The Expanded Role Of (Defective) Grantor Trusts

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A. Introduction: The “Defective” Grantor Trust

1. The grantor trust income tax rules provide that a person who makes a gratuitous transfer to a trust will be deemed to own the items of the trust’s ordinary income and realized gains if the person retains certain powers and rights over the trust property. See generally IRC §671. Many of these powers and rights, however, would make the gift incomplete for gift tax purposes or would cause inclusion in the transferor’s gross estate under IRC §§2036 and 2038, including:
   a. A reversion. IRC §673.
   b. A retained right to income. IRC §677.
   c. A power to revoke the trust. IRC §676.
   d. The grantor’s power to distribute income and principal based on a standard other than a “reasonably definite standard.” IRC §674.

2. On the other hand, the grantor trust rules also confer grantor trust status for certain powers and features retained by a transferor that do not trigger estate tax inclusion or an incomplete gift.
a. A trust will be a grantor trust when a nonadverse party who acts as trustee can make distributions to the trust beneficiaries pursuant to a standard that is not a “reasonably definite standard.” See generally IRC §674(a). Sections 674(b)(5)(A) and 674(d) do not allow grantor trust treatment when the trustee’s distribution powers are limited by a reasonably definite standard. A reasonably definite standard is similar to an ascertainable standard under IRC §2041, but not identical. Furthermore, IRC §674(c) generally precludes grantor trust status when the trustee of such a discretionary trust is not related to or subordinate to the grantor within the meaning of IRC §672(c). Thus, IRC §674 establishes only a limited opportunity for grantor trust status based on the identity of the trustee.

b. A trust will be a grantor trust if the trustee can make loans to the grantor without adequate security. IRC §675(2). For a trust to be a grantor trust under this rule, the trust instrument must either give the trustee specific authority to make such a loan or the trustee must in fact make such a loan.

c. Grantor trust treatment also occurs when the trust instrument permits the grantor or any other person acting in a nonfiduciary capacity to reacquire corpus of the trust by substituting assets of equivalent value. IRC §675(4)(C).

d. Congress accorded grantor trust status to a trust of which the trustee has the power to distribute income to the grantor’s spouse. IRC §677(a)(2).

e. Finally, a discretionary trust will be a grantor trust when an independent trustee can add beneficiaries to the trust. IRC §674.

3. Grantor trusts have another advantage in that under current law, transactions between the grantor and the trust are not recognized for income tax purposes. Thus, a grantor can sell appreciated assets to a grantor trust and not realize any gain on the sale. See Rev. Rul. 85-13, 1985-1 C.B. 184. Accordingly, a grantor trust provides a current benefit—a tax-free environment for its initial assets—but also possible future benefits.

B. Grantor Trusts: The New Pink

1 EGTRRA And The Gift Tax

a. In May 2001 Congress passed the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), which President Bush signed on June 7, 2001. At first glance, this legislation appeared to promise significant tax relief. Congress projected the legislation would reduce taxes by $1.35 trillion over 10 years, which would make it the most significant tax act since the 1981 Economic Recovery Tax Act. One particular feature of EGTRRA that many politicians and the media touted was the repeal of the “death tax.”

b. Although many of the legislative proposals would have repealed both the estate and gift tax, Congress decided to repeal only the federal estate tax. Congress concluded that repealing both the federal gift tax and the federal estate tax would cause too great a revenue loss, due primarily to perceived income tax avoidance opportunities that would result from a repeal of the gift tax.
c. Congress did increase the gift tax applicable exclusion amount to $1 million as of January 1, 2002. Under pre-EGTRRA law, the gift tax applicable exclusion amount was scheduled to reach $1 million on January 1, 2006. The highest gift tax rates now are as follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>Highest Gift Tax Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>2007</td>
<td>45%</td>
</tr>
<tr>
<td>2008</td>
<td>45%</td>
</tr>
<tr>
<td>2009</td>
<td>45%</td>
</tr>
</tbody>
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i. In 2010, when the estate tax is repealed, the top gift tax rate will be the same as the top marginal federal income tax rate, which is scheduled to be 35 percent under EGTRRA. On January 1, 2011, unless Congress passes contrary legislation, the top gift tax rate will return to 55 percent. The gift tax applicable exclusion amount will be $1 million at that time.

d. Congress has struggled to resolve the uncertainties it wrought with EGTRRA. The House has regularly voted for the permanent repeal of the estate tax. As recently as June 8, 2006, however, the Republicans in the Senate failed in their attempt to pass a procedural motion that would have allowed for the passage of permanent repeal of the estate tax. The vote was 57 to 41 in favor of the motion, three votes shy of the 60 votes required to pass the motion. Press reports continually speculate that the Senate will compromise on a permanent or phased-in reduction in rates and a permanent or phased-in increase in exemptions. For example, Tax Analysts reported on its “TaxWire” website on June 13, 2006, that the latest proposal from certain advocates of repeal was for a $5 million per person estate tax applicable exclusion amount and rates of 15 percent and 30 percent, with the 30 percent rate kicking in at $30 million. On June 15, 2006, however, Tax Analysts on its TaxWire website reported that Democrats’ “strong feelings” about the estate tax could prevent any action until after the July 4 recess. But on June 22, 2006, the House of Representatives passed H.R. 5638, the “Permanent Estate Tax Relief Act of 2006.” The legislation would raise both the estate and gift tax applicable exclusion amount to $5 million and have two rates based on the capital gains tax rates. The Senate placed the bill on its calendar on June 23, 2006, but has taken no further action on it. An attempt by Senate backers of estate tax repeal to tie repeal to an increase in the minimum wage failed in early August 2006. The 2006 election, which handed control of Congress to the Democrats, further complicated the prospects of estate and gift tax reform.

2. **Why Grantor Trusts Are The New Pink**

   a. Before EGTRRA, clients would often pay gift tax on lifetime wealth transfers because of the unified nature of the federal estate tax and the federal gift tax. Uncertainty as to the future of the estate tax, however, has made most clients skittish about paying gift tax.

   b. Clients with large estates are now generally reluctant to pay federal gift tax in light of the remote possibility of a repeal of the federal estate tax. Who wants to be the sucker who paid a gift tax when there would be no tax in the event of repeal of the federal estate tax?

   c. Clients with modest estates are also reluctant to pay federal gift tax because of the larger estate tax applicable exclusion amount; the payment of federal gift tax could cause a loss of the benefit of the
federal estate tax applicable exclusion amount if the client’s taxable estate is less than the client’s estate tax applicable exclusion amount. Furthermore, if Congress actually increases the gift tax applicable exclusion amount, as the House did in its 2006 estate tax legislation (H.R. 5638), clients with modest estates who paid gift tax will feel like chumps.

d. The uncertainty about the long-term status of the federal gift tax and estate tax will not stop clients’ generous impulses and financial reasons for making gifts. Instead, clients are now looking for ways to transfer wealth during their lifetime without paying gift tax.

e. An intentional or “defective” grantor trust is one of the best ways to make a lifetime gift without the payment of gift tax. A client can make a completed gift for gift tax and estate tax purposes to a grantor trust. This combination can enhance the benefit of the client’s taxable gift to the trust. The trust—the assets of which will not be included in the settlor’s gross estate—can grow in a tax-free environment during the settlor’s lifetime by the settlor’s payment of the income tax without a resulting gift tax. Under current law the grantor’s payment of income tax generally is not a taxable gift, regardless of whether the trust assets are includable or not includable in the settlor’s estate. See Rev. Rul. 2004-64, 2004-2 C.B. 7.

f. This outline addresses the ways in which clients can use grantor trusts to make tax-free lifetime gifts, which is a significant benefit in light of clients’ unwillingness to pay gift tax. A precondition to using a grantor trust to make tax-free gifts is, of course, having a grantor trust to use. A client can make lifetime gifts to new grantor trusts and go from there, though as discussed above a client will probably not want to incur gift tax to create such a trust. Thus, the upper limit of a gift to such a trust may be $1 million per client. The client, however, may have previously established a non-grantor trust. As discussed below, it may be possible to convert that trust from a nongrantor trust to a grantor trust to allow the client to take advantage of the tax-free gifts possible with grantor trusts.

C. Turning Grantor Trust Status On And Off

1. Introduction

   a. Clients who create a new grantor trust may flinch at the thought of having to pay income tax on a grantor trust’s income and gains on a continuous basis. For instance, a client may worry that a trustee will choose to sell highly appreciated assets in a particular year, thereby generating a large capital gain tax liability for the grantor.

   b. Conversely, a client may want to convert an existing nongrantor trust to a grantor trust so that the client can pay income tax on the trust’s income, thereby making tax-free gifts.

   c. A trust instrument may contain several mechanisms that allow grantor trust status to be turned off (and perhaps turned on again). Some of the more exotic ways to turn grantor trust status on and off, such as by adding beneficiaries, must be written in to the trust instrument. There are a few ways, however, to turn on grantor trust status even if toggling of this kind was not anticipated. This part of the outline addresses some of these ways to “toggle” a trust’s income tax status.

2. Change Trustee To A Related Or Subordinate Party