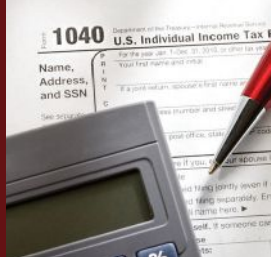


By **Joel H. Yudenfreund**

Is Your Trust a Grantor Trust?

Factors to consider to achieve the desired result

Many articles have been written on planning with both grantor and non-grantor trusts for gift, estate and income tax planning purposes. Most articles focus on grantor trusts because of the flexibility and benefits associated with such trusts. Other articles have been written, statutes enacted and Internal Revenue Service rulings issued regarding a trustee's power to reimburse a grantor under state law or the governing instrument for income taxes paid by the grantor due to the grantor's deemed ownership of the trust. I won't focus on these issues but on the fundamental question of whether a trust is in fact a grantor trust. There are many ways, both intended and unintended, for a trust to achieve grantor trust status under the Internal Revenue Code.[1]

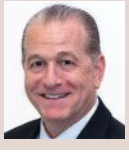
The language most frequently used to create a grantor trust is the power to substitute assets of an equivalent value.[2] Other powers frequently used to create a grantor trust in addition to or instead of the substitution power are the powers of the grantor to borrow[3] from the trust and add beneficiaries.[4] Another method to create grantor trust status is a beneficiary's power to vest the corpus or income in the beneficiary.[5] The intended result of this power is for the beneficiary to be taxed on the trust's income at the beneficiary's lower tax rates. To show the importance of this power, in 2025, trusts reach the top income tax bracket at $15,650, while a single taxpayer reaches the top income tax bracket at $626,350. This method of creating grantor trust status has gained popularity because of changes to rules for inherited individual retirement accounts, which in most cases now require that all assets of an IRA be withdrawn within 10 years of the IRA owner's death, as opposed to being able to be withdrawn over life expectancy.[6]

Many grantor trust provisions enable others to hold the powers creating grantor trust status, but I'll assume the powers reside with the grantor. Although the methods to create a grantor trust appear straightforward and without risk, I'll set forth points to consider to achieve the desired result. Other, less known provisions cause a trust to be a grantor trust, but I'll focus on the more common methods mentioned above.

Power Of Substitution

IRC Section 675(4)(C) generally provides that the grantor of a trust will be treated as the owner of any portion of a trust in which the grantor, in a nonfiduciary capacity without the approval or consent of any person in a fiduciary capacity, can reacquire the trust corpus by substituting other property of an equivalent value. The power to substitute property in a nonfiduciary capacity seems simple enough. Many assume that by including this provision in the trust, the trust is a grantor trust with no further inquiry.

A more thorough analysis needs to be made of the trust itself and any continuing powers a grantor may have. The first point of inquiry is whether the grantor can substitute property in a "nonfiduciary" capacity. If the grantor is a trustee, the power may not be exercisable in a nonfiduciary capacity. Treasury Regulations Section 1.675-1(b)(4) provides that if a power is exercisable by a person as trustee, it's presumed that the power is exercisable



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in a fiduciary capacity primarily in the interests of the beneficiaries. The regulations further provide that this presumption may only be rebutted by clear and convincing evidence. Even if the grantor isn't a trustee, the power still needs to be viewed considering the terms of the trust and the circumstances surrounding its creation and administration. If the grantor's spouse is a trustee, will the spouse's powers be imputed to the grantor?[7] Although the grantor's ability to act in a nonfiduciary capacity is paramount when relying on the substitution power, the IRS won't generally rule on whether a power can be exercised in a nonfiduciary capacity because it's a question of fact.[8] Plain language included in a trust stating that the grantor can exercise a power in a nonfiduciary capacity isn't the end of the inquiry. A more thorough analysis needs to be made of the language and circumstances of the particular trust in question.

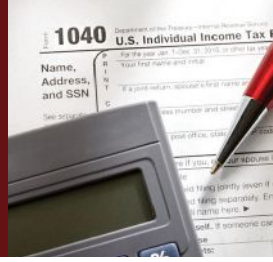
Under Section 674(b)(5)(A), it seems clear that by limiting the power to make distributions to a reasonably definite standard, the trust won't be a grantor trust.

Power to Borrow

Two provisions in the IRC relate to borrowing by the grantor that result in a trust being a grantor trust. IRC Section 675(2) results in grantor trust status by retaining a power to borrow, while Section 675(3) results in grantor trust status through the affirmative act of borrowing.[9] Under Section 675(2), if the grantor has the power to borrow the corpus or income without adequate interest or security, the entire trust will be treated as a grantor trust, and the income and gains will be taxable to the grantor. The grantor won't be treated as the owner if a trustee (other than the grantor acting alone) is authorized under a general lending power to make loans to any person without regard to interest or security.[10] Curiously, this same regulation further provides that a grantor acting alone as trustee under a general power in which the grantor has the power to determine interest rates and the adequacy of security isn't in and of itself an indication that the grantor has the power to borrow the corpus or income without adequate interest or security. If a grantor doesn't want to be treated as the trust owner and wants to be the trustee but may want to borrow money from the trust at some point, a general lending power could be considered.

Section 675(2) should be contrasted with Section 675(3). Section 675(3) provides that the grantor will be treated as the owner of any portion of a trust if the grantor has borrowed income or corpus and the loan plus interest hasn't been completely repaid before the beginning of the taxable year. Section 675(3) contains an important exception. The grantor won't be treated as the owner if the loan provides for adequate interest and security and the loan is made by a trustee who isn't the grantor or a related or subordinate[11] trustee subservient to the grantor. This section appears to give sufficient flexibility to toggle grantor trust status on and off because it takes an affirmative act to trigger grantor trust status. Other grantor trust provisions require the retention of a power, which, once given up, may be hard to reclaim.

Section 675(3) raises further questions. One is what portion of a trust the grantor will be treated as owning. How is ownership calculated if the grantor doesn't borrow the whole trust? Further, which taxable year is the IRC referring to regarding repayment? *Bennett v. Commissioner*[12] holds that if less than all of the trust is borrowed, the grantor will only be taxable on a portion of the trust. The case sets forth a formula for calculating the portion of the trust the grantor will be deemed to own.[13] Revenue Ruling 86-82 makes it clear that if a loan is made in one year and repaid in the same year, the grantor is taxed on the income in that year. The grantor wouldn't be taxed in the next year because the loan



was repaid before the beginning of that taxable year, but the grantor is taxed for any year a loan is outstanding at any time.

Many clients have created spousal lifetime access trusts to remove assets from their taxable estates, enabling access to the assets by a beneficiary spouse. The spouse is often appointed as the trustee. The spouse's right to receive income creates a grantor trust if income can be distributed to the grantor's spouse without the approval or consent of an adverse party[14] or in the discretion of the grantor or a nonadverse party.[15] If paying taxes on the income and gains could become onerous or the grantor simply doesn't want to bear the tax on the income and gains of the trust, when drafting a trust including a borrowing provision, practitioners should consider including a reimbursement provision or the ability to appoint an independent trustee who can make distributions to the beneficiary spouse beyond the standard of health, education, maintenance and support so additional funds can be distributed from the trust to pay taxes.

Power to Control Enjoyment

Section 674(a) sets forth what appears to be a fairly simplistic rule. It generally provides that the grantor will be treated as the owner of any portion of a trust in which the grantor or nonadverse party has a power of disposition of corpus or income without the approval or consent of an adverse party. This power could create estate tax inclusion issues, so the power to make distributions is limited by a reasonably ascertainable standard set forth in the trust. Under Section 674(b)(5)(A), it seems clear that by limiting the power to make distributions to a reasonably definite standard, the trust won't be a grantor trust. Although this provision seems clear, this result gets murky if the regulations thereunder are considered. Treas. Regs. 1.674(b)-1(b)(5)(i) states:

> the entire context of a provision of a trust instrument granting a power must be considered in determining whether the power is limited by a reasonably definite standard. For example, if a trust instrument provides that the determination of the trustee shall be conclusive with respect to the exercise or nonexercise of a power, the power is not limited by a reasonably definite standard.

It's often assumed that if an independent trustee is acting, there are no concerns with causing grantor trust status under a power to control enjoyment. It isn't uncommon for an independent trustee to be appointed along with family members or trusted friends. A careful reading of Section 674(c) could cause issues with grantor trust status if family members and/or trusted friends are appointed with the independent trustee. The exception for an independent trustee only applies if no more than half of the trustees are related or subordinate parties who are subservient to the wishes of the grantor.

Power to Add Beneficiaries

The power to add beneficiaries can be used to create grantor trust status. This result isn't set forth as an affirmative power in the IRC but as an exception to other powers that avoid grantor trust status. Including a power to add beneficiaries negates exceptions to avoiding grantor trust status, resulting in grantor trust status.[16]

As can be seen, creating a grantor trust isn't completely straightforward. The terms of the whole trust need to be examined to ensure that the intended result, that is, grantor or non-grantor status, is achieved.

Endnotes

1. Internal Revenue Code Sections 671-679.
2. IRC Section 675(4)(C).
3. Sections 675(2) and (3).
4. IRC Sections 674(b)(5), (6) and (7), (c) and (d).
5. IRC Section 678.
6. IRC Section 401(a)(9)(H).
7. IRC Section 672(e).
8. Private Letter Ruling 201349001 (July 11, 2013).
9. Revenue Ruling 85-13.
10. Treasury Regulations Section 1.675-1(b)(2).
11. *See* Section 672(c) for a definition of related or subordinate.
12. *Bennett v. Commissioner*, 79 T.C. 470.
13. *Ibid.*, at pps. 484-485.
14. *See* Section 672(a) for a definition of adverse party.
15. *See* Section 672(b) for a definition of nonadverse party; IRC Sections 677(a)(1) and (2).
16. Sections 674(b)(5), (6) and (7), (c) and (d).