

Trusts Serving as Grantors to Other Trusts: Drafting Multi-Trust Structures for Beneficial Tax Results

Essential language in Grantor and Grantee Trusts

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TRUSTS SERVING AS GRANTORS TO OTHER TRUSTS: DRAFTING MULTI-TRUST STRUCTURES FOR BENEFICIAL TAX RESULTS

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Outline

- Grantor trust rules – §§ 671-679
- Options for structuring trust's taxpayer
 - Original grantor
 - Beneficiary (BDIT)
 - Trust (complex)
- Private Letter Ruling 201633021
- Impact and take aways from Private Letter Ruling

§ 671 – Income and Deductions Attributable to Grantor

- Grantor or another person is deemed owner of income, principal or both for federal income tax purposes.
- “Where it is specified in this subpart [grantor trust rules §§ 672-679] that the grantor or another person shall be treated as the owner of any portion of a trust, there shall then be included in computing the taxable income and credits of the grantor or the other person those items of income, deductions, and credits against tax of the trust which are attributable to that portion of the trust to the extent that such items would be taken into account under this chapter in computing taxable income or credits against the tax of an individual.”

§ 672 – Definitions and Rules

- Adverse party – 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.
- Related or subordinate:
 - Grantor's spouse;
 - Grantor's father, mother, issue, brother or sister; and
 - Employee of grantor (including of a corporation which grantor has voting control or is an executive).
- Grantor deemed to hold powers that spouse holds.

§ 672 – Definitions and Rules continued

- Grantor trust rules only apply if results in income being taxable to U.S. citizen or resident or domestic corporation.
- Exceptions to apply rules with foreign grantor:
 - Revocable trusts by the grantor alone (or with a related or subordinate party); or
 - During lifetime of grantor, income and principal distributable only to grantor or grantor's spouse.

§ 673 – Reversionary Interests

- Grantor treated as owner to any portion which there is a reversion and such reversion exceeds 5% of the value of the portion which such reversion is over.
- Reversion valued using section 7520 tables.
- Not often used because likely to be includable in estate.
- Reversion in trust for minor descendant not a grantor trust if effective prior to such beneficiary attaining age 21.

§ 674 – Power to Control Beneficial Enjoyment

- Grantor trust as to any portion of trust that grantor or nonadverse party (without consent of adverse party) can control disposition.
- There are 8 exceptions even when holding a power of disposition.
- Power to add beneficiary is often confused as a trigger unto itself for grantor trust status; however, it merely eliminates some of the exceptions to § 674.

§ 674 – Exceptions

- Exceptions regardless of who holds power:
 - Power to apply income to support dependent
 - Power commencing only after occurrence of an event
 - Power exercisable by Will
 - Power to allocated among charitable beneficiaries
 - Power limited by a reasonable definite standard*
 - Power to withhold income temporarily*
 - Power to withhold income for disabled beneficiary*
 - Power to allocate between principal and income

*Power to add beneficiary negates exception

§ 674 – Continued

- “Independent Trustee Exception” – power over principal and income held by trustees if no more than half related or subordinate to grantor, does not trigger grantor trust status.
- Exception for power to distribute income limited by reasonable standard.
- Power to add beneficiaries will negate both exceptions resulting in grantor trust status.

§ 674 – Continued

- Drafting language to add beneficiary:
 - “the trustee, in his sole discretion, may add **[do not use if trust owns insurance on spouse: any spouse of mine,]** any descendant of mine, the spouse of any such descendant or any charitable organization as a current or future beneficiary of such trust or any trust created thereunder, and determine the terms and conditions under which such person or charitable organization shall be a beneficiary; provided, however, that the trustee may not participate in any decision to add himself as a beneficiary of the trust.”
- Language can be expanded or limited for each client.

§ 675 – Administrative Powers

Summary

- Grantor trust status applies to any portion of a trust subject to a power or action described in § 675.
- 4 described powers or actions.
- Requiring approval or consent by another party may impact grantor trust status.

§ 675 – Less Than Adequate and Full Consideration

- A power to purchase, exchange, or otherwise deal with or dispose of trust property or income for less than fair market value creates grantor trust treatment.
- If the power is subject to the consent of an adverse party, it does not create grantor trust treatment.

§ 675 – Less than Adequate Interest or Security

- A power to borrow, directly or indirectly, without adequate interest or without adequate security, causes grantor trust treatment.
- Helpful exception: A general lending power to make loans to any person without regard to interest or security will not create grantor trust treatment, unless the grantor is also the trustee.

§ 675 – Actual Borrowing by the Grantor

- If the grantor or the grantor's spouse actually borrows property or income from a trust, the borrowed portion will receive grantor trust treatment until it is fully repaid, with any interest.
 - Applies to direct and indirect borrowing.
 - Eliminates deductions and recognition of interest associated with loans to a grantor.

§ 675 – Powers of Administration Exercisable by Nonfiduciary

- If a nonfiduciary may exercise one or more of certain powers of administration, without the consent of any fiduciary, the portion of the trust subject to such power will have grantor trust treatment.
- Powers that will cause grantor trust treatment:
 - Power to vote or direct the voting of closely-held stock;
 - Power to direct or veto investments if the trust is invested in one or more closely held corporations; and
 - **Power to reacquire the trust corpus by substituting property of an equivalent value.**

§ 675 – Drafting a Power to Reacquire Trust Property

- “The Settlor shall have the right at any time and from time to time, acting in a nonfiduciary capacity, without the approval or consent of any person, to acquire the assets of the trust by substituting property of equivalent value.”
- See also Rev. Rul. 2008-22 (excludable from estate) and Rev. Rul. 2011-28 (insurance) as safe harbors to follow.

§ 675 – Drafting a Power to Reacquire Trust Property: Additional Trust Terms to Consider

- Value the property as of the date of substitution.
- Give the Trustee authority to determine fair market value.
 - For example, value may be determined by appraisal or court approval.
 - Allow the trustee to decline to obtain an appraisal or court approval.
- Prohibit the Settlor from exercising the power in a way that could shift beneficial interests.
- Exclude voting stock in a controlled corporation, as defined in §2036(b).
- Prohibit assignment of the Settlor's power.
- Permit the Settlor to irrevocably release the power to toggle off grantor status.
- Consider giving a third party the authority to give a grantor trust power back to the Settlor, to toggle on grantor status.

§ 676 – Power to Revoke

- If the grantor or any non-adverse party (or both) has the power to revoke a trust or to revest the trust property in the grantor, grantor trust treatment applies.
- Exception: power subject to consent from an adverse party.
- Exception: power subject to a contingency that is remote enough to be a de minimis reversionary interest under 673.
 - But if the event occurs, grantor trust status will apply unless such power is released.

§ 677 – Income for the Grantor’s Benefit

- If income from any portion of a trust may applied in any one or more of the following ways without the approval or consent of an adverse party, that portion of the trust is subject to grantor trust treatment:
 - Distributed to the grantor or the grantor’s spouse.
 - Held or accumulated for future distribution to the grantor or the grantor’s spouse.
 - Premium payments on life insurance for which the grantor or the grantor’s spouse is settlor.
 - Applied or distributed to fulfill obligations of support owed by the grantor, but only to the extent actually applied or distributed, whether distributed from income or principal.

§ 678 – Beneficiary or Other Person as Grantor

- A person other than the settlor may be treated as grantor of any portion of a trust for which any one or more of the following is true:
 - Such person has a power exercisable solely by himself to vest the corpus or the income therefrom in himself.
 - Also known as a *Mallinckrodt* power.
 - The requirement of consent by any party, including a nonadverse party such as a trustee, prevents §678 grantor trust treatment.
 - Such person has previously partially released or otherwise modified such a power and after the release or modification retains such control as would, within the principles of sections 671-677, inclusive, create grantor trust treatment.

§ 678 – Traps for the Unwary

- *Crummey* releases in excess of 5% or \$5,000.
 - Even if the beneficiary is legally unable to exercise or release the power, it can cause § 678 grantor trust treatment.
- Trustee powers exercisable in favor of the trustee or the trustee's spouse.
- Trustee powers that may be applied to reduce a trustee's obligation of support owed to any individual.
- If any portion of a trust is taxed to the settlor as grantor under any of §§ 671-677, that portion of the trust will not be taxed to anyone else under § 678 as long as the original settlor is living. § 678(b).
 - Exception: payments actually made to relieve obligations of support.

§ 679 – Foreign Trusts

- Grantor trust status applies to foreign trust with U.S. grantor and U.S. beneficiaries.
- Foreign grantor becomes U.S. person within 5 years of transfer, grantor trust rules may apply.
- Domestic trust becomes a foreign trust, then this section applies on conversion date to determine grantor trust status.

Grantor Trust Triggers

- Often practitioners rely on only a handful of triggers.
- 4 of most common:
 - Spouse as trustee or beneficiary
 - Substitution power
 - Lending without adequate security
 - Ability to use income for insurance premiums
- May be harder to turn off grantor trust status then to turn on.

BDIT

- Beneficiary Defective Inheritor's Trust ("BDIT").
- § IRC 678 (a)(2) – such person has previously partially released or otherwise modified such a power and after the release or modification retains such control as would, within the principles of sections 671 to 677, inclusive, subject to grantor of a trust to treatment as the owner thereof.
- Benefits:
 - Beneficiary deemed as grantor
 - Grantor trust status last longer because younger generation is beneficiary
 - Beneficiary can make sales of assets without gain recognition and remove from estate (hypothetically)

BDIT – Concerns

- Issue with wording of “Partial”
- Seeding issue and 10% rule of thumb (9:1 ratio)
- Need for guarantor of note other than Settlor
- Illiquid asset miscalculation/audit might result in estate inclusion
- Uncertainties not known until death of client

Complex Trust

- A trust which can do any of the following: (1) accumulate income annually, (2) distribute corpus and (3) distribute to charity
- No grantor trust rules apply - must be sure to remove all triggers
- Trust is its own taxpayer and needs an EIN number
- All income taxes reportable on trust fiduciary return
 - Rates between 15% to 39.6%
 - Highest rate starts at any amount over \$12,500
- Distributable net income (DNI) rules apply
 - Usually capital gains not carried out

§ 678 in Multi-Trust Structures

- If a trustee of a trust uses trust property to fund a new trust, typically the grantor of the new trust is the same as the grantor of the old trust. Regs. § 1.671-2(e)(5).
 - Exception: if a person with a general power of appointment exercises that power in favor of another trust, then such person will be treated as grantor of the transferee trust. Regs. § 1.671-2(e)(5) and § 1.671-2(e)(6), Examples 8 and 9.

PLR 201633021: Facts

- Settlor created a trust for his descendants. During his lifetime, the trust was divided pursuant to court authority into separate trusts for each of Settlor's children. Each separate trust included decanting powers.
- Settlor has died. We presume that each separate trust has been a complex trust since Settlor's death or earlier.
- Proposed action: The trustees of a trust for one of Settlor's children ("Trust 1") propose forming and funding a new trust ("Trust 2"), with the same beneficiaries as Trust 1. Trust 1 will retain the power to revest the net income of Trust 2 for one calendar year after funding it, after which the power shall lapse. Income is defined in Trust 2 to include net capital gains.

PLR 201633021: IRS Analysis and Conclusion

- The IRS cites Regs. § 1.671-2(e)(5) and § 1.671-2(e)(6), Example 8 and confirms that “if a trust makes a gratuitous transfer of property to another trust, the grantor of the transferor trust generally will be treated as the grantor of the transferee trust.”
- However, the IRS also cites § 678(a) and concludes that Trust 1 is “a person other than the grantor” with a power exercisable solely by itself to vest the corpus or income of Trust 2 in itself.
- Further, the IRS concludes that the DNI of Trust 1 will be determined as it is calculated in Trust 2, so the net capital gains of Trust 2 will be carried out as DNI in both trusts.

Applying PLR 201633021: Net Capital Gains

- This nonbinding ruling indicates that a structure similar to that in PLR 201633021 may carry out net capital gains as income from a trust that, by its terms, applies net gains to principal.
- Note that other estate planning techniques are available to carry out net capital gains as income from trusts that do not currently have language expressly permitting such treatment. For example:
 - Amendment or reformation of the trust instrument to add language expressly permitting the allocation of net capital gains to income.
 - Actual annual distributions of all income, including net capital gains, combined with allocation of those gains as income in the trust accounting.
 - Distributing all trust property into a new trust that has the desired powers, through decanting or exercise of a power of appointment.

Applying PLR 201633021: Foreign Trusts

- This logic applied in this nonbinding ruling might also apply to give domestic status to a trust that would otherwise be foreign.
- Example: Trust 1, a domestic trust, decants a portion of its property to Trust 2, a new trust established in another country. Trust 1 retains the power to revoke Trust 2 and reconstitute all of Trust 2's assets in Trust 1.
- Avoid throwback rule and deemed transfer rule.

Other Possible Applications of PLR 201633021

- Any undesired tax consequence that could possibly be resolved through grantor trust treatment, or through rewording the administrative provisions of a trust, is a possible candidate for this structure.
- Splitting trusts into GST-exempt and non-exempt and having non-exempt trust pay taxes of GST-exempt trust.
- It should be noted that other cases have supported beneficiaries with this power as deemed owner of the trust. See *Campbell T.C. Memo 1979-495*.

Possible Drawbacks of PLR 201633021

- Taxpayers may not rely on PLRs issued to other taxpayers. Any taxpayer wishing to obtain this result should consider requesting a PLR.
- The IRS might change its position that a trust can be a “person” for § 678 purposes.
- Similar tax results may be achievable through methods that are more cost-effective and that provide greater certainty.
- It is unclear if trust was grantor trust or not and exactly when grantor died.

Thank You

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