When is a Non-Grantor Trust Preferable?

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Introduction

Grantor trusts became one of the most commonly used tools for estate tax planning beginning with the enactment of the Tax Reform Act of 1986 (P.L. 99–514), which substantially reduced the increases in federal income tax rates. Two major perceived benefits have been (1) to allow the trust to grow free of income taxes because the income of the trust is attributed to the grantor[1] and (2) the ability of the trust's grantor to sell appreciated assets to the trust without a gain or other income recognition in exchange for a note. This note typically has interest at the applicable federal rate, and this interest is not taxed as income. Instead, the position of the Treasury and the Internal Revenue Service (IRS) is that the grantor will continue to be treated as the owner of the trust assets for federal income tax purposes.[2]

Grantor trusts also offer other benefits. For instance, the grantor, or the grantor's spouse under Section 1041, can buy low basis assets from a grantor trust before death and achieve an automatic (commonly called a "tax-free") change in basis upon death. Moreover, a grantor trust whose grantor is a U.S. individual taxpayer is automatically a qualified S corporation shareholder.[3]

Uses of Non-Grantor Trusts in Income Tax Planning

The ability to divide or split income has long been used to reduce income taxes, largely on account of the progressive income tax rates. The benefits became readily apparent for couples in community property states.

The income, gift, and estate tax benefits for community property were so significant before the enactment of the Tax Revenue Act of 1948 (P.L. 80-471)[4] that, after the Supreme Court ruled that each spouse could report one-half of their community property income,[5] virtually all states considered changing their historic marital property regimes to community property ones. Some actually did so[6] to permit a second "run up" of the increasing income tax brackets and a second personal exemption. Attributing one-half of the gifts of community property to each spouse meant a second run up of gift tax brackets, for gifts as well as a second annual exclusion, and a second lifetime gift tax exemption. When one spouse dies, only one-half of the community property is included in his or her estate, again providing an opportunity for a second run up in the estate tax brackets, a second estate tax exemption, and the postponement of half of what the tax would have been if the assets did not consist of community property.

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By allowing joint income tax returns, gift splitting, and a 50% marital deduction that now may be 100% for non-community property transferred to the surviving spouse, Congress intended to put non-community property married couples on par with those in community property states.[7]

Trusts provide another opportunity to reduce income taxes by shifting income to others. Indeed, this can be so effective that the gift tax was retained to thwart shifting income-producing assets to others, such as a property owner's child. Although the anticipatory assignment of income doctrine blocks attempts to assign compensation income or to have the income earned on property prior to the transfer of the property to another person,[8] opportunities to shift income to others have for decades been a key method of reducing income taxes.

The opportunities to use trusts as separate and independent income taxpayers to achieve an overall reduction in income taxes became so prevalent that, in order to stop this use, the Treasury issued regulations which were essentially adopted by Congress in the Internal Revenue Act of 1954.[9] The result was the enactment of the "grantor trust" rules, which are set forth in subpart E of part 1 of subchapter J of chapter 1 of subtitle A of the Code. To the extent the rules apply, they can cause the income, deductions, and credits against taxes to be

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attributed pursuant to Section 671 to the person who is regarded as the owner of the trust.

Indeed, the grantor trust rules were so effective that such trusts were commonly labelled as defective by practitioners. However, as explained above, they can now be a very effective tool in estate tax planning. Nonetheless, as explained below, non-grantor trusts may be preferable in some cases.

Income Taxation of Trusts

The basic rules of the federal income taxation of estates, trusts, and their beneficiaries has remained relatively constant since the enactment of the Internal Revenue Act of 1954 (P.L. 83–591).

Until the effective date of the enactment of the Tax Reform Act of 1986, estates and non-grantor trusts were taxed at the same rates as married persons filing separately. Since 1986, they have faced very compressed rates, reaching the top (currently 37%) bracket for taxable income above $12,950 (for 2020 and inflation adjusted for later years). This effectively eliminates the benefits of using a decedent's estate or a non-grantor trust as a separate taxpayer for most income tax purposes.

Other steps have also been taken to eliminate or at least reduce the ability to use a trust as a separate income taxpayer. One is the grantor trust rules mentioned above. Another is the so-called multiple trust rule of Section 643(f). This rule causes more than one trust to be treated as one if, among other conditions, the principal purpose of forming such a trust is the avoidance of income taxes.[10]

Certain Attributes of a Non-Grantor Trust

Section 267(b) delineates relationships that are defined as "related parties." With regard to any trust, the following persons are defined as related-parties:

1. The grantor and any fiduciary of the trust.[11]
2. If the same person is a grantor of multiple trusts, the fiduciaries of the trusts are related parties.[12]
3. Any fiduciary of a trust and any beneficiary of that trust are related parties.[13]
4. If the same person is the grantor of multiple trusts, then the fiduciary of one trust and any beneficiary of another trust are related parties.[14]
5. if a trust owns more than 50% (in value) of a corporation's stock, the fiduciary of the trust and the corporation are related parties.[15]

However, despite the relationship between a grantor and the fiduciary of a trust under 267(b)(4), ordinary income is not triggered under IRC 1239 on a sale between the grantor and the non-grantor trust nor is use of the installment method denied under IRC 453(g). A properly drafted non-grantor trust will not retain any of the "grantor-trust" attributes of IRC Sections 671 through 679. The non-grantor trust is its own taxable entity, of which the grantor has no beneficial interest or control. The trustee has to have complete administrative control over the trust. All beneficial interest has to be relinquished by the grantor.

In addition to the relinquishment of beneficial interest, the grantor of a non-grantor trust relinquishes all rights to modify, amend, revoke, or terminate the trust and all rights to principal, income, and possession and enjoyment of trust property. As a result, there can be no attribution between the grantor and the trust.

Next, under IRC § 318(a)(2)(B)(ii) stock interests held in a non-grantor trust are not attributed to the grantor. Under that section, stock owned, directly or indirectly, by or for any portion of a grantor-trust, shall be considered as owned by such a person. Essentially, stock

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A grantor is the taxpayer for the grantor trust, whereas the non-grantor trust is a separate tax entity from the grantor and therefore a non-related party under IRC 318(a)(2)(B)(ii). None of the "grantor-trust" attributes of IRC Sections 671 through 679 are present with a properly drafted non-grantor trust.

Section 1239(a) dictates that, in the case of a sale or exchange of property between related persons, any gain recognized to the transferor shall be treated as ordinary income if such property is, in the hands of the transferee, of a character that is subject to the allowance for depreciation provided in Section 167. Section 1239 contains its own definition of related persons, but it also borrows the constructive ownership rules of Section 267(c). Under the 1239(b) a grantor of a non-grantor trust and the trust are determined to be unrelated parties.

Pursuant to section 1239(b), persons are considered to be related if any one of the following relationships exists:

1. A person and all entities that are controlled entities with respect to such a person.
2. A taxpayer and any trust in which such a taxpayer (or his/her spouse) is a beneficiary, unless such a beneficiary's interest in the trust is a remote contingent interest.
3. Except in the case of a sale or exchange in satisfaction of a pecuniary bequest, an executor of an estate and a beneficiary of such an estate.

As stated above, the grantors of a non-grantor trust have no beneficial interest in the trust, thereby voiding any implication the grantor is related to the trust under 1239(b)(2). As for 1239(b)(3), the subdivision is irrelevant as the grantor is still alive. Therefore, no executor exists for the grantor's estate and there is no transfer or sale between an executor of the grantor's estate and a beneficiary of the estate.

Turning back to 1239(b)(1), a person and all entities that are "controlled entities" of such a person are deemed to be related parties. Section 1239(c)(1) defines "controlled entities" as follows:

1. A corporation more than 50 percent of the outstanding value of the outstanding stock of which is owned (directly or indirectly) by such person;
2. A partnership more than 50 percent of the capital interest or profits interest in which is owned (directly or indirectly) by such person; and
3. Any entity which is a related person to such person under paragraph (3),[16] (10),[17] (11),[18] or (12)[19] or Section 267(b).

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Non-grantor trusts do not fit into any of the "controlled entity" definitions under 1239(c)(1) and no related-party exists under IRC 1239(b)(1). Further, as IRC 453(g)(1) borrows IRC 1239(b)(1)'s definition of a related-party, the installment method is available on sales between a grantor and a non-grantor trust.

Some Benefits of Non-Grantor Trusts

Despite the potential estate planning benefits of grantor trusts, non-grantor trusts may produce a better result in some situations. For example, if the grantor pays income taxes on the taxable income of a trust under the grantor trust rules, this will cause the assets of the trust to build free of income tax. But the grantor may be in a higher effective income tax bracket than the trust or the trust beneficiaries.

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How important this can be is not always easy to figure out. For example, if the grantor pays state income tax, then that tax payment reduces the grantor's taxable estate, which has the effect of reducing the overall cost of the income tax.

Of course, it is impossible (or at least almost impossible) to determine what the tax laws and rates will be in the future. Avoiding tax today falls under the wise old accountant's adage "A tax dollar delayed may never be paid." Hence, if the state income tax is significant (as it is now in states such as California, New Jersey, New York, and Oregon, among others, especially in light of the annual $10,000 state and local tax deduction limitation through 2025), avoiding state income taxes will probably seem the best choice.

Although it may be relatively easy for a taxpayer who resides in a high income tax state to avoid non-source state income tax by using a non-grantor trust, the trust will face the very compressed rates. Nonetheless, the trust can avoid that tax by distributing its distributable net income (DNI) defined in Section 643(a) to its beneficiaries who are in lower tax brackets than either the trust or the grantor. Flexibility can be significant when there are several discretionary beneficiaries (to whom DNI may be distributed). The trustee can even wait until 65 days after the close of the year to determine whom to make distributions to allocate DNI to the lowest income taxed persons.

Normally, in order to create a non-grantor trust, any contribution to the trust must be complete for federal gift tax purposes.[20] However, certain retained powers or interests necessary to prevent the transfer from being completed usually cause the trust to be a grantor trust under Section 674 or another section. So, the cost in using a non-grantor trust is typically a gift tax or use of a gift tax exemption or exclusion. However, the IRS has consistently ruled that one may create a trust that allows for incomplete transfers (so no gift tax is due and no exclusions or exemptions are used), but it is still a non-grantor trust. The IRS has issued dozens of such rulings, and its reasoning for its conclusions seems sound.[21]

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Having a trust be a non-grantor trust permits its income to be taxed to any beneficiary, including an individual in a low tax bracket. Moreover, it may permit capital gains to be distributed and reported by an individual beneficiary who has otherwise unused capital losses.

With a grantor trust, the installment sale of appreciating assets to the trust can be very effective in estate planning, especially in periods of extremely low applicable federal rates. However, there may be situations in which it is preferable for the sale to be deemed a sale in order to receive a Section 754 step-up in basis.

In the real world, using a grantor trust, as opposed to a non-grantor trust, may cause unexpected problems for the grantor. In at least one unreported case, a man was found guilty of bankruptcy fraud because he failed to list with his assets those in a grantor trust he created. His failure to disclose those assets, even though the grantor trust was for his daughters, caused the jury to find him guilty of fraud.

Also, when setting alimony or child support, courts traditionally consider the spouses' or parents' income. In more than one case, the court rejected excluding income from a grantor trust, even though the grantor had no entitlement to that income.

And in yet another case, a grantor who became overburdened by the payment of tax on a grantor trust sought relief by petitioning for the inclusion of a tax reimbursement clause in an existing irrevocable trust. The court denied the request for relief finding that the grantor had no standing to petition for a variance.[22] In response, some states have amended their state laws to provide that any grantor trust automatically grants the trustee discretion to

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reimburse the grantor for the payment of income taxes on the trust's assets.[23]

Building in Toggling

As just demonstrated, in some situations, it will be best for a trust not to be a grantor trust. In others, grantor trust status is desirable, for tax or other reasons. Hence, it is appropriate to consider structuring a trust so the best tax status can be obtained. In other words, it may be best to build in a mechanism to toggle grantor trust status off or on. This usually will not be a problem. However, the IRS issued Notice 2007-73 in which it stated that the Internal Revenue Service and the Treasury Department are aware of a type of transaction, described below, that uses a grantor trust and the purported termination and subsequent re-creation of the trust's grantor trust status. Why? *For the purpose of allowing the grantor to claim a tax loss greater than any actual economic loss* sustained by the taxpayer or to avoid inappropriately the recognition of gain and labelled it a transaction of interest.

But just turning grantor trust status off and on does not seem to present such a problem, although depending on the toggling mechanism, it may be advisable to include express fiduciary authority to consider the interests of the grantor in removing grantor trust attracting powers. Of course, changing the status of a trust can have tax consequences. See, e.g., Rev. Rul. 77-402, 1977-2 C.B. 222.

Summary and Conclusions

The status of a trust can be important in providing opportunities to reduce income, estate, and gift taxes. Although many start with a premise that all (or almost all) lifetime trusts should be grantor ones, there are some cases where non-grantor status will be preferred. In any case, building in one or more mechanisms to change the status of a trust is important to consider.

NOTE: *Many of the options that are touched on in this article are quite complex in nature and should be executed under the guidance of a skilled advisor. The brief general statements here cannot cover the many complexities of this subject. This information is not legal or tax advice and may not be relied upon as such. Every situation is unique, and individuals should consult with competent legal counsel for specific advice.*

Endnotes

1 Income tax-free compounding is, perhaps, the most important factor in building wealth. See, e.g., Glickman & Blattmachr, "High Returns and Tax-Free Compounding: Keys to Building Wealth," 46 Estate Planning 11 (May 2016). In PLR 9444033 (not precedent), the IRS claimed the grantor would be making a gift to the trust by reporting and paying income taxes on the income imputed to the grantor under Section 671 of the Code. That position was renounced in Rev. Rul. 2004-64, IRB 2004-27. Throughout this article, "Section" refers to one in the Internal Revenue Code of 1986, as amended.

2 Rev. Rul. 85-13. 1985-1 CB 184; Treas. Reg. 1.1001-2(c) Example 5. The concept of selling assets to a grantor trust in exchange for a note was apparently first discussed in Blattmachr, "Adventures in Partial Interest Transfers: Avoiding the Legacy of Zero Valuation Under Section 2702," 45 Major Tax Plan—University of Southern California's Annual Institute of Federal Taxation (1993) at 1304.5G. *See Petter v. Commissioner*, 653 F 3d 1012 (9th Cir. 2011).

3 Section 1361(c)(2)(A)(i).

4 For a discussion of the 1948 Act, see Surrey, "Federal Taxation of the Family: The Revenue Act of 1948," 61 Harvard Law Review 1097 (July 1948).

5 *Poe v. Seaborn*, 282 U.S. 101 (1930).

6 See discussion in https://en.wikipedia.org/wiki/Poe_v._Seaborn.

7 One remaining and significant advantage of community property is the automatic change in income tax basis pursuant to Section 1014(b)(6) for the surviving spouse's half of community property when the first spouse dies.

8 Lucas v. Earl, 281 U.S. 111 (1930).

9 See discussion in Blattmachr & Boyle, "Income Taxation of Estates and Trusts" (PLI 17th Ed. 2019) at

10 See, e.g., discussion in Blattmachr, Shenkman, & Gans, "Use Trusts to Bypass Limit on State and Local Tax Deduction." 45 Estate Planning 3 (April 2018).

11 IRC § 267(b)(4). As analyzed above, a non-grantor trust for income tax purposes is an entity separate and apart from the Taxpayer. *Cf.* Chief Counsel Advisory 201343021, wherein a grantor- trust was deemed related for purposes of Section 267—facts that are inapplicable in the instant matter.

12 IRC § 267(b)(5).

13 IRC § 267(b)(6).

14 IRC § 267(b)(7).

15 IRC § 267(b)(8).

16 Two corporations that are members of the same controlled group are deemed related parties under 267(b)(3).

17 Under 267(b)(10), related parties include: A corporation and a partnership if the same persons own a) more than 50% in value of the outstanding stock of the corporation and b) more than 50% of the capital interest, or the profits interest, in the partnership.

18 Under 267(b)(11), an S corporation and another S corporation if the same persons own more than 50% in value of the outstanding stock of each corporation.

19 Under 267(b)(12), an S corporation and a C corporation, if the same persons own more than 50% in the value of the outstanding stock of each corporation.

20 See Reg. 25.2511-2 for a determination of when a gift is complete.

21 See Lipkind, Shenkman, & Blattmachr, "How ING Trusts Can Offset Adverse Effects of Tax Law; Part 1," 157 Trusts & Estates 16 (Sept 2018); "How ING Trusts Can Offset Adverse Effects of Tax Law; Part 2," 157 Trusts & Estates 29 (Nov 2018).

22 *Millstein v. Millstein*, 2018 WL 3005347 (Oh. App. 8th Dist. June 14, 2018).

23 See https://www.wealthmanagement.com/estate-planning/where-are-all-grantor-trust-reimbursement-statutes.