A Discussion of
Intentionally Defective Grantor Trusts

Presented and Written by:

Philip M. Lindquist
phil@le-llp.com

Lindquist Eisenberg LLP
5700 Plano Parkway
Suite 3400
Plano, Texas 75093
Tel. (469) 917-5975

ESTATE PLANNING COUNCIL OF NORTH TEXAS

September 15, 2021

This outline was derived from an outline written by Lora G. Davis and Judith K. Tobey. It is with appreciation that their contribution is acknowledged.

NOTE: This paper is to be used for educational purposes only and is not to be construed as the rendering of legal advice.

TABLE OF CONTENTS

I. General Overview

When a grantor irrevocably delivers property to a trustee to be held, administered and disposed of by the trustee for the benefit of certain beneficiaries, the grantor generally intends to transfer the property, along with all of its associated benefits and responsibilities, to the trustee. These associated responsibilities generally include the responsibility for paying taxes on the income generated by the trust property. The trust is usually established as a separate taxpayer with its own taxpayer identification number and becomes subject to a compressed schedule of income tax rates. The trustee is then responsible for using trust property to pay any taxes associated with income generated by the trust property.

Top marginal bracket taxpayers realized that they could save income taxes by putting income-producing assets in a trust. This is because each trust has its own set of income tax brackets, yielding a tax savings over the income taxes that would have been paid at the grantor's top marginal income tax rate. This then led to a protracted series of cases and legislative responses as to when a trust should be respected as a separate taxpayer and when the trust's income should be included by the grantor in his income tax return. Eventually, the grantor trust rules came to be relatively stable, and tax planners knew what they had to do to avoid having the income of the trusts they drafted included on the income tax returns of their clients (who were often top marginal bracket taxpayers).

More recently the income tax brackets were narrowed to the point that there was little income tax benefit to be gained by shifting income from a top-bracket taxpayer to a trust. However, tax advisors came to realize that grantor trusts could be used to provide other tax benefits to their clients.

A Grantor, or a person affiliated with the grantor, can intentionally retain certain powers with respect to the property transferred to the trust. In that case, the grantor will be treated as the owner of the trust property for federal income tax purposes. The trust will not be an independent taxpayer for income tax purposes, but rather, the grantor will report items of income, deduction and credit associated with the trust property on his or her own individual income tax return. Importantly, the separate identity of the trust will be ignored only for income tax purposes; it will not be ignored for transfer tax purposes. This type of trust is called a "grantor trust," and this paper will explore the various ways in which a grantor may intentionally cause or avoid grantor trust status.

The rules governing the determination of grantor trust status are contained in Sections 671 through 679 of the Internal Revenue Code (§§ 671-679)[1]. Section 671 states the general proposition that if the grantor is treated as the owner of trust property under Sections 672 through 679, then he or she should include the trust's items of income, deduction and credit in computing his or her taxable income and credits. From the words of the statute, it is not clear that a grantor trust is treated as being but one and the same as the grantor, but that is the longstanding position of the Internal Revenue Service, as set forth in Rev. Rul. 85-13, 1985-1 C.B. 184, and that

[1] Unless otherwise indicated, all Section ("§") references are to the Internal Revenue Code of 1986, as amended (the "Code"), and all Regulation Section ("Reg. §") references are to the Treasury Regulations promulgated thereunder.

position is not seriously questioned. Treating a grantor trust and the grantor as being the same person for income tax purposes (while the distinction is recognized for state law and transfer tax purposes) is why grantor trusts are often so useful in tax planning.

Section 672 provides some definitions and ground rules that apply to the remaining seven sections of the subpart. Finally, Sections 673 through 679 describe various powers and controls that if retained by the grantor, an affiliated party, and sometimes even an unrelated party, will cause the trust to be a grantor trust for federal income tax purposes. These powers and controls include the right to a reversionary interest in the trust property (Section 673), the power to control beneficial enjoyment of the trust property (Section 674), various administrative powers with respect to the trust property (Section 675), the power to revoke the trust (Section 676), and the right to income generated by the trust property (Section 677).

There are many different reasons why a grantor may chose to create a grantor trust, as well as some more obvious reasons why a grantor might want to avoid grantor trust status. In particular, grantor trusts can be very powerful vehicles for estate planning and wealth transfer for a variety of reasons that will be explored in more detail below. As a summary, grantor trust status may be desirable because: (1) the grantor's payment of income taxes on trust property is a "gift" that is not taxed by the federal transfer tax system; (2) transactions between the grantor and the grantor trust are ignored for federal income tax purposes (such as sales between the grantor and the trust and transactions between different trusts with the same grantor); (3) the grantor may use the trust losses against his or her personal income; (4) a grantor trust may be an eligible shareholder of a subchapter-S corporation; and (5) a grantor trust can take advantage of the less compressed income tax rates that apply to individuals without having to make distributions of trust property to the individual trust beneficiaries.

Of course, grantor trust status is not for everyone. The most obvious drawback to grantor trust status is the possibility that the grantor will owe taxes on trust income and not have the cash to cover the expense. The trust will probably be structured to prohibit distributions of trust property to the grantor, and a provision requiring the trustee to use trust property to reimburse the grantor for income taxes paid on trust income will result in the inclusion of the entire trust corpus (or, even if the IRS is wrong, at least a part thereof) in the grantor's estate for federal estate tax purposes under Section 2036(a)(1). *See* Rev. Rul. 2004-64, 2004-2 C.B. 7. If the terms of the trust agreement permit, but do not require, the trustee to reimburse the grantor for income taxes paid on trust income, this will not, by itself, cause the trust property to be included in the grantor's estate; however, under the laws of most states, the trust property will be included in the grantor's estate because of the rights of the grantor's creditors. Rev. Rul. 2004-64, 2004-2 C.B. 7. Another possible solution to the potential cash flow problem might be a properly structured loan from the trustee to the grantor.

In addition to the potential cash flow problem, there is also a possibility in some circumstances that the grantor's payment of income taxes will be treated as a gift for federal gift taxes purposes. For example, if state law or the trust agreement requires the trustee to reimburse the grantor for his or her payment of the trust's income taxes, and the trustee fails to reimburse the grantor, then the grantor will be deemed to have made a gift to the trust of the amount of the taxes that should have been reimbursed. *See generally* Rev. Rul. 2004-64, 2004-2 C.B. 7.

In summary, there are many good reasons to create a trust that will be treated as a grantor trust for federal income tax purposes, and there are also good reasons to avoid grantor trust status. The key, as with all of life's endeavors, is to know what you are getting into. Unlike many of life's other endeavors, the rules relating to grantor trust status are finite.

II. Definitions and Rules

The first step in determining whether an existing trust is a grantor trust or how you should structure a new trust to avoid or obtain grantor trust status is to be familiar with the definition of four key terms found in Section 672.

A. Adverse Party.

When the grantor creates a trust and retains certain powers with respect to the trust property (such as the right to revoke the trust and take ownership of the trust property), the trust will be treated as a grantor trust. § 676(a). However, if the grantor may exercise this power only with the approval of an adverse party, then the trust may not be treated as a grantor trust. *See* Reg § 1.676(a)-1. An adverse party is "any person having a substantial beneficial interest in the trust which would be adversely affected by the exercise or non-exercise 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." § 672(a).

In order to determine if a potentially adverse party has an interest that is a "substantial beneficial interest," you must compare the value of the party's interest to the total value of the property subject to the party's power. If the value of the interest is not insignificant when compared to the total value of the property subject to the party's power, then the interest is a "substantial beneficial interest." Reg. § 1.672(a)-1(a). Once you have determined that the party has a substantial beneficial interest in the trust, you must consider whether that interest would be "adversely affected" by the exercise or non-exercise of his power over the trust.

B. Nonadverse Party.

The good news is that once you have determined who the adverse parties are, it is easy to figure out who the nonadverse parties are. They are everyone else. § 672(b).

C. Related or Subordinate Party.

When a grantor establishes an irrevocable trust, he or she should be very careful and deliberate (i) in selecting the individuals or institutions appointed to serve as trustee and successor trustee and (ii) in granting the trustee discretion and authority to distribute the trust property. For example, if the grantor or a nonadverse party is serving as trustee, the trust may be treated as a grantor trust if the trustee has certain powers to control the beneficial enjoyment of the trust property. *See* § 674(a). However, if a person who is not a grantor and who is neither related nor subordinate to the grantor is serving as trustee instead, many of those same powers to control the beneficial enjoyment of the trust property will not cause the trust to be treated as a grantor trust. *See* § 674(c). As a second example, if the grantor borrows money from the trust and has not completely repaid the loan before the beginning of the next taxable year, the trust will be treated as a grantor trust. *See* § 675(3). However, there is one exception to this rule: if the trustee who made the loan to the grantor charged adequate interest, required adequate security, and was neither the grantor nor related or subordinate to the grantor, then the loan will not cause the trust to be treated as a grantor trust. § 675(3).

A related or subordinate party is "any nonadverse party who is – (1) the grantor's spouse if living with the grantor; [or] (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; a subordinate employee of a corporation in which the grantor is an executive." § 672(c). For purposes of Sections 672(c), 674(c) and 675(3), a "related or subordinate" party is presumed to be subservient to the grantor's wishes with respect to the exercise or nonexercise of the powers conferred upon him or her unless the contrary is shown by a preponderance of evidence. Reg. § 1.672(c)-1.

D. Spouse.

For purposes of the grantor trust rules, the grantor will be treated as holding any power or interest that is held by his or her spouse. § 672(e). The grantor's "spouse" is defined in Section 672(e)(1) to include: "(A) any individual who was the spouse of the grantor at the time of the creation of such power or interest, or (B) any individual who became the spouse of the grantor after the creation of such power or interest, but only with respect to periods after such individual became the spouse of the grantor." For purposes of determining the identity of the grantor's spouse, an individual who was legally separated from the grantor under a divorce decree or separate maintenance decree at the time the power or interest was created will not be considered a spouse of the grantor. § 672(e)(2).

III. Grantor Trust Status

To determine if you have a grantor trust for income tax purposes, you look to Sections 673 through 679. Whether you are intentionally creating a grantor trust or you want to avoid grantor trust status, it is important to review each Code section to determine if you have a grantor trust under the terms of the trust instrument.

In general, each Code section first sets out the power that results in grantor trust status, then lists the exceptions to this general rule. Following is a brief summary of the provisions of these Code sections.

A. IRC § 673 – Reversionary Interests.

(1) General Rule. A trust will be considered a grantor trust if the value of the retained interest (whether that interest is a reversionary interest in the principal or interest) exceeds five percent of the value of the trust property. However, a grantor can be treated as the owner of only a portion of a trust. Although a retained interest may not be sufficient to make the entire trust a grantor trust under Section 673, under Section 677, the grantor will be subject to taxation on the portion he or she retains, such as a remainder interest.

The value of the retained interest is determined at the time of the transfer to the trust. The interest rate prescribed by Section 7520 (the "7520 rate") is used to value a retained interest. The value of the retained interest for a term can be found in Internal Revenue Service Publication 1457, Book Aleph, Table B.

Example. Sam creates a trust for the benefit of Debbie that has a term of 45 years, with the remainder passing to Sam or his estate. If the 7520 rate on the date the trust is created is 4.4%, Sam's retained interest is 14.4038% and the trust is a grantor trust. If the 7520 rate had been 7% instead of 4.4%, the value of Sam's retained interest would have been 4.7613% and the trust would not have been considered a grantor trust.

If the reversionary interest takes effect at the death of an individual, actuarial tables are used to determine the value of the retained interest. The value of the retained interest based on a single life can be found in Internal Revenue Service Publication 1457, Book Aleph, Table S.

Example. Sam creates a trust for the benefit of Debbie (who is 22 years old) for her life, with the remainder passing to Sam or his estate at Debbie's death. If the 7520 rate on the date the trust is created is 4.4%, Sam's retained interest is 12.13% and the trust is a grantor trust. If the 7520 rate had been 7% instead of 4.841%, the value of Sam's retained interest would have been 4.7613% and the trust would not have been considered a grantor trust.

(2) Application of Trust Provisions. If the trust agreement includes discretionary terms, the maximum exercise of discretion in favor of the grantor will be assumed in determining the value of the retained interest.

(3) Postponement of Vesting of Reversionary Interest. If the time of vesting of the reversionary interest to the grantor is postponed for any reason, the postponement will be treated as a new transfer in trust. This transfer will take effect on the effective date of the postponement and end on the date provided by the postponement. However, if the income of the trust is not taxable to the grantor prior to the postponement, the postponement will not result in the income being taxable to the grantor following the postponement.

(4) Exceptions to the General Rule. If the grantor retains a reversionary interest in a trust established solely for the benefit of the grantor's lineal descendant, and the retained interest is limited to a reversionary interest that only takes effect if the beneficiary dies before reaching age 21, the trust will not be considered a grantor trust.

(5) Problems that Arise for Estate Tax Planning. An interest retained by the grantor may result in estate inclusion under Section 2037. Additionally, any retained interest is treated as owned by the grantor for income tax purposes even if the interest doesn't rise to the five percent limit in the general rule.

In drafting for the possibility that a trust beneficiary might die prematurely, consider providing that the trust property will pass at the beneficiary's death to the beneficiary's probate estate. The grantor will not have retained an interest, even though the grantor may be a beneficiary of the estate.

B. <u>IRC § 674 – Power to Control Beneficial Enjoyment</u>.

<u>General Rule</u>. A trust will be a grantor trust if the grantor or a nonadverse party (or both) has the power to dispose of the income or corpus of the trust without the consent of an adverse party. Although this rule is very broad, there are a number of exceptions that substantially limit the application of the rule, which are described below.

Various places in the grantor trust rules, including Section 674, distinguish between "income" and "corpus." One may be tempted to understand these words in their state law, or trust accounting, context. However, Regulation § 1.671-2(b) provides that "when it is stated in the regulations [for these Code sections] that 'income' is attributed to the grantor or another person, the reference, unless specifically limited, is to income determined for tax purposes and not to income for trust accounting purposes. When it is intended to emphasize that income for trust accounting purposes (determined in accordance with the provisions set forth in [Regulation § 1.643(b)-1]) is meant, the phrase 'ordinary income' is used."

(1) <u>Exceptions to the General Rule</u>. Certain powers that are held by any person, <u>including</u> the grantor or a nonadverse party, will not result in grantor trust status. These include:

(a) to the extent unexercised, a discretionary power held by the trustee (including a grantor who is serving as trustee) to apply trust income for the support or maintenance of a beneficiary whom the grantor or his or her spouse is legally obligated to support;

(b) a power to affect beneficial enjoyment of the trust that can only be exercised after the occurrence of an event that has not yet occurred, to the extent the grantor would not be considered an owner under Section 673 (reversionary interest of less than five percent) if the power was a reversionary interest;

(c) a testamentary power of appointment over the trust, except for:

(i) a power held by the grantor to appoint accumulated income of the trust, where income is required to be accumulated or where it may be accumulated at the discretion of the grantor or a nonadverse party, without the approval or consent of an adverse party; or

(ii) a power held by the grantor to appoint the trust principal where capital gains are added to corpus, if the power can be exercised without the approval or consent of an adverse party (see Reg. § 1.674(b)-1(b)(3));

(d) the power to allocate corpus or income among charitable beneficiaries of the trust;

(e) the power to make distributions of corpus among the beneficiaries of the trust if the distributions are subject to a reasonably definite standard <u>or</u> if the distributions must be charged against the beneficiaries' respective shares (as if a separate share exists for each beneficiary);

(f) the power to distribute income to a beneficiary or accumulate income, provided that any one of the following conditions is met:

(i) any income accumulated for a beneficiary must ultimately be payable to that beneficiary, to his estate, or to his appointees including anyone other than his estate, his creditors, or the creditors of his estate (i.e., a broad special power of appointment); or

(ii) any income accumulated for a beneficiary must ultimately be payable on termination of the trust, or in conjunction with a distribution of corpus that includes accumulated income, to the current income beneficiaries in shares that have been irrevocably specified in the trust instrument; or

(iii) any income accumulated for a beneficiary is payable to the beneficiary's appointees or to one or more designated alternate takers whose shares have been irrevocably specified in the trust instrument (other than the grantor or grantor's estate) if the beneficiary dies before a distribution date that could reasonably be expected to occur within the beneficiary's lifetime;

(g) the power to withhold income during the disability of a beneficiary (due to legal disability or being under age 21); and

(h) the power to allocate receipts and disbursements of the trust between corpus and income.

(2) Other Powers that Will Not Result in Grantor Trust Status.

(a) Grantor trust treatment will not apply if the trustees (other than the grantor or grantor's spouse) have the power to make or withhold distributions of income or corpus to or for a beneficiary, beneficiaries, or a class of beneficiaries, if the power is limited by a reasonably definite external standard set forth in the trust agreement.

(b) Grantor trust treatment will not apply if:

(i) the grantor or the grantor's spouse is not serving as trustee, and no more than half of the trustees are related or subordinate parties who are subservient to the wishes of the grantor; and

(ii) the trustees have the power to distribute or accumulate income or corpus to or for a beneficiary, beneficiaries, or a class of beneficiaries.

(c) Neither of the exceptions set forth in (a) and (b) above applies if any person has the power to add a beneficiary (other than after-born or after-adopted children) to the trust.

(3) Problems that Arise for Estate Tax Planning. If the grantor retains the right to remove and replace a trustee, and the grantor can appoint any person, including himself as trustee, the trustee's powers are deemed to be held

by the grantor for purposes of determining grantor trust status and estate tax inclusion. *See* Reg. §§ 1.674(d)-2(a), 20.2036-1(b)(3) and 20.2038-1(a)(3). Accordingly, Section 674 powers held by a grantor are likely to frustrate the grantor's estate tax planning.

C. IRC § 675 – Administrative Powers.

Grantor trust status will result from certain administrative powers over the trust, which are described as follows.

(1) Power to Deal for less than Adequate and Full Consideration. A trust will be treated as a grantor trust if the grantor or a nonadverse party can allow any person to deal with the trust property for less than adequate consideration without the consent of an adverse party.

(2) Power to Borrow without Adequate Interest or Security. A trust will be treated as a grantor trust if the grantor or a nonadverse party can make a loan to the grantor without adequate interest or security unless the trustee (who is not the grantor or the grantor's spouse) can make loans to any other person under the same conditions.

(3) Actual Borrowing of Trust Funds by Grantor or Grantor's Spouse without Adequate Interest or Security. If the grantor or the grantor's spouse has actually borrowed corpus or income from the trust, whether directly or indirectly, and has not completely repaid the loan with interest before the beginning of the taxable year, the trust will be treated as a grantor trust. However, if the loan is made by a trustee other than the grantor or a related or subordinate party who is subservient to the grantor, and adequate interest and security are provided, the trust will not be considered a grantor trust. Under the Code, actual borrowing is required; the mere power to borrow is not sufficient to cause grantor trust status. It is important to note however, that unless the grantor borrows the entire corpus, there can be no assurance that the grantor will be treated as the owner of the entire income and corpus of the trust for income tax purposes.

(4) Administrative Powers Exercised in Nonfiduciary Capacity without Consent of Fiduciary. Grantor trust status will result if any person has the ability to exercise one of the following powers in a nonfiduciary capacity without the approval or consent of a person in a fiduciary capacity.

(a) Voting Trust's Stock. A trust will be treated as a grantor trust if a person who is not serving in a fiduciary capacity has the power to vote the trust's stock if the trust's and grantor's holdings are significant from the viewpoint of voting control.

(b) Controlling Investment. A trust will be treated as a grantor trust if a person who is not serving in a fiduciary capacity has the power to control the trust's investment in stock if the trust's and grantor's holdings in the stock are significant from the viewpoint of voting control.

(c) Substitution of Assets. A trust will be treated as a grantor trust if a person who is not serving in a fiduciary capacity has the power to reacquire trust assets by substituting assets of equivalent value. *See* discussion on PLR 201216034 on page 10.

(5) Problems that Arise for Estate Tax Planning. If the grantor has the power to (a) allow any person to deal with the trust property for less than full and adequate consideration (as described in paragraph (1) above), or (b) make loans without adequate interest or security (as described in paragraph (2) above), the trust may be included in the grantor's estate for estate tax purposes.

D. IRC § 676 – Power to Revoke.

(1) General Rule. If the grantor or a nonadverse party has the power to revoke or otherwise revest the assets of the trust in the grantor without the consent of an adverse party, the trust will be treated as a grantor trust.

(2) Exception to the General Rule. If the power described in the general rule is postponed for a period of time that would result in the revested interest being equal to or less than five percent of the value of the trust funds, so that the grantor is not considered the owner under Section 673, the trust will not be treated as a grantor trust.

(3) Problems that Arise for Estate Tax Planning. A revocable trust will be included in the grantor's estate for estate tax purposes.

E. IRC § 677 – Income for Benefit of Grantor.

(1) A trust will be treated as a grantor trust if the grantor or nonadverse party has the power to distribute the income of the trust for benefit of the grantor or the grantor's spouse without the consent or approval of an adverse party. Distributions for the benefit of the grantor or the grantor's spouse include:

(a) actual or constructive distributions to the grantor or the grantor's spouse;

(b) amounts held or accumulated for future distribution to the grantor or the grantor's spouse;

(c) actual or constructive distributions used to pay premiums on policies of insurance on the life of the grantor or the grantor's spouse; and

(d) income actually applied to or distributed in satisfaction of the grantor's or the grantor's spouse's legal obligation to support another.

(2) Problems that Arise for Estate Tax Planning. It is unclear whether including this power within a trust results in the grantor being treated as the owner of only the income portion of the trust or of both the income and the corpus of the trust. Estate inclusion issues also arise.

F. IRC § 678 – Person Other Than Grantor Treated as Substantial Owner.

If the grantor is not treated as the owner of the trust under Sections 673 through 677 or Section 679, a third party may be treated as the owner of the trust if the third party (1) has the sole power to vest the corpus or income of the trust in himself or herself or (2) has partially released or modified this power and retains control that would result in a grantor be treated as the owner of the trust. The power described in (1) above is referred to as a "Mallinckrodt power" after the 1945 8th Circuit case, Mallinckrodt v. Nunan, 146 F.2d 1 (8th Cir. 1945). This situation often arises in the context of trusts that give beneficiaries a power of withdrawal over the trust (known as a *Crummey* withdrawal power). *See, e.g.,* PLR 200949012. It can also arise if a beneficiary is the sole trustee of the trust to the extent that the beneficiary/trustee has a power to distribute to himself or herself; however, the consequences might be limited if the distribution power is limited to an ascertainable standard.

In PLR 201633021, the IRS considered a situation where the governing document for a trust authorized a distribution from the trust to be made to a second trust for the beneficiary of the first trust. The governing document for the second trust provided that the first trust retained the power, solely exercisable by the first trust, to revest the net income and net capital gains of the second trust in the first trust; provided, however, that such power shall lapse on the last day of such calendar year. As a result, the second trust was a grantor trust under Section 678(a) and the first trust had to report the second trust's income and expenses that entered into the computation of distributable net income.

An example of the application of Section 678 to a trust is found in PLR 201216034. The primary beneficiary was the trustee, with his distribution powers being limited by an ascertainable standard. The primary beneficiary also was given "hanging" *Crummey* withdrawal rights and a non-fiduciary power to substitute trust assets. The trust owned stock in an S Corporation. The trust grantor's only relationship with the trust was to establish and fund it.

The IRS ruled that, pursuant to Section 678(a)(1), the trust was a grantor trust as to the primary beneficiary with respect to the portion of the trust over which his withdrawal power had not lapsed. The IRS further ruled that, pursuant to Section 678(a)(2), the trust was a grantor trust as to the primary beneficiary with respect to the portion of the trust over which his unexercised withdrawal power had lapsed but over which he held a non-fiduciary power of substitution. The IRS thus concluded that the primary beneficiary would be treated as the owner of the entire trust, and the owner of the trust's S Corporation stock for income tax purposes.

The IRS was right that the trust was a grantor trust in full, but appears to have gotten it wrong as to who the owner was for income tax purposes. The ruling correctly recites the rule that a non-grantor of the trust will not be treated as the owner if the grantor of the trust is otherwise treated as the owner. And a non-fiduciary power to substitute assets causes the grantor to be treated as the owner, regardless of who holds the swap power. While the IRS might have gotten it wrong in this ruling, PLR's cannot be relied upon by any other taxpayer, so another grantor who relies upon this PLR to conclude that he or she does not have any income tax liability from this arrangement may get a shock when the trust's share of the S Corporation's income is included in the grantor's taxable income.

The grantor trust rules can be even more complex than is suggested by simply reading the Code and the related Treasury Regulations. For an analysis of the impact of state judicial review when a trustee has the power to distribute to himself or herself as a beneficiary pursuant to an ascertainable standard, *see* Jonathan G. Blattmachr, Mitchell M. Gans and Alvina H. Lo, *A Beneficiary as Trust Owner: Decoding Section 678*, 35 ACTEC J. 106 (2009) (available at: http://scholarlycommons.law.hofstra.edu/faculty_scholarship/525.

G. IRC § 679 – Foreign Trusts Having One or More United States Beneficiaries.

(1) General Rule. Any foreign trust with a United States person as a grantor and a United States person as a beneficiary will be treated as grantor trust. In order to enhance compliance, this section was amended by the Hiring Incentives to Restore Employment ("HIRE") Act (Pub. L. No. 1110147, March 18, 2010).

(2) Exceptions to the General Rule. The general rule does not apply to any transfer to a foreign trust at death. There is also an exclusion for certain transfers in exchange for consideration of at least the fair market value of the transferred property. For transfers after February 6, 1995, consideration received does not include the value of any obligations issued or guaranteed by the trust, the grantor, any beneficiary, any deemed owner of the trust, or any person related to the trust, grantor, beneficiary, or deemed owner, unless the obligations meet certain requirements described in the regulations under Section 679.

IV. Common Methods for Creating a Grantor Trust that do not Result in Estate Tax Inclusion

A. Substitution of Assets.

The grantor can be given a power to reacquire trust assets by substituting assets of equivalent value. This power must be exercisable in a nonfiduciary capacity. The regulations under Section 675 provide that the determination of whether the power of substitution is exercisable in a fiduciary capacity depends on all the terms of the trust and the circumstances surrounding its creation and administration. Despite the fact that this power had long been used with the understanding that its use did not create estate tax problems, there was a recent surge of concern regarding this practice. However, in Rev. Rul. 2008-22, 2008-16 I.R.B. 796, the Internal Revenue Service ruled that a grantor could hold a power to substitute assets without adverse estate tax consequences in most situations. Similarly, in Rev. Rul. 2011-28, 2011-49 I.R.B. 830, the Internal Revenue Service ruled that the same result applied when the grantor had a substitution power that could be used to acquire an insurance policy on the grantor's life, and that the value of the insurance policy will not be includible in grantor's gross estate under Code Sec. 2042. The latter ruling is consistent with how the Tax Court ruled on the issue in *Estate of Jordahl v. Commissioner*, 65 T.C. 92 (1975).

While it should be possible for the grantor to release this power, and thereby terminate grantor trust status, the Internal Revenue Service has expressed concern about abusive transactions that use this technique. Under Notice 2007-73, the Internal Revenue Service has indicated that it is looking at various transactions using grantor trusts that result in nonrecognition of gain or recognition of tax losses in excess of economic losses. The Internal Revenue Service has also asked for comment on changing from grantor trust to non-grantor trust status, or vice-versa, as a result of "decanting" from an old trust to a new trust. *See* Notice 2011-101.

The power of substitution can be given to not only the grantor, but can also be given to the grantor's spouse or another party. By giving the power to someone other than the grantor, there should be no risk of estate inclusion. However, the language of the Code provision is "a power to "reacquire" trust corpus." Does this mean only the grantor can satisfy this requirement? Such a narrow reading would seem to be inconsistent with Section 675(4) applying by its terms to a power held by "any person." Further, the Internal Revenue Service has issued private letter rulings that have allowed grantor trust status where a third party held the power of substitution. *But see* discussion of PLR 201216034 on page 10. As with other powers given to a spouse or a third party to trigger grantor trust status, upon the death of the spouse or third party, grantor trust status will terminate unless a successor has been provided for in the document.

This power of substitution should not be held by the trustee, because it must be held in a "nonfiduciary" capacity, which arguably could be inconsistent with a trustee's fiduciary duties. *See generally* Rev. Rul. 2008-22, 2008-16 I.R.B. 796.

B. Loans.

Grantor trust status results in the case of either the actual borrowing of funds by the grantor or his spouse without adequate interest or adequate security or the power held by a nonadverse trustee to make loans to the grantor or his spouse without adequate security.

(1) Actual Borrowing. If the grantor directly or indirectly actually borrows corpus or income from the trust and it is not completely repaid with interest before the beginning of the tax year, the trust is treated as a grantor trust in the year of the loan. This means that in any year a loan is outstanding, the trust would be considered a grantor trust. It is important to note that for this method of creating a grantor trust, actual borrowing is required – not the mere power to borrow.

Grantor trust status is not triggered if (a) the loan has adequate interest and security and (b) the loan is made by a trustee other than a related or subordinate party. Note that both requirements must be met to result in a trust that is not a grantor trust. Thus, if the trustee is a related or subordinate party, he or she can provide for adequate interest and security and still obtain grantor trust status.

It is unclear if grantor trust status applies only to the amount actually borrowed, or if once you have actual borrowing, the borrowing creates grantor trust status as to the entire trust property. To rely on this provision for grantor trust status, a practitioner may want to have the grantor borrow the entire trust property. The grantor can then repay the loan before year end and reassess the benefit of grantor trust status going forward on a year-to-year basis.

(2) Power of Nonadverse Trustee to Make Loans without Adequate Security. Under the provisions of Section 675(2), the mere power in the trust instrument to allow the grantor or a non-adverse party to borrow corpus or income without adequate interest or adequate security is enough to trigger grantor trust status; no actual borrowing is required. However, if the trustee can make loans without adequate interest or adequate security to any person under the general powers of the trust, this provision will not trigger grantor trust status.

The power to so borrow should be held by a nonadverse party other than the grantor to avoid estate inclusion issues. It is preferable to give this power to a person who is not a related or subordinate party. By doing so, the risk that their powers will be deemed attributable to the grantor is reduced.

If the power to borrow extends to the entire income and corpus of the trust, grantor trust status extends to the entire trust. This is in contrast to actual borrowing described above, where it is uncertain what portion of the trust is treated as a grantor trust.

It is advisable to provide for adequate interest (and no security) to avoid potential gift or estate tax problems for the grantor. But query if the power to borrow without adequate security can cause estate tax problems.

C. Power of Disposition by a Related or Subordinate Party without a Reasonably Definite Outside Standard.

Under the Section 674(a) general rule, if the grantor or a nonadverse party has the power to dispose of trust property without the consent of an adverse party, the trust will be a treated as a grantor trust. The technique used to create grantor trust status for income tax purposes without estate tax inclusion issues, involves giving a power to the trustees, more than half of whom are related or subordinate, to sprinkle or accumulate the income or principal of the trust that is not subject to a "reasonably definite standard." A reasonably definite standard is defined as an ascertainable standard, such as health, education, support, and maintenance (*see* Reg. § 1.674(b)-1(b)(5)(i)).

To avoid the numerous exceptions from grantor trust status under Section 674, there should not be separate shares for beneficiaries and there should not be a requirement that the trustee charge distributions to a beneficiary's share. If the grantor wants separate shares for the beneficiaries, the trust should last for the lifetime of the beneficiary, the trust should not provide for the distribution of accumulated income in the trust to the beneficiary's estate at the beneficiary's death, and the beneficiary should not have a general or a broad special testamentary power of appointment (i.e., the power to appoint to anyone other than himself or herself, his or her estate, his or her creditors, or the creditors of his or her estate). For purposes of Section 674, related or subordinate parties are not considered independent trustees.

A variation of this technique involves giving the grantor's spouse an inter vivos power to allocate the income or corpus of the trust not subject to an ascertainable standard. For example, the grantor can create an irrevocable trust for the benefit of her children that includes a provision that allows the grantor's husband to appoint the remaining principal among their children and the children's spouses in an inter vivos writing. When using this technique, the practitioner should make sure that the grantor's spouse has not made a contribution to the trust, either directly or indirectly (e.g., by the grantor contributing community property to the trust).

D. Addition of Beneficiaries.

Grantor trust status under Section 674(a) is generally triggered by giving the grantor or a nonadverse party a power of disposition that affects the beneficial enjoyment of the trust corpus or income. Giving such a power to a nonadverse party would often be a simple matter (but giving such a power to the grantor may cause the initial transfer to be considered an incomplete gift that results in estate inclusion under Section 2036(a)(2) or Section 2038). However, the broad reach of Section 674(a) is substantially narrowed by a number of exceptions that largely swallow the rule. Nonetheless, several of the exceptions are not available 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). Thus, grantor trust status can be triggered under Section 674(a) if all of the exceptions are avoided, which may require eliminating one or more of the exceptions by giving someone the power to add a beneficiary (other than after-born or after-adopted children) to the trust.

The grantor should be excluded from the list of potential new beneficiaries. Additionally, the grantor should not hold this power, because the retention of this power may cause the initial transfer to be considered an incomplete gift that results in estate inclusion under Section 2036(a)(2) or Section 2038.

(1) Who should hold the power?

Under the Code, this power can be held by "any person." Obviously, the grantor will want to be comfortable with the person given this power.

The power could be held by the grantor's spouse without risking estate inclusion as long as the spouse does not contribute property to the trust. However, a successor holder of the power should be provided in the event of the spouse's death, as the death of the spouse could cause a termination of grantor trust status.

If a beneficiary holds the power to add beneficiaries, the beneficiary's exercise of this power may be considered a deemed gift by the beneficiary. However, a gift may not result if the beneficiary merely has the power to add to the class of permissible beneficiaries where another trustee holds the power to make discretionary distributions to the added beneficiaries.

A trust granting such a power to the trustee must be carefully structured to avoid the "additional" beneficiary being treated as an initial beneficiary, and thus not added. If the trustee is free to add a beneficiary at any time, that potential beneficiary is, in fact, an initial beneficiary because the trustee was always able to choose to make distributions to him or her. A trustee can hold this power if it is subject to limitations provided in the trust agreement. Caution should be exercised, however, in the limitations placed on the trustee. A court could find that no real power exists if the limitations on the power held by the trustee are too great. Thus, this power may be more easily vested in someone who does not have the power to make distributions from the trust. Practical considerations should also be taken into account and a review of fiduciary duties, particularly in the case of a corporate trustee, should be considered before giving this right to a trustee.

(2) What class of beneficiaries can be added?

There is no limit in the Code as to the permissible class of beneficiaries to be added. Of course, the grantor will need to be comfortable with the potential new beneficiaries.

One option is to include charitable organizations as permitted additional beneficiaries. Another option is to permit the addition of only a charitable lead trust or a charitable remainder trust that has the grantor's family members as individual beneficiaries.

Another class might be grandchildren, who may have otherwise been excluded if the trust is not exempt from generation skipping transfer tax.

Other class examples include the spouses of the grantor's children, nieces and nephews, or the grantor's grandchildren or other living descendants. However, if the class of beneficiaries that is permitted to be added is already a contingent remainder beneficiary, naming them may not be considered adding a beneficiary.

If the grantor wants to leave the determination of the class to the person holding the power, the trust can give a nonadverse person a lifetime special power of appointment over the trust assets. This power should be treated as a power to add beneficiaries, resulting in grantor trust status.

In any event, whoever holds the power to add beneficiaries should not be able to name himself or herself.

E. Spouse as a Beneficiary or Powerholder.

As discussed above, a trust will, in certain circumstances, be treated as a grantor trust if the income of the trust can be distributed for the benefit of the grantor's spouse or if the grantor's spouse holds certain powers. If the grantor held these powers, the trust assets would be included in the grantor's taxable estate, but such is not true for the grantor's spouse. However, relying on either of these powers to preserve grantor trust status will work only as long as the grantor is married.

F. Foreign Trust.

If a U.S. grantor creates a foreign trust for the benefit of U.S. persons, the trust will be a grantor trust under Section 679.

G. Note - Switching Between Grantor and Non-Grantor Trust Status.

While it is beyond the scope of this paper, there is some limited authority regarding the income tax consequences of converting a grantor trust to a non-grantor trust. *See, e.g.,* Rev. Rul. 77-402, 1977-2 C.B. 222; Treas. Reg. § 1.1001-2(c), Ex. 5; and *Madorin*, 84 T.C. 667 (1985). A Chief Counsel Advice, 200923024 (June 5, 2009), has considered a situation that appeared to be an abuse of the grantor trust rules where nongrantor trusts were converted to grantor trusts in the midst of a transaction. The Chief Counsel distinguished the situation from Revenue Ruling 85-13. In short, switches between grantor trust and non-grantor trust status are reason for careful legal analysis, hopefully before the change is made.

V. Uses of Grantor Trusts in Estate Planning

As noted above, grantor trusts can be extremely powerful estate planning tools.

A benefit of grantor trusts that was long overlooked is the ability of the grantor to benefit the trust beneficiaries by bearing the trust's income tax, without having to pay gift tax (and reducing the grantor's taxable estate). As with tax-deferred retirement accounts, the benefits of tax-free growth increase at a compound rate with the passage of time. The benefits are also greater if the taxes paid by the grantor are on ordinary income as opposed to unrealized capital gains. A simple example illustrates the potential benefit. Assume that a trust owns an interest in a family business that yields taxable ordinary income of 10% a year for 25 years and that after-tax trust income is reinvested in additional interests in the family business. This is a particularly powerful technique if the family business is a pass-through entity for income tax purposes, such as an S corporation, partnership, or LLC. After 25 years, a grantor trust will have more than twice the assets of a non-grantor trust. Indeed, it is important when creating a large grantor trust to have a means to terminate the grantor trust status so that the grantor (who is typically the attorney's client) will have a way to limit the wealth transfer.

Other estate planning strategies involve transactions between grantors and grantor trusts that are not subject to federal income taxes as a result of Section 671. Note that for tax and non-tax reasons these transactions are typically done where the fair market value of the assets given and received are equal. One common strategy described below involves the sale of assets from the grantor to a grantor trust. Any capital gains that would otherwise be subject to federal income tax upon the sale of property by the grantor are not realized or recognized for federal income tax purposes when the property is purchased by a grantor trust. This can be useful in a variety of contexts. For example, a highly-appreciated asset that is identified as still having good potential for future above-average appreciation can be sold to, or exchanged with, a grantor trust without triggering tax on the accumulated capital gain. Or assets with low basis can be swapped out of a grantor trust in exchange for assets with high basis in anticipation of the grantor's passing so that the low basis assets get a new basis at the grantor's death while the high basis assets (which can even have a basis in excess of current fair market value) in the grantor trust do not take a new basis if they are not part of the grantor's taxable estate. In another variation, assets with low basis in a grantor trust can simply be sold back to the grantor for cash – either cash that the grantor has on hand or borrows.

The ability to exchange assets with a grantor trust without income tax consequences can also be useful for non-tax reasons. For example, a grantor might decide that she would rather have an asset that is in a grantor trust and have the grantor trust hold a different asset (note that this can be motivated more by what the beneficiaries will get via the grantor trust than what the grantor will own). Such an exchange can be pursuant to an agreement entered into between the grantor and the trustee of the grantor trust, or made by the grantor without the consent of the trustee of the grantor trust if the grantor holds a swap power (*see* Substitution of Assets on page 8), with the latter being easier to effect because there are no concerns about anyone's fiduciary duties.

Other estate planning strategies focus on special varieties of grantor trusts that are designed to achieve very specific goals. These grantor trusts, including leveraged grantor trusts, grantor retained annuity trusts (GRATs), irrevocable life insurance trusts (ILITs) and qualified personal residence trusts (QPRTs) obtain their grantor trust status by conforming to the description set forth in one of the grantor trust rules described above. Examples of these types of estate planning strategies are described in more detail below.

A. <u>Sales to Leveraged Grantor Trusts</u>.

The simplest of the estate planning strategies described in this paper is the sale to a grantor trust (in this context, often referred to as an "intentionally defective grantor trust" or IDGT). There are several estate planning benefits that can be derived from a sale of assets by the grantor to a grantor trust. Sales to grantor trusts are commonly used by individuals who would like to freeze the value of certain assets that will be included in their taxable estates for estate tax purposes. Another reason for the sale of assets to a grantor trust is to provide liquidity to the grantor. The sale can also go the other way. The grantor can buy appreciated assets from the grantor trust, in anticipation of a step-up in basis at the grantor's death. Since estate freezing is the most common goal of grantors who sell assets to grantor trusts, the remainder of this section will focus on that strategy.

(1) Sale. The grantor typically sells assets to a grantor trust in exchange for a note payable by the trust. Because Section 671 states that the grantor will be treated as the owner of all trust property for federal income tax purposes, the sale will be ignored for federal income tax purposes and no gain or loss on the sale is recognized. In addition, no income will be recognized when the grantor receives interest payments on the note. The income generated by the trust property will be taxable to the grantor, and the appreciation and income from the trust assets after the date of the sale will be removed from the grantor's estate for federal estate tax purposes (*i.e.*, the value of the grantor's asset is "frozen" with future appreciation accruing outside of the grantor's taxable estate). If the grantor dies during the term of the note, the fair market value of the note will be included in the grantor's estate. The fair market value of the note is the face amount plus any accrued interest. Reg. § 20.2031-4.

(2) Note Payable by IDGT. The note from the grantor trust to the grantor may be structured so that all principal and interest payments are payable in one balloon payment at the end of the term of the note. However, many practitioners prefer to see the payments of interest payable at least annually, even if the principal is paid in one balloon payment at the end of the term. This is believed to bolster the argument that the loan was neither a gift to the grantor trust (potentially giving rise to gift tax liability) nor should it be treated as an interest in the trust that was retained by the grantor (causing inclusion of all trust property in the grantor's estate for federal estate tax purposes). Another guideline that many practitioners adhere to requires that the grantor trust own assets equal in value to at least 10% of the face amount of the note on the date of the sale. This also helps to characterize the loan as a loan, rather than a gift or an interest in the trust retained by the grantor (it is vital that the transaction be treated as a sale for federal income tax purposes, and not some other type of transaction – an issue developed by substantial case law). If the grantor trust does not already hold assets of sufficient value, the grantor may use part of his or her lifetime exemption from gift tax, or make a gift that gives rise to gift tax, to fund the trust in advance of the sale. For similar reasons, interest on the note should be payable at a rate at (or above) the applicable federal rate for the term of the note. Frequently, the term of the note is selected based upon the applicable federal rate for that term (*e.g.*, a nine year note uses the mid-term applicable federal rate, which is typically less than the long-term applicable federal rate that must be used for a ten year note).

B. Grantor Retained Annuity Trusts (GRATs).

The use of a grantor retained annuity trust is another type of estate planning strategy that is designed to freeze the value of one or more assets in the grantor's estate and transfer the future income or appreciation associated with the assets to other beneficiaries. GRATs are products of the technical rules found in Section 2702 and must be very carefully drafted to comply with the statutory requirements. Running afoul of these requirements will subject the taxpayer to severe, and punitive, gift tax consequences. The grantor of a GRAT will transfer property to the trust and retain the right to an annuity payable for a term of years, for the grantor's lifetime or for the shorter of the grantor's lifetime and a term of years. Reg. § 25.2702-3(d)(4). At the end of the initial term, the trust property will pass directly to other beneficiaries or remain in further trust for their benefit without any further transfer tax liability (other than generation-skipping transfer tax, if applicable). The GRAT will be a grantor trust during the initial term under Section 677(a) because the income of the trust will be distributed to the grantor in the form of annuity payments for the duration of the initial term without the approval of an adverse party. Therefore, during the initial term, the grantor will report the GRATs items of income, deduction and credit on his or her own income tax return. Furthermore, the grantor will be taxed as if he or she owned all of the trust assets (as opposed to paying taxes only on the annuity payments he or she receives). In addition, no gain or loss will be recognized as a result of (i) the grantor's initial transfer of property to the GRAT, (ii) the GRATs subsequent transfer of property back to the grantor in the form of annuity payments, or (iii) the grantor's exchange of cash or other property for property held by the GRAT.

(1) Taxable Gift. When the grantor makes the initial transfer to the GRAT, he or she will make a taxable gift of the value of the remainder interest in the GRAT (the value of the trust property remaining after the satisfaction of all annuity payments and the expiration of the initial term). The amount of the gift is determined by using actuarial tables published by the Treasury Department and depends upon (i) the length of the initial term; (ii) the amount of the retained annuity; and (iii) the interest rate prescribed by Section 7520 (the "7520 rate") that is applicable on the date of the initial transfer. Since the remainder beneficiaries will not have a present interest in the GRAT, the initial transfer to the GRAT will not qualify for the annual exclusion from gift tax.

(a) Term. If the grantor dies during the initial term, part or all of the trust assets may be included in his or her estate for federal estate tax purposes. In that case, the grantor will have forgone the opportunity to use a different estate planning strategy that might have successfully removed the trust property from his or her estate. Therefore, the grantor should carefully consider the proper term of the GRAT. Both long-term and short-term GRATs have benefits and disadvantages.

The benefits of a long-term GRAT include: (1) a smaller annuity has to be retained by the grantor in order to minimize the gift tax liability; (2) the grantor's ability to lock in a low 7520 rate for an extended period of time; (3) less risk that a change in the law (such as a prohibition on GRATs or a minimum taxable remainder for gift tax purposes) will affect a plan already in place (as opposed to wreaking havoc on a plan involving a series of short-term GRATs); and (4) lower transaction costs than establishing a series of successive short-term GRATs. However, the primary disadvantage of a long-term GRAT is the increased risk that the grantor will die during the term and part or all of the trust property will be included in his or her estate for federal estate tax purposes.

By contrast, some of the benefits of a short-term GRAT include: (1) a decreased risk of the grantor's death during the initial term, and (2) the potential to capture more of the volatility of the GRAT assets, particularly with a series of successive short-term GRATs (also called "rolling GRATs," which allow the grantor to use each annuity payment he or she receives to fund a new GRAT).

(b) Annuity. A qualified annuity interest is an irrevocable right to receive a fixed amount. Reg. § 25.2702-3(b)(1)(i). A fixed amount is a stated dollar amount or a fixed percentage of the initial fair market value of the property transferred to the trust (as finally determined for federal tax purposes) that is payable periodically, but not less frequently than annually. Reg. § 25.2702-3(b)(1)(ii).

The annuity must be payable to the grantor at least once per year during the initial term, and the amount payable in each year cannot exceed 120% of the amount payable in the preceding year. Reg. § 25.2702-3(b)(1)(ii). Many estate planners do take advantage of the fact that the regulations allow the annuity to increase by up to 20% per year (but no more!). These "graduated" annuity payments may make sense in a given transaction because they allow the trust corpus to grow in the early years of the initial term and accumulate funds to pay the later years' annuity payments.

If the GRAT does not have sufficient cash or other liquid assets to make the required annuity payments, the annuity may be paid in kind. Although making a payment in kind is technically a sale, the sale will be ignored for federal income tax purposes because the transaction occurs between the grantor and grantor trust. Note, however, that the trust may not satisfy annuity payments by issuing a note or other debt instrument.

(c) 7520 Rate. The 7520 rate is the interest rate used by the Treasury to value annuities and term interests. It is set at 120% of the mid-term applicable federal rate and rounded to the nearest 0.2%. The real planning opportunity occurs when the grantor transfers assets that are expected to generate income or to grow in excess of the 7520 rate. Thus the benefits of the GRAT can be enormous when the assets transferred to the GRAT appreciate rapidly and the 7520 rate is low.

(2) Zero-Gift GRAT. In many instances, the grantor will attempt to reduce the taxable value of the initial transfer to the GRAT to zero. This can be accomplished by setting the annuity factor so that the present value of the

grantor's annuity interest is equal to the fair market value of the property transferred to the GRAT. The Internal Revenue Service will not issue a private letter ruling regarding the qualification of a GRAT if the value of the remainder interest is less than 10% of the value of the property initially transferred to the GRAT, but this is typically of little consequence in establishing a GRAT. Rev. Proc. 2007-3, 2007-1 IRB 108.

(3) Estate Tax Inclusion. There appears to be some authority for all three of the following positions regarding the inclusion of trust property in the grantor's estate in the event that the grantor dies during the term of the GRAT: (i) none of the trust property is included in the grantor's estate, (ii) some of the trust property is included in the grantor's estate, and (iii) all of the trust property is included in the grantor's estate. Despite the variety of different outcomes that have been obtained in Federal Circuit Courts, Tax Court and Rulings issued by the Internal Revenue Service, if the grantor dies during the term of a GRAT, he or she should be prepared for at least a portion of the trust property to be included in his or her estate.

(4) Comparison of GRAT to Sale to IDGT. Since GRATs and sales to grantor trusts are both commonly used to achieve similar estate freezing goals, many practitioners consider both strategies before deciding which one is most appropriate for their clients in particular circumstances. Some of the key points to consider in this comparison include:

(a) Estate Tax. If the grantor survives the initial term of the GRAT, the transferred property will not be included in his or her estate for federal estate tax purposes. However, if the grantor dies during the initial term, part or all of the trust property will be included in his or her estate. By comparison, when the grantor sells property to a grantor trust, that property is immediately removed from his or her estate. Of course, if the grantor dies before the note is fully paid, then the value of the note will be included in his or her estate. Both techniques may result in inclusion of the value of the trust property plus an interest factor in the grantor's estate if the grantor dies before the initial phase of the transaction is completed. However, as discussed above, there may be more uncertainty regarding exactly how much of the value of the trust property is included in the grantor's estate in the case of a GRAT.

(b) Gift Tax. A GRAT may be structured so that virtually no gift tax is payable upon the initial transfer of assets to the trust. Similarly, the grantor will not make a taxable gift if he or she sells property to a grantor trust for fair market value (or a note for fair market value plus a sufficient interest rate). However, the GRAT can include trust provisions that automatically adjust the amount of the annuity payments payable to the grantor in the event that the value of the trust property for federal gift tax purposes is different from that anticipated. Reg. §§ 25.2702-3(b) and 25.2702-3(b)(1)(ii)(B). The effect of a similar formula in the context of a sale to a grantor trust is less clear. Therefore, the sale to a grantor trust presents a higher risk of re-valuation of the trust property resulting in increased gift tax liability, and a GRAT may be the prudent choice if the value of the assets being sold is particularly difficult to determine.

(c) Generation-Skipping Transfer Tax. Generation-skipping transfer tax ("GSTT") exemption can be allocated to a grantor trust to fully exempt it (assuming that the grantor has sufficient exemption). A subsequent sale of additional assets to the grantor trust at fair market value will not change the grantor trust's GSTT inclusion ratio. In contrast, a GRAT cannot be used to make leveraged GSTT-exempt gifts.

(d) Income Tax. No gain or loss is recognized for federal income tax purposes whether the grantor uses a GRAT or a sale to a grantor trust. The grantor will be taxable on all income generated by the trust property as long as the GRAT or IDGT remains a grantor trust.

(e) Applicable Interest Factors. The annuity payable to the grantor from a GRAT will be discounted by the 7520 rate, which is 120% of the applicable federal mid-term rate, rounded to the nearest 0.2%. The interest payments on a note issued in a sale to a grantor trust will reflect the applicable federal rate, which will usually be lower than the 7520 rate. Thus, the interest factor applicable to a sale to a grantor trust is likely to be more favorable from a wealth transfer perspective.

(f) Flexibility. The annuity payments from a GRAT and installment payments on a note can both be paid with appreciated property without triggering any tax consequences (since both the GRAT and the IDGT are grantor trusts). However, annuity payments from a GRAT may increase only at the rate of 20% per year, whereas installment payments of the note's interest and principal components may be entirely back-loaded and payable in one balloon payment. Thus for assets that are not expected to generate income or that may not appreciate in the early years of the transaction, a sale to a grantor trust may be more attractive.

(g) Final Thoughts. There is less tax risk with a GRAT than with a sale to a grantor trust, since the GRAT is an estate planning strategy that is expressly permitted by the Code and corresponding regulations, although there is more risk of violating a statutory or regulatory provision. By comparison, the strategies involving sales to grantor trusts rely upon the application of general tax law principles gleaned from case law, the Code, Treasury Regulations, and Internal Revenue Service rulings.

C. Irrevocable Life Insurance Trusts (ILITs).

Life insurance policies insuring the lives of wealthy individuals are often held in irrevocable life insurance trusts (ILITs). The ILIT is a special variety of grantor trust that allows the proceeds of life insurance policies held by the trust to pass free of estate tax to the trust beneficiaries upon the death of the insured (or the death of his or her spouse). The most common reasons for acquiring and maintaining life insurance policies inside an ILIT include: (i) providing for the financial support of the insured's family after his or her death;

(ii) providing liquidity for the payment of estate taxes and other debts and expenses due upon the death of the insured; (iii) replacing the value of assets left to charitable organizations rather than the insured's descendants or other family members. The ILIT may be structured in a variety of different ways depending upon the particular goals of the grantor-insured. The feature common to most ILITs is their treatment as grantor trusts pursuant to Section 677(a)(3). Section 677(a)(3) provides that a trust will be treated as a grantor trust if trust income is used to pay premiums on an insurance policy insuring the life of the grantor or the grantor's spouse without the approval of an "adverse party," or if trust income may be used for such purpose in the discretion of the grantor or a "nonadverse party." Since ILITs frequently permit the use of trust income to pay premiums on insurance policies insuring the life of the grantor or the grantor's spouse, ILITs will often be treated as grantor trusts. However, as a practical matter, ILITs typically generate little, if any, taxable income. Therefore their status as grantor trusts will often be of limited consequence in terms of who pays the income tax on the trust's income.

(1) Mechanics. The grantor (who is usually the insured) may either assign an existing policy to the ILIT or contribute cash or other property to the ILIT to be used for the purchase of a new insurance policy. Typically, the grantor-insured will not be the trustee of the ILIT, will retain no beneficial interest in the trust, and will retain no other "incidents of ownership" (as described in Regulation 20.2042-1(c)(2)) with respect to the insurance policy or policies transferred to or purchased by the trustee of the ILIT. If the grantor-insured does serve as trustee or retain any interest in the insurance policy or policies, he or she risks the inclusion of the value of the insurance proceeds in his or her estate for federal estate tax purposes. *See* § 2042(2). As one of the primary goals of the ILIT is the exclusion of policy proceeds from the estate of the grantor-insured, this would be a most undesirable result. During the grantor-insured's lifetime, premiums on the policy or policies held by the trust will be paid by the trustee with trust property. The grantor-insured will often make additional contributions to the ILIT in the amount of the next premium payment to enable the trustee to make the premium payments as they become due. Upon the death of the grantor-insured, the insurance company will pay the proceeds of the insurance policy or policies to the trustee of the trust, to be held and administered for the benefit of the trust beneficiaries in accordance with the terms of the trust. If the grantor-insured's estate requires additional liquidity to pay estate taxes or other debts, the trustee may use the proceeds of the insurance policy or policies to purchase assets from the grantor-insured's estate or make loans to the grantor-insured's estate.

(2) Three-Year Rule. In deciding whether to transfer an existing life insurance policy to an ILIT or simply transfer cash or other property that the trustee may use to purchase a new life insurance policy, the grantor-insured should always consider the three-year rule set forth in Section 2035. Section 2035 provides that if (a) the grantor makes a transfer of property during the three-year period ending on the date of his or her death for less than full and adequate consideration (a gift), and (b) the value of the property transferred would have been included in the grantor's estate under Section 2036,

2037, 2038 or 2042 if the grantor had held the transferred property on the date of his or her death, then the value of the property will be included in the grantor's estate for federal estate tax purposes. § 2035(a). If the grantor had owned an insurance policy insuring his or her own life on the date of his or her death, the proceeds of the policy would have been included in his or her estate under Section 2042. Therefore, if the grantor-insured gifts an existing or new policy to the ILIT, he or she must live for three years following the transfer in order to keep the proceeds of the policy out of his or her taxable estate. However, if the grantor-insured transfers cash or other property to the trustee of the ILIT, and the trustee purchases a new insurance policy, the three-year rule generally will not apply.

(3) Gift Tax Valuation. The grantor-insured will typically transfer one or more life insurance policies or cash to pay policy premiums to the trustee of the ILIT by gift. If the grantor transfers an existing policy to the trustee of the ILIT, the value of the policy is established through the sale of the particular contract by the insurance company, or through the sale by the insurance company of comparable contracts. Reg. § 25.2512-6(a). However, the valuation of an insurance policy based upon the sale of comparable contracts is difficult when the gift is of a contract that has been in force for some time and on which further premium payments are to be made. Accordingly, as a matter of administrative convenience, the regulations provide generally that the value may be approximated by adding the interpolated terminal reserve at the date of the gift to the proportionate part of the gross premium last paid before the date of the gift that covers the period extending beyond that date. Reg. § 25.2512-6(a). If, however, because of the unusual nature of the contract, such approximation is not reasonably close to the full value, this method may not be used. Reg. § 25.2512-6(a). Thus a policy on the life of a terminally ill person could not be valued on this basis. Of course, if the grantor-insured contributes cash to the trustee of the ILIT, and the trustee uses that cash to purchase a life insurance policy, the value of the gift made by the grantor-insured for gift tax purposes will be the value of the cash he or she transferred, not the value of the insurance policy purchased by the trustee.

(4) Annual Exclusion from Gift Tax. Since relatively young and healthy people may purchase quite a bit of term life insurance for premiums that do not exceed the gift tax annual exclusion amount, some ILITs are structured so that contributions by the grantor-insured will qualify for the annual exclusion from gift tax under Section 2503(b). The terms of an ILIT to which contributions are eligible for the annual exclusion from gift tax likely grant the trust beneficiary or beneficiaries the right to withdraw a certain amount of each contribution made to the ILIT (also known as "*Crummey* withdrawal powers"). These withdrawal powers transform the beneficiary's interest in the ILIT into a present interest eligible for the annual exclusion from gift tax.

(5) Community Property Concerns. If the spouse of the grantor-insured is a beneficiary of the ILIT, it is very important to ensure that the grantor-insured does not contribute any community property (whether cash or an

insurance policy that is characterized as community property) to the ILIT. If the spouse-beneficiary has a community property interest in any property contributed to the ILIT, a portion of the corpus of the trust (including the proceeds of any insurance policies held by the trust) may be included in the spouse's estate as a retained interest. In order to avoid this result, the grantor-insured and his spouse should use one or more special marital property agreements to clarify and document that the grantor-insured is contributing only his or her separate property to the ILIT. Remember that if the policy premiums are paid by the grantor-insured's employer or deducted from the grantor-insured's paycheck, these premium payments will generally be treated as community property (because they are a form of compensation for the grantor-insured's services and compensation is generally community property).

D. <u>Qualified Personal Residence Trusts (QPRTs)</u>.

A qualified personal residence trust (a "QPRT") is a grantor trust to which the grantor transfers his or her personal residence and retains the right to live in the residence without paying rent for a specified term of years. After the term of years expires, the personal residence (along with any other property held by the trust) passes to other beneficiaries. If the grantor dies during the initial term, the QPRT terminates and the trust property is included in the grantor's estate for federal estate tax purposes. *See* § 2036(a)(1). However, if the grantor survives the initial term, the grantor may achieve substantial transfer tax savings. Furthermore, once the initial term expires, the grantor may continue to live in the residence for the rest of his or her life by leasing, for fair market value lease payments, the residence from the remainder beneficiary of the QPRT. The remainder beneficiary may also be a grantor trust, in which case the lease payments are ignored for income tax purposes. Any rental payments made by the grantor to the QPRT are essentially additional transfers of property to the beneficial owners of the residence and do not give rise to any additional gift or estate tax liability.

(1) <u>Taxable Gift</u>. On the date the grantor transfers his or her residence to the QPRT, the grantor makes a taxable gift of the value of the remainder interest in the residence (the right to own the residence after the initial term expires). The value of this gift is a fraction of the residence's fair market value on the date of the transfer. The factors that determine this fraction are (x) the length of the term, (y) the grantor's age and (z) the interest rate prescribed by Section 7520 (the "7520 rate") on the date of the transfer.

(a) <u>Term</u>. Some grantors may be tempted to choose a longer initial term in an effort to minimize the value of the taxable gift. The longer the initial term, the lower the value of the right to hold the property after that term expires. However, it is very important to choose a term that the grantor is expected to survive, because if the grantor dies during the initial term, the entire value of the residence will be included in his or her estate. § 2036(a)(1).

(b) <u>Grantor's Age</u>. The grantor's age will affect the calculation of the fraction only if the terms of the trust agreement provide that if the grantor does not survive the initial term, (i) the residence will revert back to the grantor's estate or (ii) the grantor will have a testamentary general power of appointment to direct the disposition of the residence at his or her death. Inclusion of either of these provisions in the trust agreement will reduce the value of the taxable gift, because a contingent right to receive a residence after a term of years if the grantor survives the term is worth less than the value of the absolute right to receive the residence at the expiration of the term. The value of the residence will be included in the grantor's estate for federal estate tax purposes if he or she dies during the initial term regardless of whether he or she retains such a contingent reversion in the residence or a general power of appointment, so such a reversion or power should be included in drafting a QPRT.

(c) 7520 Rate. The QPRT is a particularly attractive estate planning vehicle when the 7520 rate is high, because as the 7520 rate increases, the value (for federal gift tax purposes) of the interest retained by the grantor also increases, and the value attributed to the gifted remainder interest decreases.

(2) During the Initial Term. During the initial term of years, the grantor will be entitled to receive all trust income as the sole income beneficiary of the trust. As the income beneficiary, he or she will also have the right to continue living in the personal residence without paying rent. The grantor's status as the sole income beneficiary will cause the QPRT to be treated as a grantor trust during the initial term of years under Section 677(a)(1) and possibly Section 673(a) because (x) the trust agreement must require all income to be paid to the grantor during the initial term of the trust (Reg. § 25.2702-5(c)(3)) and (y) the grantor may retain a reversionary interest in the entire trust. Therefore, the grantor will receive and be taxed upon any income generated by the QPRT.

(a) Maintenance, Repairs, Etc. The grantor will be responsible for paying for the cost of any ordinary maintenance, property taxes and insurance premiums associated with the residence during the initial term. To the extent the grantor pays for the cost of improvements or major repairs, these payments will be considered additional gifts or loans to the QPRT, depending upon how the transactions are structured. Similarly, payments on debt secured by the residence may be additional gifts or loans, making an encumbered residence a cumbersome asset in a QPRT.

(b) Sale, Damage and Destruction of Residence. If the residence is sold during the initial term of the QPRT, the trustee of the QPRT will have two years to purchase a replacement residence. Reg. § 25.2702-5(c)(7)(ii). Similarly, if the residence held by the QPRT is damaged or destroyed, the trustee will have two years to repair or replace the residence. Reg. § 25.2702-5(c)(7)(iii). If the residence is not repaired or replaced (whether in the case of sale or destruction) within two years, the trustee of the QPRT must either pay the grantor an annuity from the QPRT for the remainder of the initial term, or terminate the QPRT and deliver the sales proceeds or insurance proceeds (and any other trust property) to the grantor, outright and free of trust. Reg. § 25.2702-5(c)(8). The transfer tax-advantaged option is always going to be the annuity option. The amount of the annuity payments will be calculated based upon (1) the value of the original residence at the time it was initially contributed to the QPRT, (2) the value of the original residence when it was sold or destroyed, (3) the 7520 rate for the month in which the QPRT was established, and (4) the 7520 rate for the month in which the annuity payments commence. Reg. § 25.2702-5(c)(8)(ii)(C). Similarly, if the residence held by the QPRT ceases to be used as a personal residence (other than as the result of a sale, damage or destruction), the trustee will have thirty days to commence annuity payments to the grantor as described above or deliver all of the trust property to the grantor, outright and free of trust. Reg. § 25.2702-5(c)(7).

(3) Upon Expiration of the Initial Term. If the grantor survives the initial term, the remainder beneficiaries of the QPRT will receive the residence upon expiration of the term at no further estate or gift tax cost to the grantor or his or her estate. Many grantors provide that the residence will continue to be held in trust for the benefit of the remainder beneficiaries. These continuation trusts may also be structured as grantor trusts, and the grantor may serve as trustee of these trusts.

Whether the residence is held in a continuation trust or outright by the remainder beneficiaries, and whether or not the grantor is serving as trustee of any continuation trust, the grantor and the owners of the residence may enter into a lease agreement. The grantor may lease the residence from the continuation trusts or other remainder beneficiaries in exchange for rental payments. It is very important that these rental payments reflect the fair market value of the residence. If the rent paid by the grantor is too high, this may result in a gift to the continuation trusts or other remainder beneficiaries. However, if the rental payments are too low, the value of the residence may be included in the grantor's estate for federal estate tax purposes. If the residence is held in one or more continuation trusts that are structured as grantor trusts, then the rental payments will not be subject to federal income tax, since transactions between the grantor and the grantor trusts will be ignored for federal income tax purposes. Similarly, the grantor will be able to continue taking deductions attributable to the residence.

VI. Division of a Jointly Funded Irrevocable Grantor Trust into Separate Trusts, Each with a Single Grantor

Consider a scenario in which a joint irrevocable grantor trust has been funded with a married couple's community property. Is it possible to divide this single trust in halves so that each spouse is thereafter treated as the sole grantor of one of the trusts? There is no direct authority, but the stronger view is that it is possible.

An example of when this might be important is when one of the spouses passes away, terminating grantor trust status as to that half, but grantor trust status continues as to the other half, with respect to the surviving spouse. While a half-grantor trust can continue to be administered, future planning may be compromised by having a trust that is half and half instead of having a grantor trust and a non-grantor trust. For example, if half of the trust is going to be distributed to the trust beneficiary, it might be more tax efficient to distribute the non-grantor half and continue to hold the grantor half in trust.

The best practice is to avoid the issue by first partitioning the spouses' property and then having them fund separate trusts if there is a reasonable possibility that having a half and half trust might compromise planning after the death of the first spouse.

If a joint trust comes to be half grantor trust and half non-grantor trust, a division should be possible. Section 2654(b)(1) of the Code expressly provides that a jointly funded trust is treated as separate trusts for generation-skipping transfer tax ("GSTT") purposes, but that provision is not authority to treat the trust as being multiple trusts otherwise (note that the statute says it is not authority, but is otherwise silent). The regulations do expressly permit the division of a single trust into separate trusts that will then be treated as each having a single grantor for GSTT purposes. Treas. Reg. § 26.2654-1(a)(3).

Such a division will be made under state law, so it is clear that there will be two separate trusts under state law. If a joint irrevocable trust is so divided, the Code and regulations are silent as to the treatment of such trusts for income tax purposes. It cannot hurt for the trust division to expressly reference the GSTT provisions and give that as the rational for the division. Given the choice of each trust having a single grantor for income tax purposes or having two trusts with joint grantors, the most logical and reasonable conclusion is that the income tax treatment (and state law treatment) would follow the GSTT treatment and treat each trust as having a single grantor for all purposes. It might be argued that you have trusts with separate grantors for GSTT purposes but equal grantors for income tax (and state law) purposes. But what is the sense in that? And there is no authority in support of that result.

Eric Viehman has pointed out that the GSTT regulations and the grantor trust regulations are "essentially identical" with respect to how the GSTT transferors and grantor trust grantors are identified for tax purposes when a trust has multiple grantors. *Cf.* Reg. § 26.2654-1(a)(2) to Reg. § 1.671-3(a)(3). In both cases, a pro rata allocation is made with respect to each transferor or grantor based on their relative contributions to the trust. He notes that, after a division of the trust, the regulations tell us that we have a single grantor of each trust for GSTT purposes. He argues that given that the policies are the same, there is no reason (and no authority) for applying a different rule for grantor trust purposes. He concludes that the absence of authority supports applying the GSTT rules to divided trust to divided grantor trusts as well.

Given the absence of authority on the issue, the stronger analysis is that the separate trusts should each be treated as having a single grantor. Indeed, there is no reason for the answer to be otherwise. At the very least, there is a reporting position that the divided trusts have only one grantor for all purposes.

VII. Income Tax Reporting

A. Ownership Issues.

The reporting of income for grantor trusts depends on the ownership of the trust.

(1) Grantor as Owner of Entire Trust. The grantor takes into account all items of income, deduction and credit against tax, and all capital gain or loss if

he or she is considered the sole owner of the trust.

(2) Grantor as Owner of Specific Trust Property and Income Related to such Property. The grantor takes into account all items of income, deduction and credit against tax, and all capital gain or loss directly related to the specific property that the grantor is treated as owning. Items not related to the grantor or another person are reported by the trust. Items that relate to both the grantor's and the trust's portions must be allocated in a reasonable manner based on circumstances.

(3) Grantor as Owner of Undivided Fractional Interest or Interest Represented by a Dollar Amount of the Trust. The grantor takes into account his or her pro rata share of all items of income, deduction and credit against tax that are allocable to his or her portion of the trust. The regulations under Section 671 provide details on the allocation of these amounts in situations where the grantor retains an interest in only the income or the corpus of the trust. See Reg. § 1.671-3.

B. Income Tax Reporting Methods.

(1) Traditional Reporting Method. Under the traditional method of reporting, the trustee files a fiduciary income tax return (Form 1041) by the fifteenth day of the fourth month following the end of the trust's tax year, which is typically April 15th. The top of the return is filled out, but the lines where income, deductions, and the like would normally be reported are blank. The items of income, deduction, and credit are shown on a separate statement attached to the tax return that identifies the grantor(s). The grantor(s) then, in turn, reports the information on his or her individual income tax return (Form 1040).

(2) Alternate Reporting Methods

(a) Trust with a Single Grantor. For purposes of determining the number of grantors, spouses who file jointly are considered a single grantor.

(i) Alternate Method #1. The trustee furnishes the name and taxpayer identification number of the grantor and the address of the trust to all payors of the trust during the taxable year and (unless the grantor is a trustee of the trust) furnishes the grantor with a statement (A) informing the grantor that the information on the statement must be included in computing the grantor's taxable income and credits, (B) setting out all items of income, deduction, and credit for the trust for the taxable year, (C) identifying the payor of each item of income, and (D) providing all information necessary for the grantor to compute his taxable income with respect to the trust. The grantor must provide the trustee with a Form W-9 to use this method.

(ii) Alternate Method #2. This alternate method is the only alternate method available to trusts with multiple grantors. In this method, the trustee furnishes the name, taxpayer identification number, and address of the trust to all payors of the trust during the taxable year. The trustee then files all of the trust's Form 1099s (showing the trust as payor and the grantor as payee) with the Internal Revenue Service. The trustee has the same obligations for filing the appropriate Form 1099s as a payor making reportable payments, except that the trustee must report each type of income in the aggregate and each item of gross proceeds separately. Unless the grantor is a trustee of the trust, the trustee must furnish the grantor with a statement similar to the statement described in Alternate Method #1, except that the statement does not have to identify the trust's payors.

(b) Certain Trusts Not Eligible for Alternate Reporting. These alternate methods are not available for:

(i) common trust funds;

(ii) qualified subchapter-S trusts;

(iii) non–U.S. situs trusts (or trusts that have assets located outside the U.S.);

(iv) trusts with a single grantor who reports income on a fiscal year; or

(v) trusts with a grantor who is not a U.S. person.

(3) Administrative Issues – Switching to an Alternate Reporting Method. If a trustee has been filing Form 1041s and wishes to switch to an alternate method, the trustee must file a final Form 1041. The trustee must indicate on the final Form 1041: "Pursuant to § 1.671-4(g), this is the final form 1041 for this grantor trust."

(4) Reporting Rules for Year of Grantor's Death. In the year in which the grantor (or other person who is treated as the owner of the trust) dies, the trust or the portion of the trust deemed to have been owned by the decedent continues to report in the manner previously used for the taxable year that ends *with* (not in the year of) the decedent's death, but may no longer do so for following years.

A trust, treated as owned entirely by a decedent, that continues after the decedent's death must (1) obtain a new taxpayer identification number upon the decedent's death, regardless of whether the trust had previously been assigned a taxpayer identification number during the decedent's lifetime, and (2) furnish payors a new Form W-9 or an acceptable substitute containing the trust's name, the trustee's address, and the trust's new taxpayer identification number.

If only a portion of a trust is treated as owned by the decedent, then after his or her death, the trust continues to report under the taxpayer identification number previously used by the trust, provided that the portion of the trust treated as being owned by the decedent remains part of the original trust and the other portions continue to be treated as being owned by the other grantors.

If the trust had been using the traditional method (filing Form 1041s with an attached statement indicating the trust income allocable to the portion of the trust treated as owned by the decedent), the Form 1041 due for the taxable year ending with the decedent's date of death will be due the fifteenth day of the fourth month following the close of the twelve-month period that began with the first day of the decedent's taxable year. If the trust was deemed to have been entirely owned by the decedent, then the return must also indicate that it is the final return to be filed under the decedent's social security number or the taxpayer identification number assigned to the trust during the decedent's lifetime, as the case may be.

If the trust had been treated as being owned entirely by the decedent and the trustee had been reporting pursuant to the Alternate Method #2 by issuing 1099s, a Form 1096 (Annual Summary and Transmittal of the U.S. Information Returns) filed for the taxable year ending with the decedent's death must indicate that it is the trust's final return.

> (a) If the trust had been treated as owned entirely by two or more grantors and had been filing pursuant to the Alternate Method #2 by issuing 1099s, the trust can no longer report under that method if any portion of the trust has a short taxable year because of the decedent's death and the portion deemed to have been owned by the decedent did not terminate on the decedent's death.

Exhibit A

The "Tax Exclusive" Gift Tax v. the "Tax Inclusive" Estate Tax

Based on the 2021 and estate and gift tax applicable exclusion amount ($11.7 million) and rate (maximum of 40%) apply.

To Get the Family:	Gift Tax Would Be:	Estate Tax Would Be:	Effective Rate
First $11.7 million	$0	$0	0%
Each additional $1 million	$400,000[1]	$666,667[2]	40% / 66.7%

But note that the tax exclusive advantage of the gift tax goes away if the donor dies within three years of the date the gift was made. I.R.C. § 2035(b). In that case, the $400,000 of gift tax paid on the additional $1 million gift is brought back into the estate and gives rise to an additional estate tax of $266,667.[3] The combined $400,000 of gift tax paid plus the $266,667 of additional estate tax, due to §2035(b) inclusion of the gift tax, makes the total gift tax and estate tax $666,667 ($400,000 + $266,667), which is what the estate tax would have been if the $1 million had been given at death. However, there may be other differences, both good and bad, between having made a gift within three years of death as opposed to making the gift at death, including, among others, differences in the donee's basis in the gift and differences in value at date of gift v. date of death.

[1] Because the gift tax is "tax exclusive," the gift tax is computed as 40% of the $1 million that the family receives.

[2] Because the estate tax is "tax inclusive," the estate tax is computed as 40% of the total amount of the estate tax plus the amount that the family receives. Thus, if you have $1,666,667 to begin with, you will pay 40% in estate tax, or $666,667 ($1,666,667 * 40%), leaving $1 million for the family after estate taxes. If you know the amount that you want the family to have after estate tax, you can compute the pre-tax amount you need by dividing that amount (say $1 million) by one minus the estate tax rate (1 – 40%, or 60%), which gives you a result of $1,666,667 ($1 million / (1 – 40%)).

[3] Bringing the $400,000 back into the estate as if it was an asset gives rise to $266,667 of additional estate tax, computed as follows: $400,000 / (1 – 40%) is $666,667 (*see* footnote 2 *supra)*, which is the sum of the $400,000 of gift tax brought back into the estate and the $266,667 of estate tax that results from the inclusion of the gift tax in the taxable estate. When $666,667 is multiplied by the 40% estate tax rate, the additional estate tax is $266,667. That is, estate tax has to be paid on both the $400,000 of gift tax brought back into the estate and on the $266,667 of estate tax that is needed to pay the estate tax on the gift tax.

Exhibit B

The Impact of Income Taxes on Investment Returns

Assume a 40.8% income tax rate and a 23.8% long-term capital gains tax rate.

The value of $100 invested at a 4% annual rate of return will be worth:

After this many years:	If a 40.8% income tax is paid annually:[1]	If a 23.8% capital gains tax is paid annually:[1]	If a 23.8% capital gains tax is paid at end:[2]	If no income taxes are due:[3]
1	$102.37	$103.05	$103.05	$104.00
5	$112.41	$116.20	$116.51	$121.67
10	$126.37	$135.02	$136.59	$148.02
20	$159.69	$182.30	$190.76	$219.11
50	$322.26	$448.72	$565.33	$710.67

The value of $100 invested at a 7% annual rate of return will be worth:

After this many years:	If a 40.8% income tax is paid annually:[1]	If a 23.8% capital gains tax is paid annually:[1]	If a 23.8% capital gains tax is paid at end:[2]	If no income taxes are due:[3]
1	$104.14	$105.33	$105.33	$107.00
5	$122.51	$129.67	$130.67	$140.26
10	$150.09	$168.15	$173.70	$196.72
20	$225.26	$282.73	$318.67	$386.97
50	$761.58	$1,344.09	$2,268.43	$2,945.70

The value of $100 invested at a 10% annual rate of return will be worth:

After this many years:	If a 40.8% income tax is paid annually:[1]	If a 23.8% capital gains tax is paid annually:[1]	If a 23.8% capital gains tax is paid at end:[2]	If no income taxes are due:[3]
1	$105.92	$107.62	$107.62	$110.00
5	$133.32	$144.37	$146.52	$161.05
10	$177.74	$208.42	$221.44	$259.37
20	$315.91	$434.37	$536.44	$672.75
50	$1,773.78	$3,932.32	$8,968.98	$11,739.09

[1] The formula is $(1 + (r - t))^n$, where r is the rate of return, t is the rate of tax paid annually and n is the number of years.

[2] The formula is $((1 + r)^n * (1 - t)) + (1 * t)$, where r is the rate of return, t is the annual tax rate and n is the number of years.

[3] The formula is $(1 + r)^n$, where r is the rate of return and n is the number of years.

Exhibit C

The Impact of Leverage on Investment Returns

Assume a 7% return on assets, which are taxed annually at a 23.8% average tax rate. Assume further that the trust corpus is 10% of the asset value and that the trust borrows 90% of the asset value from the grantor on a nine year note that yields 1.89% per annum (the July 2017 mid-term AFR), with the interest paid annually. If the assets are worth $10 million to begin with, the results over nine years are as follows:

Year	Beginning Value	Income @ 7%[1]	Interest Expense[2]	Tax Expense	Ending Value
1	$10,000,000	$ 700,000	$ 170,100	$ 126,116	$10,403,784
2	$10,403,784	$ 728,265	$ 170,100	$ 132,843	$10,829,106
3	$10,829,106	$ 758,037	$ 170,100	$ 139,929	$11,277,114
4	$11,277,114	$ 789,398	$ 170,100	$ 147,393	$11,749,019
5	$11,749,019	$ 822,431	$ 170,100	$ 155,255	$12,246,095
6	$12,246,095	$ 857,227	$ 170,100	$ 163,536	$12,769,686
7	$12,769,686	$ 893,878	$ 170,100	$ 172,259	$13,321,205
8	$13,321,205	$ 932,484	$ 170,100	$ 181,447	$13,902,142
9	$13,902,142	$ 973,150	$ 170,100	$ 191,126	$14,514,066
Totals		$7,454,870	$1,530,900	$1,409,904	

If the loan is paid off after 9 years, the trust will have $5,514,066 of corpus, a gain of $4,514,066 on the initial $1,000,000 of corpus, an average return of almost 21% per annum.

Now, use the same assumptions except that the trust is a grantor trust:

Year	Beginning Value	Income @ 7%[1]	Interest Expense[2]	Tax Expense	Ending Value
1	$10,000,000	$ 700,000	$ 170,100	$0	$10,529,900
2	$10,529,900	$ 737,093	$ 170,100	$0	$11,096,893
3	$11,096,893	$ 776,783	$ 170,100	$0	$11,703,576
4	$11,703,576	$ 819,250	$ 170,100	$0	$12,352,726
5	$12,352,726	$ 864,691	$ 170,100	$0	$13,047,317
6	$13,047,317	$ 913,312	$ 170,100	$0	$13,790,529
7	$13,790,529	$ 965,337	$ 170,100	$0	$14,585,766
8	$14,585,766	$1,021,004	$ 170,100	$0	$15,436,670
9	$15,436,670	$1,080,567	$ 170,100	$0	$16,347,137
Totals		$7,878,037	$1,530,900	$0	

If the loan is paid off after 9 years, the trust will have $7,347,137 of corpus, a gain of $6,347,137 on the initial $1,000,000 of corpus, an average return of almost 25% per annum. Note that this is $1,833,071 more than the non-grantor trust, and that the increase is more than the non-grantor trust's total income tax of $1,409,904 because the assets have not been reduced because of having to pay income taxes and can earn additional income.

---

[1] This is 7% of the Beginning Value for the year.

[2] This is a fixed 1.89% of the $9,000,000 that was borrowed.

Exhibit D

Example of a Distribution Clause Using a Trust Consultant

Section 2.2(a) So long as the primary beneficiary is living, trustee may pay such part or all of the income or corpus, or both, of the trust as trustee deems proper for the support of the primary beneficiary. In addition, so long as the primary beneficiary is living, the independent trustee (or a related trustee if directed by the trust consultant as provided in section 4.1(a)) may pay such part or all of the income or corpus, or both, of the trust as the independent trustee (or the trust consultant, as the case may be) deems proper for the benefit, comfort and happiness of the primary beneficiary. Any income not distributed in accordance with this section shall be accumulated and added to corpus.

Section 4.1(a) Any provision of this Agreement to the contrary notwithstanding, the trust consultant of a trust created under this Agreement shall have the power, at any time and from time to time, to direct the trustee of such trust to distribute income or corpus of such trust, or terminate such trust, in whole or in part (and distribute the property subject to such distribution or termination in accordance with the terms and provisions of section 4.1(b)) in the trust consultant's sole and absolute discretion.

Section 4.1(b) Should the trust consultant of a trust created under this Agreement direct the trustee of such trust to make a distribution from or terminate such trust as described in section 4.1(a), trustee shall distribute the income or corpus so affected, outright and free of trust to the then primary beneficiary to the exclusion of any remaindermen or other beneficiaries designated by the provisions of such trust.

Section 5.7 Support. "Support" shall mean support, maintenance, health and education. The standard of support, as so defined, shall be limited to support in the beneficiary's accustomed manner of living.

Exhibit E

Example of Grantor Trust Related Language

Section 2.18 Permitted Uses. Notwithstanding any provision contained in this Agreement to the contrary, the provisions of this section shall apply to each trust created hereunder. No trustee shall have the power to purchase, sell, exchange or otherwise deal with or dispose of the corpus or income of a trust for less than an adequate consideration in money or money's worth, except for permitted uses of trust property by or distributions to beneficiaries hereunder. No person shall have the power to borrow the corpus or income of a trust without adequate interest and adequate security. The income of a trust may not be applied to the payment of premiums on policies of insurance on the life of any contributor to the trust.

Section 2.19 Power to Substitute Assets.

(a) Notwithstanding any other provision of this Agreement to the contrary, settlor shall have the power, at any time or from time to time, without the consent or approval of trustee or any other person, to acquire or reacquire part or all of any asset owned by any trust created under this Agreement by substituting another asset or other assets having an equivalent fair market value at the time of such substitution. Although this power is exercisable by settlor in a non-fiduciary capacity without the consent of trustee, settlor shall have the power to substitute assets of a trust for other assets only to the extent that trustee believes such other assets to be of equivalent fair market value at the time of such substitution. Trustee shall not be liable to any person by reason of trustee's good faith determination of the fair market value of the substituted assets. This section 2.19(a) is subject to section 2.19(b).

(b) Settlor may disclaim the power to acquire or reacquire assets of any trust created hereunder at any time by delivering a written notice of disclaimer of the power reserved to settlor under this section 2.19 to the trustee of such trust. Such disclaimer shall include the specific date that the disclaimer becomes effective and shall be signed by settlor. If settlor disclaims this power, settlor will not thereafter possess any power to acquire or reacquire any of the assets of such trust. Trustee, however, shall always retain the right to sell any assets of any such trust to any person (including settlor) if trustee, in the exercise of trustee's discretion, determines it is in the best interest of any trust to do so.