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Subject: Joy Matak, Sandra D. Glazier & Martin M. Shenkman - Estate Planning Six-Part Series for Late 2020, Part 5: Use of Non-Grantor Trusts for Planning Benefits

“As we wind down the year – and this newsletter series – we are conscious of the ongoing rush to plan before year-end that has consumed so many advisers. 2020 may very well be the best opportunity to implement planning strategies to mitigate federal estate taxes and accomplish estate, asset protection and other objectives.

The Biden administration is expected to seek increased COVID stimulus in order to address the widespread consequences of the pandemic. Control of the Senate hangs in the balance as two contentious Senatorial races in Georgia head towards a runoff on January 5, 2021. President-elect Biden has outlined his priorities, setting forth a wish list that will require funding to accomplish. Will Congress pass tax legislation early in the Biden presidency?

Even if the Republican Party retains control of the Senate following the Georgia runoffs, President-elect Biden may be uniquely positioned by his long-standing relationships with his former Senate colleagues to pass new tax legislation. Career politicians in Washington understand that failure to deliver comprehensive measures to address the unemployment, housing, and food crises facing the nation’s populace could lead to a massive progressive wave in 2022 on a scale that could rival the 2018 elections.

For these reasons, there is still so much that remains unknown about the future of taxes. Through our Roadmap series, we have aimed to provide you with practical thoughts on planning during the last few weeks of 2020. In our fifth installment, we would encourage you to reconsider opportunities to incorporate non-grantor trusts into estate plans, as discussed below in this fifth installment of our six-part series, including discussions on:

1. *How vulnerable grantor trusts might be to inclusion in the grantor’s estate on death*

2. *Non-grantor trusts may support asset protection planning goals and help differentiate SLATs as non-reciprocal*
3. *Structuring non-grantor trusts to maximize charitable and SALT tax deductions, and minimize net investment income taxes*
4. *The merits of using beneficiary trusts and non-grantor spousal access trusts*
5. *Administration of non-grantor trusts as key to ensuring the success of an estate plan*

The final newsletter in this series will review opportunities for planning before year-end that have not been addressed in preceding newsletters of this series."

Joy Matak, JD, LLM, Sandra D. Glazier, Esq. and **Martin M. Shenkman, Esq.** provide members with important and timely commentary in the form of a six-part series, Part 5 of which is a discussion of the use of non-grantor trusts for planning benefits.[i]

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Here is their commentary:

COMMENT:

The Fate of Beloved Grantor Trusts

While there has not been significant discussion among moderate Democrats, including the President-elect, to push for inclusion of grantor trusts in the taxable estates of decedents, progressives have floated the idea of including assets owned by grantor trusts in the grantor's estate.

Although many might view the possibility of inclusion of grantor trust assets as a proposal unlikely of enactment, the fact that prominent Democrats have discussed the idea creates some uncertainty about the fate of the ubiquitous grantor trust:

- Will such a proposal be included in any future legislation?
- What will be the effective date of such a change?

- Will existing trusts be grandfathered?

Practitioners might consider two steps. First, complete grantor trust planning before year-end so that if the Democrats secure both seats in the Georgia runoff and proceed to pass such legislation, perhaps those trusts will be grandfathered. Most planning discussions have focused on use of exemptions. However, creating and funding dynastic grantor trusts that might be grandfathered could be just as important for some clients. The second step might be to consider drafting new grantor trusts, and providing that any grantor trusts that are revisited (e.g. by decanting) with mechanisms to facilitate turning off grantor trust status. This might be accomplished by incorporating provisions to permit conversion to non-grantor status by renouncing grantor powers or empowering a trust protector to switch off grantor trust status. It may be advantageous to complete such planning as soon as possible to perhaps precede any effective date of future legislation.

Non-Grantor Trusts May Support Asset Protection Planning Goals and Help Differentiate SLATs as Non-Reciprocal

When planning with an asset protection motive is pursued, having a significant tax motive can provide valuable support to the plan. In the current environment, the potential for a reduced exemption may well support many asset protection plans and transfers. But what about clients with smaller net worth that desire asset protection planning? Income tax benefits of non-grantor trusts (e.g. possible state income tax benefits) may provide the tax motivation for plans of more moderate wealth clients that also want asset protection.

> **Example**: Physician and her spouse have a net worth of $6 million. Shifting assets to non-reciprocal spousal lifetime access trusts (“SLATs”), given the current high exemptions, may not permit that same couple to realize any estate tax benefit. Under what some consider the worst case scenario of a $3.5 million exemption, there still would not be any estate tax savings. Perhaps, there are insufficient other non-asset protection justifications for the plan. However, if a non-grantor trust were instead created, and state income tax (“SALT”) and perhaps other income tax savings are realized, those income tax

savings might lend support to the viability of the asset protections provided for in the trust.

Another use of non-grantor trusts, which might be particularly useful in the waning days of 2020, is to differentiate SLATs for spouses as being non-reciprocal. There is presently insufficient time to differentiate trusts by creating them at different times and it may not be feasible to create them pursuant to otherwise sufficiently different plans. But what if one SLAT is created as a grantor trust, and the second is created as a non-grantor SLAT (some have referred to this as a spousal lifetime access non-grantor trust or "SLANT" or a "SALTy-SALT" as a SLAT structured to preserve SALT deductions restricted by the 2017 tax act)?

The above are just two examples of how a non-grantor trust might provide justification for other important 2020 planning.

Create a Non-Grantor Trust for Charitable Contribution Deductions for Moderate Income Client

President elect Biden tax proposals have included several items that could affect the use of non-grantor trusts to secure income tax benefits. One proposal is to restore the 3% Pease limitation. This might apply if income exceeds $400,000. This could require that itemized deductions be reduced by 3% of adjusted gross income ("AGI") over the threshold amount of up to 80% of itemized deductions. This reduction could be applied to charitable, SALT, mortgage interest, and miscellaneous itemized deductions. The use of a non-grantor trust and shifting some deductions to the non-grantor trust may preserve some of those deductions.

Although legislation early in 2020 allowed for individuals to maximize charitable contributions up to 100% of their AGI, taxpayers cannot use their charitable trusts or donor advised funds without losing the income tax benefit.

Further, in future years most taxpayers will not exceed the standard deduction threshold thereby losing the tax benefits of charitable giving. It is estimated that the doubling of the standard deduction to $24,000 for a married couple has lowered charitable giving by individuals $13 billion+ per year[ii]. Conversely, some commentators have suggested that the overall impact on charitable giving may not be significant.

The doubling of the estate tax exemption to more than $11 million had also been estimated to lower charitable bequests by $4 billion per year.[iii] Bunching itemized deductions and using donor advised funds (“DAFs”) to circumvent the impact of the 2017 changes, including the doubled standard deduction, may not provide benefit for many taxpayers. With the significant restriction or elimination of so many itemized deductions, bunching may not push a taxpayer over the new standard deduction threshold. Even if the exemption threshold can be exceeded every 2nd or 3rd year via bunching, the tax benefit of donations made up to that level in any given year will still be lost. It is believed that the number of itemizers plummeted following the 2017 tax act changes. One estimate predicted that the number of taxpayers who itemized would decline from $46.5 million in 2017 to only $18 million in 2018.[iv]

For some taxpayers, making direct charitable donations from an IRA for those over 70 ½ and donating appreciated assets (thereby avoiding tax on the appreciation), are still beneficial charitable planning strategies. For other clients, creating a simple non-grantor trust may serve to salvage charitable contribution deductions. When drafting these trusts, practitioners could include language in the instrument that directs that distributions to charity be made from gross income.[v] What relevance is this to late 2020 planning? If two non-reciprocal SLATs are to be created, making one non-grantor may not only provide the income tax benefits suggested above, but it could add a significant difference between the two trusts to perhaps help deflect a reciprocal trust challenge. In administering the trusts, it would be helpful for advisers to guide the client as to which expenses and distributions might be advisable to be paid from the grantor trust, and which from the non-grantor trust.

Create a Non-Grantor Trust in a Trust Friendly State to Save State Income Taxes

The economic disruptions of Covid may result in states increasing income taxes. Consider the possibility of enhanced income tax benefits when evaluating the use of non-grantor trusts as part of late 2020 planning.

State income taxation on non-source (e.g. passive assets) may be deferred or avoided through the use of non-grantor trusts. This type of planning may become more common for two reasons. First, the state and local tax

(“SALT”) deduction limitations make the net cost of state income taxes much higher, given the SALT limitations under the current tax laws. Therefore, many taxpayers, especially those in high tax states, may wish to pursue the use of non-grantor trusts in an attempt to avoid state income taxes that would otherwise no longer be deductible. Further, given a number of other tax savings opportunities that can be achieved through use of non-grantor trusts, taxpayers may already be creating non-grantor trusts for other tax planning purposes.

It could be beneficial to evaluate whether existing trusts, paying high state income tax, might be modified or moved so that high state income tax might be avoided. An existing trust may be able to be moved to a different state that has a more favorable tax system. That may require moving assets out of the initial state, changing trustees to out-of-state trustees, and assuring no initial state source income. If source income cannot be avoided, by using powers in the instrument, decanting or non-judicial modification, it may be feasible to divide the existing trust so that one resulting trust has solely non-source income and the other resulting trust earns all source income. Only the trust containing non-source income would be moved. There may be no particular need to complete this planning in late 2020 if the purpose of such planning is to effectuate these changes alone. However, many clients are using late 2020 as a time to evaluate and improve old trusts before potential changes in the law occur. So, for example, if a client had created a trust for descendants that distributed outright to children at age 35 and to which GST was not allocated, that client may seek to improve this trust before 2021 when GST exemptions might change by decanting into a new trust that retains assets more long term (e.g. the child’s lifetime) and to which a late allocation of GST may be made. Those improvements might be enhanced by moving the trust to a no tax (or low tax) state from a high tax state, and/or modifying the trust to make it a non-grantor trust if it was not.

This type of planning can raise complex issues that will need to be evaluated on a case-by-case basis. For example, the question of “what constitutes source income?” may only be answered by reference to resident state specific laws. Where a trust owns a partnership interest that has a modest amount of source income in the initial state, some states would consider even $1 of source income as sufficient to taint the trust and cause taxation on all of the income in that tax year.[vi]

In moving a trust out of a high tax state to a low tax state, what if there is an investment advisor or trust protector in the initial jurisdiction? Will that taint the trust such that it remains subject to taxation in the initial state? In an attempt to break taxation nexus to the initial jurisdiction, will it suffice to create a limited liability company ("LLC") or other entity in the new jurisdiction to house the protector, investment adviser and other positions that are residents of the initial jurisdiction?

Practitioners and trustees might consider reviewing the possible benefits of converting a grantor trust to a non-grantor trust to save state income taxes. Caution is important. What if the progressive estate tax proposal of including grantor trusts in the grantor's estate is eventually enacted?[vii] It might be wise to retain a grandfathered grantor trust (if that is feasible), even if that means sacrificing the current income tax benefits of having a non-grantor trust. Also, consider the implications of installment sales, negative basis, and income tax consequences on conversion. Evaluate whether grantor trust status versus possible state income tax savings is preferable.

Use Non-Grantor Trusts to Save Net Investment Income Tax ("NIIT")

It may be feasible to use non-grantor trusts to save net investment income tax ("NIIT").[viii] If the trustee is actively involved in a business held in a non-grantor trust the NIIT tax may not apply, whereas had the client held that interest individually it would have if the client is not actively participating in the business. Remember that the determination of what is required for a trust to actively participate to avoid the NIIT tax remains uncertain. The IRS rulings on this matter have been rather harsh.[ix] Several court cases, however, have taken a positive view of a trustee's participation as characterizing a trust as active.[x] What if the trust involved is a directed trust and the general trustee is an institution that is not involved in management, but the investment adviser (or investment trustee) is actively involved? Is that sufficient to characterize the trust as active in order to negate application of the NIIT?

Non-Grantor Trusts with Spousal Access Without Tainting Non-Grantor Status

The second and fourth newsletters in this series discussed using a non-grantor trust to benefit a spouse in order to combine the benefits of using a non-grantor trust with the flexibility of a spousal access trust in late 2020 planning.

A non-grantor trust might be a variant of a spousal trust that could be used to achieve disparate goals. These trusts have been referred to as a "SALTy-SLAT" by virtue of the non-grantor SLAT being used in an attempt to salvage some of the SALT deductions. Others have referred to it as a Spousal Lifetime Access Non-Grantor Trust ("SLANT"). Whether a new acronym is used, drafting non-grantor, completed gift, trusts that are accessible, may be a technique to consider for some clients in the current planning environment.

Under IRC Section 677(a), the grantor of SLAT is treated as the owner (for income tax purposes) of any portion of a trust whose income, without the approval or consent of an adverse party, is or may be distributed to the grantor's spouse or accumulated for future distribution to the grantor, or the grantor's spouse, as determined in the discretion of the grantor or a non-adverse party or both. The corollary to this is that if an adverse party must approve distributions to the grantor's spouse, a SLAT can both provide for distributions to the spouse and still be a non-grantor trust.

Conversely, a SLANT might provide non-grantor status if drafted as follows:

- The "grantor-trust" rules set forth in IRC Sections 673-678 should not be triggered. This is quite the opposite of most trust planning engaged in for many years, other than ING trusts.
- To avoid grantor trust status, the grantor cannot retain a reversionary interest or the right to re-vest title in SLANT trust assets in the grantor.
- The grantor must not retain the right to direct disposition of trust income or property, the right to receive trust income, or the right to have the trust pay life insurance premiums on the grantor's behalf.
- If the grantor's retained power to re-vest title to trust property or receive trust distributions is exercisable only with consent of an adverse party, the trust generally will not be considered a grantor trust.
- No income or principal of the SLANT may be distributed to the grantor's spouse without the consent of an adverse party. By way of example, the adverse party could be the eldest beneficiary of the trust

excluding grantor’s spouse. Such individual’s beneficiary interests in the trust would be adverse to those of the grantor’s spouse. If more than one person is adverse under this definition, then the Trust Protector could be empowered to designate which of such persons shall be required to provide the adverse consent.

- No portion of the income or corpus of the SLANT may be distributed to discharge any legal obligation of the grantor or grantor’s spouse without the consent of the adverse party.
- No income of the SLANT may be used to discharge debts of the grantor or to pay gift or estate taxes on grantor’s estate.
- No income of the SLANT may be used without the consent of an adverse party to pay premiums on life insurance policies on the life of the grantor or grantor’s spouse.[xi] Note that it would likely be preferable to use a separate ILIT and not include life insurance on the life of the grantor or the grantor’s spouse in a trust that is intended to be a non-grantor trust.
- If the SLANT is intended to utilize the currently high temporary exemptions amounts before they might expire, it will need to be a completed gift trust. A gift is treated as complete if the donor “has so parted with dominion and control as to leave him in no power to change its disposition.”[xii] However, if under the terms of the SLANT instrument the grantor retains the power to consent to distributions, the gift is considered incomplete. An incomplete gift does not use up the grantor’s gift tax exemption.

Planning Considerations: Since the trust must be structured to avoid grantor trust status, the grantor cannot have a power to substitute assets, thereby necessitating that these trusts be funded carefully with high basis assets. That may all change if a Biden administration is able to enact the repeal of basis step-up. Conversion from a non-grantor trust to a grantor trust by later removing the requirement of the adverse party to approve distributions to the spouse is possible but may be expensive. It’s important to consider the forfeiture of the ability to address basis problems that may arise later when evaluating this strategy.

If the trust is properly structured (with no grantor powers to the grantor spouse) and the beneficiary spouse can only receive distributions with the consent of an adverse party, the trust may achieve all objectives:

completed gift to use exemption, non-grantor trust for any or all of the planning benefits of non-grantor trust, and spousal access.

All of that said, while it is true that sophisticated clients do not mind some complexity to preserve wealth, it might be difficult for practitioners to convince a client who has spent decades building wealth to cede over to an adult child (or, step-child) the right to decide whether distributions from those assets can be made for the benefit of the client's spouse (and, by extension, the client). While it appears that the SLANT may achieve some of the client's intended goals, the required provisions may be just too restrictive to make the use of such a trust palatable for many clients.

Converting/Toggling from Grantor to Non-Grantor Status

To convert an existing grantor trust into a non-grantor trust, the grantor (and perhaps the grantor's spouse) may have to release all the powers in the instrument that would cause it to be treated as a grantor trust. Once the original grantor renounces all grantor trust powers, it's advisable for the planner to confirm that Section 678 will not cause the trust to be treated as a grantor trust with respect to any beneficiary. By way of example, so-called *Crummey* powers[xiii] in the instrument can cause the trust to be deemed a grantor trust as to the *Crummey* power holders to the extent of their withdrawal powers if the grantor cannot be treated as a grantor for income tax purposes.

Can you merge/convert/decant an existing grantor trust into a non-grantor trust? What about a non-grantor trust being converted to a grantor trust via a decanting? With changes in the law one characterization may have been preferable in the past, but a different characterization may be more advantageous now, and if the individual tax changes sunset in 2026 yet a different characterization may be more advantageous then. Practitioners might consider approaches that incorporate flexibility for this type of planning in trust instruments. For example, a power to swap assets and to lend without adequate consideration should be excluded if non-grantor trust status is desired. What if a named individual was empowered as a non-fiduciary to add these rights back into the trust, if appropriate, at a future date? If that is done, might the IRS argue that there was an understanding or implied agreement with the power holder? Also, when including a provision that might permit reimbursement of income tax consequences borne by the grantor as a result of grantor trust status, it will be important that no understanding or implied agreement exist between grantor and the trustee (or other power holder) with regard to such reimbursement power, if it is intended that estate tax inclusion be avoided.

Converting a non-grantor trust to a grantor trust should not have any adverse income tax consequence, unless some special rule applies, by way of example, when a non-grantor trust holds the right to income in respect of a decedent, such as when a trust owns an interest in an IRA.[xiv] If a non-grantor trust is converted to a grantor trust then the non-grantor trust should file a final income tax return through the date of conversion reporting that all income for the year of conversion has passed to the new grantor trust.

Converting from a grantor trust to a non-grantor trust also may trigger other income tax costs, e.g. if there are liabilities in excess of basis.

Practitioners might contemplate possible sunset or changes in planning documents by empowering a trust protector or other person to turn on or off grantor trust status in order to convert a non-grantor trust into a grantor trust if the intended income tax benefits sunset. The IRS had held against toggling on and off grantor trust status, but the circumstances of that ruling were abusive and the same rationale may not apply to other situations, especially if the toggle is a result of a change in the law (e.g., the sunset of Act changes).[xv] Incorporating a decanting power to facilitate the trustee converting the trust status via decanting might also be worth consideration.

Another issue might arise on conversion. Could it create a claim by a beneficiary against the trustee now that the trust or beneficiaries, not the grantor, have to bear the income tax burden? If that is envisioned and is of concern, it should be expressly authorized in the trust instrument and trustee liability waived for doing so as may be provided for in Alaska. However, in other states, the duty of undivided loyalty to the beneficiaries may not be waived – so caution is recommended.

2021 Follow up: Administration of Non-Grantor Trusts: Schedule Annual Trust Meetings - Proper Trust Operation is Vital to Achieving Intended Income Tax Status

It may not be sufficient to craft the trust instrument as a non-grantor trust, or to convert a grantor to non-grantor trust properly. The trust must also be administered in a manner that conforms to the non-grantor trust requirements. These are all good 2021 follow up considerations for 2020 trust planning. For example, if the trustee unbeknownst to the practitioner purchases life insurance on the grantor's life, and pays a premium, that might characterize the trust in whole or part as a grantor trust. What if a loan is made to the grantor and the interest rate or security is inadequate? Should loans be prohibited? Even if prohibited by the instrument the trustee's authorized action of making a loan might undermine the intended non-grantor status if the loan (and the interest due thereon) aren't paid before year-end. [xvi] If the instrument prohibits distributions to the grantor's spouse without the consent of an adverse party, what if the trustee makes a distribution without such consent? This might be more likely to occur if the trustee is a non-professional individual rather than a professional or institutional trustee. What if the trustee or a protector acts in a manner that suggests an implied agreement to benefit the grantor thereby undermining non-grantor trust status. In all events, as the complexity and variety of trusts in a client's plan expands, the importance of annual reviews with counsel and the rest of the planning team becomes more essential. It may be more difficult for clients, and even some of the client's non-tax advisers, to differentiate grantor from non-grantor trusts, and to use the appropriate trust administration techniques for the right trust.

The *SEC v. Wyly* case continues to serve as a reminder about the importance of proper trust operation.[xvii] In *Wyly* the trust had trust protectors for each of 17 inter-vivos trusts. None of the persons serving as trust protectors were related or subordinate. Nonetheless the trustees followed all investment recommendations made by the protectors including with regard to collectibles, etc. The conduct of the trust protectors and grantors was such that the court imputed all actions of the trust protectors to the grantors since there was a pattern of action. While the *Wyly* case might be a bit extreme, the concept of a pattern of conduct is problematic in so many situations (e.g., a pattern of distributions from a trust that is then attacked in a later divorce). Clients too often do not understand the need to meet annually with legal counsel to identify inadvisable patterns of distributions, payments, investments, etc. or to consult with counsel before inadvisable distributions, payments, or investments are made. Even if *Wyly* is viewed as an outlier, its lesson is nonetheless important. Adhering to formalities, and conducting meetings with the professional adviser team to address distributions, payments and investments remains important.

Conclusion

It remains important for clients to be informed and educated on the unique nuances of the late 2020 planning environment, and the changes that may be in the offing (or not). The potential for massive tax changes is unpredictable but yet vital for many clients to consider and thereby perhaps permit them to take proactive steps now. It might be helpful to forewarn clients that all their planning efforts may be for naught and could even leave them in a position that is less favorable, depending on political developments and future legislation, than had they done nothing. In this environment there are a range of planning considerations that might affect how practitioners handle late 2020 planning.

HOPE THIS HELPS YOU HELP OTHERS MAKE A *POSITIVE* DIFFERENCE!

Joy Matak

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CITATIONS:

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[ii] https://beta.washingtonpost.com/business/2019/02/26/definitely-bad-news-new-study-finds-charitable-giving-grew-sluggish-last-year/?noredirect=on .

[iii] https://www.councilofnonprofits.org/sites/default/files/documents/tax-bill-summary-chart.pdf .

[iv] Erica York, “Nearly 90 Percent of Taxpayers Are Projected to Take the TCJA’s Expanded Standard Deduction,” https://taxfoundation.org/90-percent-taxpayers-projected-tcja-expanded-standard-deduction/ , September 26, 2018

[v] Section 642(c).

[vi] Ed Morrow, Jonathan Blattmachr and Marty Shenkman, “Using Decanting and BDOT Provisions to Avoid a Peppercorn of Income Potentially Triggering State Income Tax on a Trust’s Entire Income,” Steve Leimberg's Income Tax Planning Email Newsletter Archive Message #205, 15-Sep-20.

[vii] “For the 99.8 Percent Act,” S. 309 116th Cong. (2019). As discussed previously, it is unlikely that this plan would be adopted in a Biden administration.

[viii] Section 1411.

[ix] TAM 200733023, and TAM 201317010. A national office technical advice memorandum (TAM) cannot be cited or used as precedent. Section 6110(k).

[x] *Mattie K. Carter Trust v. US*, 256 F. Supp. 2d 536 (N.D. Tex. 2003); *Frank Aragona Trust v. Comr*., 142 T.C. No. 9 (Mar. 24, 2014). Section 642(h). See also, • When is a Trustee Not a Trustee (in the context of Real Estate Business Held in Trust for Purposes of the Net Investment Tax)? Sandra D. Glazier, BNA Tax and Accounting Center, Apr. 2014.

[xi] IRC Section 677(a)(3).

[xii] Reg. §25.2511-2(b).

[xiii] That is, those powers granted to a beneficiary enabling her to withdraw property from the trust generally in order to qualify all or a portion of a gift for annual gift tax exclusion.

[xiv] PLR 200848017, CCA 200923024 cf. I.R.S. Notice 2007-73, 2007-36 I.R.B. 545. Cf. Rev. Rul. 77-402, 1977-22 CB 222.

[xv] I.R.S. Notice 2007-73

[xvi] IRC Section 675(3). See, Burning Questions (and Even Hotter Answers) About Grantor Trusts, Samuel A. Donaldson, NAEPC Journal, Vol. 7, 2010.

[xvii] *SEC v. Wyly et al*, No. 1:2010cv05760 - Document 622 (S.D.N.Y. 2015).