brackets. The Supreme Court ruled against the taxpayers in this case.

to the settlor (grantor).[3] This was the case in *Helvering v. Clifford*, where the Supreme Court ruled that the grantor was the owner of the trust, and income earned in the trust would be taxed to the grantor.[4] The Supreme Court, citing a lack of Congressional or regulatory guidance, determined the ownership of the trust depends "on analysis of the terms of the trust and on all the circumstances attendant on its creation and operation."[5]

In response to *Clifford*, the Treasury Department adopted the "Clifford regulations" to provide guidelines for when the grantor would be taxed, or when a trust would be considered a separate taxpayer from the grantor.[6] In 1954 Congress adopted the grantor trust sections which formalized the Clifford regulations.[7] Although married taxpayers were permitted to file jointly after 1948,[8] taxpayers continued to use trusts to shift income to other beneficiaries in lower tax brackets, but were careful to structure the trust to avoid grantor trust status.[9]

Finally, a sharp decrease in individual income taxes with the Tax Reform Act of 1986[10] increased the desirability for grantor trusts instead of non-grantor trusts.[11] Instead of aiming to shift income to the beneficiaries, the grantors had an incentive to have trust income taxed to themselves

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[3] See Helvering v. Clifford, 309 U.S. 331 (1940).

[4] Id. at 335.

[5] Id. The Court explained "the short duration of the trust, the fact that the wife was the beneficiary, and the retention of control over the corpus by respondent all lead irresistibly to the conclusion that respondent continued to be the owner for purposes of I.R.C. § 22(a)."

[6] See Treas. Reg. § 9.22(a)-1 (1939) (defining gross income); Treas. Reg. § 29.22(a)-21 (1946) (stating trust income taxable to grantor as substantial owner following provisions of T.D. 5488, 1946-1 C.B. 19).

[7] See I.R.C. §§ 671–679. Unless otherwise noted, "Code" and "I.R.C." refer to the Internal Revenue Code of 1986, and "section" refers to a section of the Code. Note that I.R.C. § 679 was added to the Code in 1976.

[8] See Revenue Act of 1948, Pub. L. No. 80-471, ch. 168, sec. 303, § 51(b), 62 Stat. 110, 115.

[9] Section 673, before amendment in 1986, permitted a trust to avoid grantor trust status as to tax income allocable to the fiduciary income portion of the trust if the grantor's reversionary interest in principal was delayed more than ten years. See I.R.C. § 673 (1954).

[10] Pub. L. No. 99-514, 100 Stat. 2085.

[11] The top income tax rate was lowered from 50% in 1986 (before passage) to an eventual top rate of 28% in 1988.

at lower rates. In 2016, trusts reach the top income tax bracket of 39.6% at only $12,400, whereas married taxpayers filing jointly don't reach the top income tax bracket of 39.6% until they have taxable income of $466,950.

III. What Grantor Trusts are Used for.

A. Income Tax.

1. Income Taxable to Grantor. Income generated in grantor trusts is taxed to the person deemed to be the owner or grantor. While the person that establishes a grantor trust is most often the one that is the grantor for tax purposes, it is not always that way. Sometimes, certain rights are reserved for some person other than the creator of the trust, which could make that other person the grantor for tax purposes.

2. Tax Rates. Under the current tax laws, income tax rates for individuals are generally lower than income tax rates for trusts. It is important to remember that with taxation of trusts we are concerned with income generated and not necessarily the amount of the underlying principal. The following are the 2016 tax rates for unmarried individuals and for trusts:

26 U.S. Code § 1(c) Unmarried individuals	
If Taxable Income Is:	The Tax Is:
Not over $9,275	10% of the taxable income
Over $9,275 but not over $37,650	$927.50 plus 15% of the excess over $9,275
Over $37,650 but not over $91,150	$5,183.75 plus 25% of the excess over $37,650
Over $91,150 but not over $190,150	$18,558.75 plus 28% of the excess over $91,150
Over $190,150 but not over $413,350	$46,278.75 plus 33% of the excess over $190,150
Over $413,350 not over $415,050	$119,934.75 plus 35% of the excess over $413,350
Over $415,050	$120,529.75 plus 39.6% of the excess over $415,050

26 U.S. Code § 1(c) Estates and trusts.	
If Taxable Income Is:	The Tax Is:
Not over $2,550	15% of the taxable income
Over $2,550 but not over $5,950	$382.50 plus 25% of the excess over $2,550
Over $5,950 but not over $9,050	$1,232.50 plus 28% of the excess over $5,950

Over $9,050 but not over $12,400	$2,100.50 plus 33% of the excess over $9,050
Over $12,400	$3,206 plus 39.6% of the excess over $12,400

3. Example of Income Tax (Grantor vs. Non-Grantor Trust).

a. A grantor trust has $10,000 of income in 2016. The Trust is disregarded and the grantor, an unmarried individual, reports tax of $927.50 + ($725 x 15%) = $1,036.25.

b. A non-grantor trust has $10,000 of income in 2016. The Trust reports tax of $2,100.5 + ($950 x 33%)= $2,414.

c. Additionally, the owner (or grantor) of a grantor trust is eligible to take deductions that a non-grantor trust is not entitled to. For example, married couples filing jointly are entitled to a standard deduction of $12,600, but trusts are only entitled to a standard deduction of either $100 or $300, depending on whether the trust is required to distribute all of its income.[12] It is also important to note that a trust is required to file an income tax return when its gross income is $600 or more, regardless of whether any tax will be owed after deductions.

B. Estate Tax.

1. Trusts can be designed so that assets are taxed to the grantor for income tax purposes but not included in the estate of the grantor for estate tax purposes. These types of trusts are generally referred to as intentionally defective grantor trusts and are used to remove assets and their appreciation form the estate of the grantor. This allows assets to grow without increasing the ultimate estate tax when the grantor dies.

2. Additionally, since the grantor pays the income taxes generated by the assets that were transferred for estate tax purposes, the grantor's estate is further reduced by the amount of the income taxes paid.

C. Capital Gains.

1. Preservation of the I.R.C. § 121 Exclusion for Sale of Principal Residence. Under Section 121 of the Internal Revenue Code, individuals are entitled to an exclusion of $250,000 per person from capital gains tax on the sale of their principal residence, if they owned the property and lived in it for two out of the last five years. This exclusion will be retained when property is transferred to a trust that is taxed as a grantor trust for income tax purposes.

[12] I.R.C. § 642(b).

2. The wording of the trust document generally controls as to whether capital gains taxes will be taxed as income or principal.[13] The drafter may want to address whether capital gains are treated as income and distributed out to the beneficiaries or treated as principal and retained in the trust. These considerations apply to non-grantor trusts.

3. In 2013, Congress enacted a new tax which affects non-grantor trusts, the 3.8% net investment income tax.[14] This tax is 3.8% and is generally imposed on net investment income in excess of $12,400. Since income and capital gains in grantor trusts are taxable to the grantor, grantor trusts are not subject to the net investment income tax. In general, investment income includes, but is not limited to interest, dividends, capital gains, rental and royalty income, non-qualified annuities, income from businesses involved in trading of financial instruments or commodities and businesses that are passive activities to the taxpayer within the meaning of I.R.C. § 469.

IV. Types of Grantor Trusts.

There are many types of grantor trusts, and grantor trusts can be either revocable or irrevocable trusts, depending on the provisions included in the trust. Brief descriptions of some of the more common types of grantor trusts are set forth below.

A. Revocable Living Trust. This is the most common type of a grantor trust. With a revocable living trust, the creator of the trust is the grantor, the trustee, and the beneficiary. Since the grantor retains virtually all the rights over the assets in the trust that the grantor had prior to establishing and funding the trust, the assets in the trust are taxed to the grantor in the same way as if the grantor still owned the assets in his or her own personal name.

B. Income Only Trust. Income only trusts provide that all income is to be distributed to or be available to the grantor, which makes the trust a grantor trust for income tax purposes under I.R.C. § 677 and for estate tax purposes under I.R.C. § 2036. The grantor would also normally reserve the right to change the trustee and the beneficiaries. The grantor gives up, however, his or her right to the principal of the trust. The most common reason this is done is to remove the principal assets from the estate of the grantor for Medicaid or other creditor protection purposes. The neat part about having this type of trust taxed as a grantor trust for income and estate tax purposes is that the Section 121 exclusion mentioned above is retained and the assets in the trust receive a stepped-up tax basis at the death of the grantor[15]

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[13] State law (such as under a principal and income act) or the discretion of the fiduciary may also influence whether capital gains are treated as income or principal.

[14] I.R.C. § 1411.

[15] I.R.C. § 1014.

C. Grantor Retained Trust (GRIT/QPRT, GRAT, & GRUT).

1. These are irrevocable trusts where the grantor retains the right to receive income from the trust for a specified time. At the end of the term, assets in the trust pass to the trust remainder beneficiaries. The amount of the assets transferred to the trust (less a discount based on projected income payments) is treated as a gift to the trust remainder beneficiaries. If the grantor does not outlive the term, the assets are included in the grantor's estate.

2. The objective is to discount the amount given away and to allow appreciation of any appreciable assets in the trust to be excluded from the grantor's estate for estate tax purposes.

3. Since a change in the tax laws in 1990, grantor retained income trusts (GRITs) have generally been limited to qualified personal residence trusts QPRTs, which are a type of GRIT. The income interest retained is the right to live in the residence. Grantor retained annuity trusts (GRATs) are designed to pay a certain annuity amount to the grantor each year and grantor retained unitrusts (GRUTs) are designed to pay an amount that is recalculated each year based on a pre-determined interest rate.

D. Intentionally Defective Grantor Trust (IDGT).

1. As mentioned above, this type of trust is designed to have the income of the trust taxed to the grantor but not have the trust assets included in the grantor's estate for estate tax purposes. For that reason, the grantor trust provisions drafted into the trust document are intended to trigger grantor trust status for income tax purposes but not trigger them for estate tax purposes.

2. The most common way for a grantor to achieve grantor trust status for income tax purposes without causing the assets to be included in the grantor's estate is for the grantor to retain the power to substitute assets in a non-fiduciary capacity (a swap power).[16] The swap power is popular because it achieves grantor trust status for income tax purposes without affecting the economic interests of the beneficiaries.

E. Special Needs Trust.

1. There are two main types of trusts that are used to help disabled people qualify for government benefits.[17] Supplemental needs trusts are established by someone for the benefit of a disabled person and are designed to hold and administer assets that did not belong to the disabled person. These trusts are referred to as third party trusts. Special needs trusts established under 42 U.S.C. § 1396(p)(d)(4)(A) ("(d)(4)(A) trusts") are designed to hold and administer assets that belong

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[16] See I.R.C. § 675(4).

[17] 42 U.S.C. § 1396p(d)(4) also provides for other types of trusts that may apply in certain more specific circumstances.

to the disabled person and which would otherwise disqualify the disabled person from government benefits. These types of trusts are referred to as first party trusts.

2. When drafting supplemental needs trusts, it is important to consider who will be responsible for the income tax generated from the assets in the trust. The tax is normally attributed to the grantor because the grantor would normally reserve the right to receive the assets in the trust if the disabled person predeceases them. If not, the income would most likely be taxed at the trust level. The income generated in (d)(4)(A) trusts is generally taxed to the disabled person.

V. Provisions Triggering Grantor Trust Status.

A. The rules governing grantor trusts are set forth in I.R.C. §§ 671-679. I.R.C. § 671 provides that the grantor (or person deemed to be the owner for income tax purposes) is taxed for items in the grantor trust; I.R.C. § 672 provides certain definition provisions and the related rules; and I.R.C. §§ 673-679 provide the specific provisions that trigger grantor trust status.

B. Definitions.[18]

1. Adverse party.

a. Generally, any person who has an interest in the trust that would be adversely affected by the exercise of a power.[19]

b. Ordinarily, a beneficiary will be an adverse party to the extent the beneficiary has a right to share in the income or corpus of a trust.[20]

c. Beneficiaries with only remainder interests are adverse parties only to the extent of an exercise of power over the principal, but will not be adverse to the extent of an exercise of power over the income.[21] The opposite is also true: beneficiaries with only lifetime

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[18] The term grantor is confusing in the context of explaining who will be taxed as the owner of trust assets. For purposes of this outline, the term settlor, grantor and creator are used interchangeably to mean the person that established a trust. The term owner is used to mean the person that is responsible for the tax generated by the trust. The term grantor is also used to mean the same thing as the owner in this context. Therefore, at times, depending on the context, the term grantor is used to mean both the person that established the trust and the person that will be taxed on income generated by the trust.

[19] I.R.C. § 672(a).

[20] Treas. Reg. § 1.672(a)-1(b).

[21] Id.

income interests are adverse parties only to the extent of an exercise of power over the income, but will not be adverse to the exercise of power over the remainder.[22]

d. The statutory definition provides that an adverse party is "any person having a substantial beneficial interest in the trust which would be adversely affected by the exercise or nonexercise of the power which he possesses respecting the trust. A person having a general power of appointment over the trust property shall be deemed to have a beneficial interest in the trust."[23]

2. Nonadverse party.

a. "[A]ny person who is not an adverse party."[24]

3. Related or subordinate party.

a. "[A]ny nonadverse party who is—

(1) the grantor's spouse if living with the grantor;

(2) any one of the following: The grantor's father, mother, issue, brother or sister; an employee of the grantor; a corporation or any employee of a corporation in which the stock holdings of the grantor and the trust are significant from the viewpoint of voting control; or a subordinate employee of a corporation in which the grantor is an executive. A related or subordinate party will be presumed to be subservient to the grantor in respect of the exercise or nonexercise of the powers conferred on him unless such party is shown not to be subservient by a preponderance of the evidence.

C. Reversionary Interests (I.R.C. § 673).

1. Under I.R.C. § 673, a grantor retains a reversionary interest in either the trust income or principal, and the value of such interest exceeds 5% of the value of the income or principal of the trust (using I.R.C. § 7520 tables, calculated using age of life beneficiary or years before reversion).

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[22] Id.

[23] I.R.C. 672(a).

[24] I.R.C. 672(b).

2. Estate Tax Consequences.

a. If possession of the assets can only be obtained by surviving the grantor and the value of grantor's interest exceeds 5% of the value of the assets, then the value of grantor's interest will be included in his or her estate.[25]

b. When determining whether the grantor retains 5%, The "grantor trust" status is assessed upon the creation of the trust, and the "estate tax" status is assessed immediately before death.

D. Power to Control Beneficial Enjoyment (I.R.C. § 674).

1. The grantor is treated as the owner of any portion of a trust in respect of which the beneficial enjoyment of the corpus or the income therefrom is subject to a power of disposition, exercisable by the grantor or a nonadverse party, or both, without the approval or consent of any adverse party.[26] In other words, if the creator of the trust retains the right to enjoy the benefits of the trust, he or she would be taxed on any income in the trust. However, a grantor trust will not be created if an adverse party is required to consent to an action affecting the interest of the beneficiaries.

2. Exceptions.

a. I.R.C. § 674(b)(1) Power to apply income to support of a dependent. The trust will not be considered a grantor trust solely because the income may in the discretion of any person other than the grantor (except when he is acting as trustee or cotrustee) be used for the support of a beneficiary whom the grantor is legally obligated to support, such as a minor child of the grantor, except to the extent that it is in fact used for that purpose.

b. I.R.C. § 674(b)(2) Power affecting beneficial enjoyment only after occurrence of event. The grantor will not be considered the owner of a trust during the time grantor's power is not yet vested. For example, grantor funds a trust with income to son for 10 years, reserving the power to substitute other beneficiaries after 10 years has passed. The grantor is not treated as the owner of the trust for the first 10 years, but the grantor will be treated as the owner after 10 years unless grantor relinquishes that power.[27]

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[25] I.R.C. § 2037.

[26] I.R.C. § 674(a).

[27] 26 CFR 1.674(b)-1(b)(2).

c. I.R.C. § 674(b)(3) Power exercisable only by will. A power to control the beneficial enjoyment that is exercisable only by will does not create a grantor trust unless the grantor reserves in himself the power to appoint the income by will and the income is or may be accumulated without the consent of an adverse party.

(1) Examples.

(a) A trust instrument provides that the income is to be accumulated during the grantor's life and that the grantor may appoint the accumulated income by will; the grantor is treated as the owner of the trust.

(c) A trust instrument provides that the income is payable to another person for his life, but the grantor has a testamentary power of appointment over the remainder, and under the trust instrument and local law capital gains are added to corpus, the grantor is treated as the owner of a portion of the trust and capital gains and losses are included in that portion.[28]

d. I.R.C. § 674(b)(4) Power to allocate among charitable beneficiaries. A trust is not a grantor trust if the grantor retains only a power to allocate the corpus or the income for charitable contributions or to certain employee stock ownership plans.

e. I.R.C. § 674(b)(5) Power to distribute corpus. A trust is not a grantor trust if the grantor retains only a power to distribute corpus to 1) a beneficiary if the power is limited by an ascertainable standard;[29] or 2) a current income beneficiary so long as the distribution is chargeable against the proportionate share of corpus held for the payment of income to that beneficiary.

A trust will be a grantor trust if any person has a power to add to the beneficiary or beneficiaries or to a class of beneficiaries designated to receive the income or corpus, except where such action is to provide for after-born or after-adopted children.

f. I.R.C. § 674(b)(6) Power to withhold income temporarily. A trust will not be a grantor trust if it is a power to distribute or apply income to or for any current income beneficiary or to accumulate the income, provided that any accumulated income must ultimately be payable-

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[28] See Treas. Reg. § 1.671-3.

[29] An ascertainable standard (also referred to as a reasonably definite standard) generally means a standard limited to the beneficiary's health, education, maintenance and support in reasonable comfort, taking into consideration the beneficiary's other assets. It does not mean the "happiness of a beneficiary." See Treas. Reg. § 1.674(b)-5.

(1) to the beneficiary from whom distribution or application is withheld, to his estate, or to his appointees (or persons named as alternate takers in default of appointment) provided that such beneficiary possesses a power of appointment which does not exclude from the class of possible appointees any person other than the beneficiary, his estate, his creditors, or the creditors of his estate, or

(2) on termination of the trust, or in conjunction with a distribution of corpus which is augmented by such accumulated income, to the current income beneficiaries in shares which have been irrevocably specified in the trust instrument.

Accumulated income shall be considered payable although it is provided that if any beneficiary does not survive a date of distribution which could reasonably have been expected to occur within the beneficiary's lifetime, the share of the deceased beneficiary is to be paid to his appointees or to one or more designated alternate takers (other than the grantor or the grantor's estate) whose shares have been irrevocably specified. A power does not fall within the powers described in this paragraph if any person has a power to add to the beneficiary or beneficiaries or to a class of beneficiaries designated to receive the income or corpus except where such action is to provide for after-born or after-adopted children.

g. I.R.C. § 674(b)(7) Power to withhold income during disability of beneficiary. A grantor is not taxed on trust income simply because he or she has the right to withhold distribution to a beneficiary during the disability of the beneficiary, unless the grantor also has the right to add to the class of beneficiaries.

h. I.R.C. § 674(b)(8) Power to allocate between corpus and income. The power of the grantor to allocate receipts between corpus and income is not enough to constitute a power to control the beneficial enjoyment of a trust.

i. I.R.C. § 674(c) Exception for certain powers of independent trustees. This provision creates separation between the trustee powers and the grantor. The rationale is that an independent trustee would not be subject to the influence or control of the grantor.

j. I.R.C. § 674(d) Power to allocate income if limited by a standard. A grantor is not taxed on trust income if any trustee other than the grantor or the grantor's spouse holds the power to distribute, apportion, or accumulate income to or for a beneficiary or class of beneficiaries, if the power is limited by an ascertainable standard.[30]

Power to remove trustee. A power in the grantor to remove, substitute, or add trustees (other than a power exercisable only upon limited conditions which do not exist during the taxable year, such as the death or resignation of, or breach of fiduciary duty by, an existing trustee) may prevent a trust from qualifying under section 674 (c) or (d). For example, if a grantor

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[30] Treas. Reg. § 1.674(d)-1.

has an unrestricted power to remove an independent trustee and substitute any person including himself as trustee, the trust will not qualify under section 674 (c) or (d). On the other hand, if the grantor's power to remove, substitute, or add trustees is limited so that its exercise could not alter the trust in a manner that would disqualify it under section 674 (c) or (d), as the case may be, the power itself does not disqualify this exception. Thus, for example, a power in the grantor to remove or discharge an independent trustee on the condition that he substitute another independent trustee will not prevent a trust from qualifying under section 674(c).[31]

Power to add beneficiaries. The exceptions described in section 674 (b) (5), (6), and (7), (c), and (d), are not applicable if any person has a power to add to the beneficiary or beneficiaries or to a class of beneficiaries designated to receive the income or corpus, except where the action is to provide for after-born or after-adopted children. This limitation does not apply to a power held by a beneficiary to substitute other beneficiaries to succeed to his interest in the trust (so that he would be an adverse party as to the exercise or nonexercise of that power). For example, the limitation does not apply to a power in a beneficiary of a nonspendthrift trust to assign his interest. Nor does the limitation apply to a power held by any person which would qualify as an exception under section 674(b)(3) (relating to testamentary powers). [32]

E. Administrative Powers (I.R.C. § 675). Each of the below powers, if be exercisable without the consent of an adverse party, results in treatment of the trust as a grantor trust.

1. Power to Deal for Less than Adequate and Full Consideration (I.R.C. § 675(1)). "The grantor shall be treated as the owner of any portion of a trust in respect of which . . . [a] power exercisable by the grantor or a nonadverse party, or both, without the approval or consent of any adverse party enables the grantor or any person to purchase, exchange, or otherwise deal with or dispose of the corpus or the income therefrom for less than an adequate consideration in money or money's worth."

Estate Tax Considerations. A power of revocation triggers inclusion of the trust in the estate, and the power to dispose of assets for less than adequate consideration could be considered a power of revocation.[33]

2. Power to Borrow Trust Property Without Adequate Interest or Security (I.R.C. § 675(2)). "The grantor shall be treated as the owner of any portion of a trust in respect of which . . . a grantor or nonadverse party enables the grantor to borrow the corpus or income, directly or indirectly, without adequate interest or without adequate security except where a trustee (other than the grantor) is authorized under a general lending power to make loans to any person without regard to interest or security."

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[31] Treas. Reg. §1.674(d)-2.

[32] Treas. Reg. § 1.674(d)-2.

[33] See I.R.C. § 2038.

3. Grantor Borrows Trust Property Without Adequate Interest or Security (I.R.C. § 675(3)). "The grantor shall be treated as the owner of any portion of a trust in respect of which . . . [t]he grantor has directly or indirectly borrowed the corpus or income and has not completely repaid the loan, including any interest, before the beginning of the taxable year."[34] In other words, if the grantor actually borrows trust principal or income without adequate interest, and the grantor does not repay the loan, the trust is a grantor trust.

If the loan was made with adequate stated interest and if such loan is made by a trustee other than the grantor and other than a related or subordinate trustee subservient to the grantor, then the grantor will not be treated as the owner.

4. Power to Vote Stock, Control Investments, or Substitute Property (I.R.C. § 675(4)). The grantor shall be treated as the owner of any portion of a trust in respect of which "a power of administration is exercisable in a nonfiduciary capacity by any person without the approval or consent of any person in a fiduciary capacity." The term "power of administration" means any one or more of the following powers:

a. a power to vote or direct the voting of stock or other securities of a corporation in which the holdings of the grantor and the trust are significant from the viewpoint of voting control;[35]

b. a power to control the investment of the trust funds either by directing investments or reinvestments, or by vetoing proposed investments or reinvestments, to the extent that the trust funds consist of stocks or securities of corporations in which the holdings of the grantor and the trust are significant from the viewpoint of voting control;[36] or

c. a power to reacquire the trust corpus by substituting other property of an equivalent value.[37]

d. Estate Tax Considerations.

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[34] I.R.C. § 675(3).

[35] I.R.C. § 675(4)(A).

[36] I.R.C. § 675(4)(B).

[37] I.R.C. § 675(4)(C).

(1) The retention by the grantor of the right to vote (directly or indirectly) shares of stock of a controlled corporation is considered "a retention of the enjoyment of transferred property," triggering estate tax inclusion.[38]

(2) The retained power to substitute assets of equivalent value will not prevent the grantor from having made a completed gift for transfer tax purposes and will not trigger estate tax inclusion under section 2038.[39]

F. Power to Revoke (I.R.C. § 676). If a grantor or a grantor's spouse or a nonadverse party has the right to revoke the trust and revest the assets of the trust in the grantor, the trust assets will be taxed to the grantor. A power of revocation could trigger inclusion of the trust in the estate of the grantor.[40]

G. Income for the Benefit of Grantor (I.R.C. § 677). The grantor is taxed as the owner of a trust that provides that the grantor or a nonadverse party has the power to distribute or accumulate for distribution the trust income to the grantor or the grantor's spouse without the consent of an adverse party.

H. Grantor Trust to Someone Other than Grantor (I.R.C. § 678). This provision lays out the framework for some person or beneficiary other than the creator of the trust to be treated as the grantor and owner for tax purposes. If the beneficiary is vested with the right invade corpus or income from the trust, then he or she will be deemed as the owner for tax purposes. This section would not attribute this status to the beneficiary if the creator of the trust is otherwise deemed to be the owner of the trust under I.R.C. §§ 673-677.[41]

I. Foreign Trusts with U.S. Beneficiaries (I.R.C. § 679). This provision is designed to capture income in a foreign trust when a U.S. person directly or indirectly transfers property to the foreign trust. The U.S. person that contributed the assets to the trust is treated as the owner of the property transferred if for the year the property is transferred the foreign trust has any U.S. beneficiaries.

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[38] I.R.C. § 2036(b). In addition, family attribution rules of I.R.C. § 318 apply for determining "ownership" in a "controlled corporation."

[39] Rev. Rul. 2008-22. Note that estate tax will not be triggered so long as the trustee has a fiduciary obligation under the trust agreement or statute to ensure that the grantor complies with the trust terms.

[40] I.R.C. § 2038.

[41] I.R.C. § 678(b).

VI. Funding the Grantor Trust - Who is the Grantor?

A. The term "grantor" is defined in Treas. Reg. §1.671-2(e)(1), which provides that for purposes of part I of subchapter J of chapter 1 of the Code, a grantor includes any person to the extent such person either creates a trust, or directly or indirectly makes a gratuitous transfer of property to a trust.

1. "Gratuitous transfer" - For purposes of Treas. Reg. §1.671-2(e)(1), a gratuitous transfer is any transfer other than a transfer for fair market value.

2. Example. A creates and funds a trust for the benefit of her children. B subsequently makes a gratuitous transfer to the trust. Under Treas. Reg. §1.671-2(e)(1), both A and B are grantors of the trust. A created and made a gratuitous transfer to the trust; B made a gratuitous transfer to the trust.[42]

VII. Drafting Tips and Examples.

When drafting trust documents the estate planner should understand the overall purpose for the trust, along with a way to accomplish the purpose in the most tax conscious way without creating unnecessary administrative burdens for the trustee. A common pitfall that planners get caught in is when the planner takes a form trust document that they received from some reliable source and changes some internal provision to accommodate what seems to be harmless request of the client, not knowing that the request would change how the trust income is taxed. For example, if the trust is not otherwise a grantor trust and the provisions are changed so that the trust corpus or income may revert back to the grantor upon the death of a beneficiary, or if the grantor is given the right to appoint the trust assets, then the trust may be changed to a grantor trust when that was not the intended result. As a general rule, it is much easier to make a trust a grantor trust than a non-grantor trust when drafting the trust.

There are a number of provisions that can be drafted into a trust to cause grantor trust status. Below are some examples of language that is used. This is by no means an exhaustive list of provisions. There are numerous ways to trigger the grantor trust provisions.

A. I.R.C. § 673 Reversionary Interest.

In a supplemental needs trust where the parents establish the trust for the benefit of their disabled child and provide that if the child passes before they do, the trust assets would revert to the parents, the trust may include a provision similar to "upon the death of the beneficiary, the balance of the trust estate as then constituted shall be distributed to the grantor."

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[42] See Treas. Reg. §1.671-2(e)(6)(ex. 1).

B. I.R.C. § 674 Power to Control Beneficial Enjoyment.

"The grantor reserves the right to appoint the trust principal to any of the grantor's issue, by written statement or in the grantor's last will and testament." This language retains for the grantor a special power of appointment and would cause inclusion under I.R.C. § 674. The way to avoid grantor trust status in this instance is to make the power subject to approval by someone that is an adverse party. Remember, an adverse party is someone that has a vested interest in the trust, or who could be affected financially in some way by the grantor's exercise of the power.

C. I.R.C. § 675 Administrative Powers.

There are several subsections to this section that cover trust provisions that would cause a trust to be taxed as a grantor trust. One of the most popular provisions is set forth in I.R.C. § 675(4). "The grantor or a non-adverse party for the grantor shall have the power to reacquire trust corpus by substituting other property of equivalent value." This provision is used frequently because it is economically harmless to the other beneficiaries. However, in the elder law context this provision may not be a good idea. States with tough Medicaid laws may take this provision to mean that the grantor has access to the trust principal and therefore the principal would be a countable asset.

D. I.R.C. § 676 Power of Revocation.

This provision is straight forward. "The grantor reserves the right to amend, alter, or revoke this trust at its discretion." Language similar to this is included in every revocable living trust.

E. I.R.C. § 677 Income for the Grantor's Benefit.

"For and during the grantor's life, the trustee shall distribute all income of the trust to or for the benefit of the grantor." This provisions would cause the trust to be treated as a grantor trust.

F. I.R.C. § 678 Person Other than Grantor Treated as Owner.

As mentioned above, it is important to remember that a grantor trust does not necessarily mean that the income is taxed to the creator of the trust. The deemed owner or grantor for tax purposes can be someone other than the creator or the original grantor of the trust. Language such as "Bob Smith [who is not the original creator of the trust] shall receive all income and principal at his discretion from the trust during his life." This section is a little confusing and should be considered with caution, as it would be easy to stumble into unintended tax consequences.

A question with this section is whether an earlier grantor trust provision that causes the trust to be a grantor trust to the creator of the trust would trump the application of this section.

The answer is that it would.[43] The tax burden would belong to the person that is the deemed owner under I.RC. § 673-677 and not the person who would be an owner under I.R.C. § 678.

Another issue is when the trustee is given the unfettered right to distribute assets to a class in which the trustee is a member, such as issue of the grantor. This could cause the trust assets to be taxed to the trustee. The way to address this section is to limit the trustee's power to an ascertainable standard, such as "the trustee may pay to or apply for the benefit of the beneficiary such sums from the income and principal of the trust as the trustee in its sole discretion deems necessary or advisable from time to time for the medical care, education, support and maintenance in reasonable comfort of the beneficiary, taking into consideration to the extent the trustee deems advisable, any other income or resources of the beneficiary known to the trustee."

G. I.R.C. § 679 Foreign Trusts Having one or More United States Beneficiaries.

This section deals with the taxation of income when a U.S. person makes a contribution to a foreign trust that has a U.S. beneficiary in the year that the contribution is made. In that case, the U.S. person that made the contribution would be taxed on income that was made on the assets that were contributed that year.

VIII. Taxation Considerations - When to File the Return?

Generally, trusts must annually file Form 1041, U.S. Income Tax Return for Estates and Trusts. However, this may not be required for most grantor trusts.[44] When a trust is taxed as a grantor trust, the deemed owner of the trust must include the activity of the trust on his or her personal tax return.[45] As mentioned earlier, grantor trust status can apply to either a revocable or an irrevocable trust.

When a grantor trust has a tax identification number separate from the deemed owners's social security number, it is important to notify the Internal Revenue Service where the income from the trust will be reported. This is done by filing an informational 1041 return that includes only the trust's name, address, and tax identification number[46]. The government encourages filers to provide limited income information on an attachment to the 1041 return. The information on the attachment should be limited to basic information so as not to create any confusion between the 1041 return the 1040 return for the deemed owner.

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[43] See I.R.C. § 678(b).

[44] The instructions published by the Internal Revenue Service for Form 1041 set out when grantor trusts must file a return.

[45] See Treas. Reg. § 1.671-2(a).

[46] See Treas. Reg. § 1.671-4(a).

It is important to know how the payor (such as a stock brokerage company, corporation or partnership) of the income for trust assets will be reporting the income. If the income is reported using the trust name and trust tax identification number, then a 1041 return needs to be filed. On the other hand, if the payor has the assets set up under the deemed owner's social security number and name, then income from the assets can be reported only on the deemed owner's 1040 return without the need to file a 1041 return.

There are also two ways that a grantor trust with its own tax identification number can avoid filing Form 1041. One option is for the trustee of the trust to file Form 1099 instead of Form 1041.[47] The trustee shows itself as the payor and the deemed owner as the payee, which in effect shifts the income tax burden from the trust to the deemed owner. However, depending on the types and different sources of income generated by the trust, this may actually end up being more involved than just filing an informational 1041 return with an attachment. Also, for this method of reporting to be effective in simplifying the filing requirements, the deemed owner would also need to be the trustee of the trust, because otherwise the trustee would still have a duty to send the deemed owner the necessary tax information to include on his or her individual 1040 return.

The other option was briefly mentioned above. This involves changing the way the ownership of the assets in the trust is listed with the payor. As long as the grantor trust is treated as owned by a single person (individual or couple that files married filing jointly), Treasury Regulation § 1.671-4(b)(2)(i)(A) allows the payor to issue any related 1099s and/or Schedules K-1 directly to the deemed owner. With this option it is important to maintain for titling purposes that the assets are technically owned by the trust and not the deemed owner. Otherwise, this option could inadvertently create problems with the deemed owner's overall estate plan.

In light of this analysis of tax reporting, the simplest way to handle reporting for a grantor trust is: a) if the trust does not have a separate tax identification number, such as a revocable living trust, only report the tax information on the deemed owner's 1040 return, or b) if the grantor trust has a separate tax identification number, file an informational 1041 return with an attachment.

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[47] See Treas. Reg. § 1.671-4(b)(2)(iii).