# I HAVE A GRANTOR TRUST AND AM TIRED OF PAYING THE INCOME TAX ON TRUST INCOME. WHAT CAN I DO?

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## Introduction

Grantor trusts, trusts for which the income of the trust is taxed to the settlor creating the trust, have been and remain the foundation of most modern estate planning. One of the many "benefits" of grantor trusts is that the settlor creating the trust pays the income tax on income earned inside the trust. That is a great way to accelerate the growth of trust assets and continue to reduce the creator's estate. But, as with so many things, too much of a "good thing" can grow old. At some point, the cost of paying that income tax may feel just too burdensome and people want out. What options exist to mollify growing angst the grantor feels from continuing to bear the tax cost on trust income? We'll refer to this as "grantor trust angst."

## Settlor's Payment of Taxes on The Income Earned by The Grantor Trust

Though clients may not always remember, the requirement of the grantor to continue to pay the income taxes due on income earned by assets in the trust is a feature, and not a bug. Under Revenue Ruling 2004-64, the Internal Revenue Service determined that the grantor will not be treated as having made a gift of the amount of the tax to the trust beneficiaries since the grantor is legally responsible for the taxes due, even though paying taxes on income earned by the trust is likely to be a huge benefit to the beneficiaries of the trust. Paying the taxes on the income earned by the trust enhances the value of the trust which receives the income but not the tax burden while also allowing the grantor to reduce their taxable estate by the amount of the taxes paid.

## Grantor Trusts Background

Before digging into ways that a practitioner might address grantor trust angst, let us do a quick review of grantor trust planning. While practitioners are likely familiar with all of this, clients often forget what was discussed when the grantor trust was originally settled and funded. Perhaps the first step in addressing grantor trust angst is to review with the client what a grantor trust is, the benefits of a grantor trust, and a reminder about any specific discussions that may have occurred at the time the trust was originally created and funded.

All of the income, deductions, and credits of the trust are reported on the grantor's personal income tax return for that portion of the trust for which he or she is deemed to be the owner.[1] A grantor can be treated as the owner only as to a portion of a trust (e.g., 50%), only as to trust income, only as to trust principal, or as to both income and principal.[2]

It is important that no client turn off grantor trust status before understanding the implications of that step. By way of example, turning off grantor trust status could have severe income tax consequences which ought to be evaluated. By way of example, consider the following:

- A grantor trust status and the grantor can engage in the tax free sale or substitution of assets between the grantor and the trust.[3] Once grantor trust status is turned off, such transactions will no longer be feasible without income tax implications.
- Once grantor trust status is turned off, caution may have to be exercised if grantor trust status is ever turned back on (even if that is possible). Some may take the view that the grantor trust "switch" should not be flipped more than one time. Conversion from nongrantor to grantor trust status may not be a taxable event.[4]
- Only certain types of trusts can hold stock in an S corporation without jeopardizing the corporation's favorable "S" status (i.e., so income flows through to the shareholders without double corporate taxation). Grantor trusts can hold S corporation stock. Prior to turning off the grantor trust status of a trust that owns S corporation stock, the trustee should consider which election the trust should make in order to continue owning S corporation shares of stock.[5]

In a recent malpractice case the client, after turning off grantor trust, sued the attorney claiming they did not understand the consequences of having done so. [6]

## A Rose by Any Other Name Would Smell as Sweet

Grantor Trusts are also sometimes referred to as "Intentionally Defective Grantor Trusts" or by the acronym "IDGTs" even though there is very little that is "defective" about them. Although the trust is defective (an incomplete transfer) for income tax purposes (income is taxed to the creator of the trust), it can be effective (a complete transfer) for estate tax

[1] IRC Sections 672-679.
[2] Treas. Reg. Sec.1.671-2(b).
[33] Rev. Rul. 85-13.
[4] CCA 200923024.
[5] Nongrantor trusts can either make an Electing Small Business Trust (ESBT) election pursuant to IRC Sect. 1361(e) or a Qualified Subchapter S Trust (QSST) election under IRC Sect. 1361(d). Each type of election has benefits and drawbacks, a complete discussion of which is beyond the scope of this article.
[6] Scott v. Rosen, et al, Broward County docket no. CACE20000868. The plaintiff's filed suit in Nevada in an attempt, among other things, to enforce a grantor swap rights the client believed she had retained in an attempt to substitute assets of the trust. The Plaintiff had previously turned off grantor trust status in a document dated December 11, 2015 under which she had relinquished the rights of substitution.

purposes so that the property is not included in the grantor's gross estate. If the trust is irrevocable and the grantor does not retain ownership powers that would cause the trust principal to be included in his or her estate, the value of the trust assets should not be subject to estate inclusion by the grantor.

## How to Create a Grantor Trust

How does one create a grantor trust? It will be critical to understand exactly what makes a trust a "grantor trust" for income tax purposes. If the decision is ultimately made to terminate grantor trust status, each mechanism that results in grantor trust treatment will have to be modified in order to "turn off" that status.

Fortunately, the Internal Revenue Code at Subchapter J identifies the specific powers that will make a trust a "grantor trust" if any such power is retained by the settlor who created the trust. Following is a brief summary of each provision though practitioners would be well-advised to review the specific language in each relevant code section before concluding on whether such power exists:

- IRC Sect. 673 - a reversionary interest in either the corpus or the income of the trust.
- IRC Sect. 674 - if the beneficial enjoyment of the corpus or the income from the trust is subject to a power of disposition by the grantor without the approval or consent of any adverse party.
- IRC Sect. 675 - certain administrative powers exercisable by the grantor for the benefit of the grantor rather than for the trust beneficiaries, or powers exercisable in a nonfiduciary capacity, including those noted below.
    - IRC Sect. 675(2) the power to deal with trust assets for less than full and adequate consideration.
    - IRC Sect. 675(3) the power to borrow trust assets without adequate interest and security other powers exercised in a nonfiduciary capacity by any person without the approval or consent of any person in a fiduciary capacity, including those following. If the grantor has the right to borrow trust assets for less than adequate security, or less than adequate interest payments, the trust will be a grantor trust. Loans for less than adequate interest are often avoided as that may create an estate inclusion risk. If the grantor borrows trust assets without adequate security or adequate interest (even if the trust instrument does not specifically allow for such loans), and the loan is not repaid by the end of the tax year, the trust will be characterized as a grantor trust. These restrictions are applied in a broad manner such that even an indirect borrowing can result in grantor trust treatment. If improperly structured, a loan to a partnership of which the grantor is a general partner could present a problem in that the grantor may be

personally liable for the loan as a general partner.[7] However, a loan to a corporation controlled by the grantor would not have the same result. [8]

- IRC Sect. 675(4)(A) – power to vote the stock of entity in which grantor retains voting control. The powers must be exercised in a non-fiduciary capacity.[9] If a power is exercised "primarily" in the "beneficiary's interest" it is exercised in a fiduciary capacity. Therefore, the power has to be exercised in a manner that is not primarily in the beneficiary's interest. If the person exercising the power is a fiduciary the exercise of the power is presumed to be done in a fiduciary capacity unless the contrary can be demonstrated by clear and convincing evidence. Not an easy standard. The terms of the trust and the surrounding facts and circumstances will be considered in this evaluation.

- IRC Sect. 676 – power of grantor (or spouse) to revoke the trust.
- IRC Sect. 677 - if income from the trust is used, without the consent of an adverse person, to pay the premiums on a life insurance policy on the grantor's (or grantor's spouse's) life, at least to the extent of such income.

## Common Types of Grantor Trusts

Grantor trusts are ubiquitous in estate planning and many different types of trusts can be structured to be grantor trusts. Some trusts, by virtue of their very nature, will automatically have to be grantor trusts.

With limited exceptions, the following trusts are often characterized as "grantor" trusts:

- Spousal Lifetime Access Trusts ("SLATs") or "Spousal Access Trusts" are grantor trusts pursuant to IRC Sect. 674. Note that if the right of the spouse to receive distributions is subject to the approval of an adverse party, e.g. a child who is also a beneficiary, the trust will be a non-grantor SLAT. This has been referred to as a Spousal Lifetime Access Non-Grantor Trust or "SLANT." An Adverse party is any person who meets the following criteria: The person has a "beneficial interest" in the trust; the interest the person has in the trust is "substantial"; and the interests involved would be adversely affected if the grantor (or anyone who is not adverse to the grantor) exercised the particular power, or chose not to exercise it.

- Irrevocable Life Insurance Trusts ("ILITs") are generally grantor trusts pursuant to IRC Sect. 677, though it may be feasible to craft a non-grantor ILIT. If trust income can be used, directly or indirectly, to benefit the grantor, the grantor will be treated as the owner of the trust. This includes the application of income to pay premiums

[7] Bennet v. Comr. 79 T.C. 470 (1982).
[8] Buehner v. Comr., 65 T.C. 723 (1976).
[9] Treas. Reg. Sec. 1.675-1(b)(4).

on life insurance policies insuring the life of the grantor or the grantor's spouse.[10] Specifically, the grantor is deemed the owner of any portion of the trust or the trust income which can be used (without the consent of an adverse party) to pay premiums on life insurance policies.[11] Prior cases, under a predecessor statute, held that the grantor was only taxable on trust income actually used to pay premiums. The IRS has held that if trust income is used to purchase life insurance even in contradiction of the terms of the trust, the trust will still be characterized as a grantor trust. [12]

- Retained Interest Trusts, such as: revocable living trusts, Grantor Retained[13] Annuity Trusts ("GRATs"), and Qualified Personal Residence Trusts ("QPRTs") are grantor trusts under one or both of IRC Sect 673 and 674.

For income tax purposes, the grantor (and not a beneficiary) is taxed on all income earned by the grantor trust.

**Some Benefits of a Grantor trust**

Strategic usage of grantor trusts can maximize opportunities to transfer assets to heirs and protect assets from potential creditor claims. Since the grantor trust is disregarded for income tax purposes, transactions between the grantor and the trust are also disregarded for income tax purposes. Transactions that would ordinarily result in an income tax may be disregarded. These opportunities offer a grantor some additional flexibility, while satisfying the main objectives of setting up the trust in the first place: to reduce estate taxes by freezing the value of the assets transferred to trust and allowing assets to appreciate outside of the grantor's taxable estate.

Practitioners should collaborate to quantify the potential consequences of turning off grantor trust status, particularly if the grantor and the grantor trust are engaged in one or more of the following activities:

- Lending to the trust.
- Selling assets to the trust.
- Substituting assets in the trust, whether by purchasing the assets using a Note or by transferring other assets of equivalent value.
- Borrowing from the trust.

It is vital for clients to understand any income tax consequences in such circumstances before they undertake to turn off grantor trust status.

[10] IRC Sec. 677(a); Treas. Reg. Sec. 1.677(a)-1.
[11] IRC Sec. 677(a)(3).
[12] PLR 8839008.
[13] Rand v. Comr., 40 B.T.A. 233 (1939), acq., 1939-2 C.B. 30, aff'd, 116 F.2nd 929 (8th Cir. 1941), cert. denied, 313 U.S. 594 (1941).

## Common Issues in Administration of a Grantor Trust

Additionally, practitioners may need to discuss important differences in the rules governing grantor trusts and nongrantor trusts. By way of example, on some occasions, grantor trusts may not file federal or state income tax returns of their own since the income flows through to the settlor who created the trust.

The Regulations provide that the trustee is not required to file a Form 1041 so long as the trustee provides a statement to the grantor containing all of the income, deductions, and tax credits of the trust, the payor of each item of income, and any other information the grantor may need in calculating the grantor's taxable income, and (2) informing the grantor that all items of income, deduction, and credit shown on the statement must be included on the grantor's income tax return.[14] Alternatively, the Trustee may use the Form 1041 reporting all items of income and issuing an income statement to the grantor. Further, the Trustee may decide to file a separate trust income tax return to report the income earned by a grantor trust to help corroborate and demonstrate the respect for the trust as an independent legal entity even though it is ignored for income tax purposes. This may, for example, be important if asset protection is a motive of the trust plan.

For non-grantor trusts, the inquiry is significantly different and perhaps easier to resolve. That is, a non-grantor trust is a separate taxpayer from the settlor. In general, income tax returns must be filed in any year that the trust has more than $600 of gross income or any taxable income. So, whether a return had been filed or not for the trust when it was a grantor trust, once the decision is made to convert the trust into a non-grantor trust in order to soothe grantor trust angst, separate income tax returns will have to be filed thereafter.

## Keeping Assets Outside of the Client's Estate

One of the primary goals of creating the grantor trust in the first place was probably to reduce the size of the client's taxable estate by transferring assets that are likely to appreciate so that, as a matter of current law, the appreciation can be transferred to heirs without a transfer tax. Funding the irrevocable grantor trust most likely required that the original owner relinquish control and significant (or all) access to the assets transferred, depending upon the type of trust used. Because the trust is a grantor trust, the transferor retained the income tax liability even though the income from the assets and the assets themselves were deliberately placed out of reach, in order to avoid estate tax inclusion under IRC Sect. 2036 and 2038.

[14] Treas. Reg Sect. 1.671-4(b)(2)(ii).

In addressing grantor trust angst, practitioners should remind clients about their estate planning goals and avoid proceeding in a way that might undermine the original plan and inadvertently cause inclusion of the trust assets into the grantor's estate for estate tax purposes. By way of example, practitioners should caution clients against taking steps on their own to mitigate their grantor trust angst, such as the following non-exhaustive list of common issues:

- If the trust did not have a tax reimbursement clause but Uncle Joe (the trustee) has been reimbursing the settlor for income taxes anyway.
- If the trust has a tax reimbursement clause but it was exercised excessively, inappropriately, or regularly. Generally, a tax reimbursement clause requires that an independent trustee evaluate whether it is appropriate to reimburse the settlor and then reimbursement should only be made in the specific amount needed to cover the tax costs resulting from inclusion of the grantor trust income.
- The trust has no provision permitting a loan to the settlor but the family trustee made loans to the settlor under the general powers they had as a trustee. That may undermine the planning and possibly cause inclusion if the loans are not properly documented, are made regularly and excessively, or there is evidence to suggest that there is no intent for the loan to be paid back.
- The trust is a SLAT and large distributions are regularly made to the settlor's spouse beyond the distribution standards set forth in the trust agreement.
- Distributions from a SLAT to the beneficiary-spouse can be traced to the settlor's tax costs or the settlor's living expenses.

The bottom line is that clients seeking to address grantor trust angst must deal realistically with the risks of undermining the initial intent to have those trust assets outside of their estate and outside of the reach of creditors.

## **Financial Analysis: Is there A Real Problem**?

When originally discussing the estate plan with a client, it is recommended to provide a cash-flow analysis to project how income taxes might be paid for client's life expectancy. This analysis can be helpful to refer back to if/when client expresses concern about continuing to pay the taxes on the income earned by the trust.

Once the client starts indicating discomfort with the arrangement, practitioners should update the initial financial forecasts to ascertain the scope of the issue and get a better understanding of the source of the grantor trust angst. If no financial forecast had been created during the initial planning, a model should be created currently to illustrate the benefits of the original planning. Projections should be based on a realistic budget and should endeavor to quantify the real tax exposure to the settlor so that the practitioner

and the settlor can review them together and determine whether and what modifications might be warranted.

Realistically, there are occasions when modifying the original forecasts highlight financial hardship from continued payment by the grantor of the taxes on the income earned by the grantor trust. By way of illustration, consider the following non-exhaustive list:

- Medical expenses tend to increase as clients age or if a significant health problem arose subsequent to the plan being implemented. Such costs may not have been anticipated and could make it difficult for the client to continue paying tax on income earned by the trust.
- Perhaps the client has purchased a substantial new residence, which could increase lifestyle expenses dramatically.
- Where a client has recently retired, their cash flow may have declined significantly. The practitioner would need to consider whether this declination in cash flow is temporary or permanent.
- The assets in the trust could be generating significantly more income than had originally been projected, squeezing the grantor's personal cash flow. It would be important to understand whether this circumstance is temporary or permanent – and whether there might be ways to address the squeeze without turning off grantor trust status (e.g., swapping personal assets that generate less income for trust assets of equivalent value that generate greater taxable income and cash flow).

An important step in deciding how to address grantor trust angst is understanding the underlying cause of grantor trust angst and whether the circumstances are temporary or permanent. Turning off grantor trust status is generally a permanent solution (some view flipping that grantor trust switch again in the future as inappropriate) and may be too dramatic if the problem is temporary and can be solved by gentler means.

## When Grantor Trust Angst Arises from Personal Feelings and Family Dynamics

Even when an estate plan looks great on a spreadsheet, personal feelings and family dynamics must also be considered. Perhaps there is no material change in the financial picture, but the client just doesn't want to be as generous to their children by paying the taxes on the income earned by the grantor trust. Maybe the parent is uncomfortable with an adult child's lifestyle choices, or possibly the parent thinks the child has already benefited enough. Practitioners may need to read between the lines when discussing grantor trust angst with their client in order to understand whether there is any material adverse and long-term financial circumstance. If not, the practitioner should consider whether the source of the angst is that the client is frustrated or disappointed with the

beneficiaries, expressed with some variation of the following: “Those darn kids are already getting more than they deserve, I’m sick of paying the taxes for them too!”

It is important to identify the actual cause of the client’s grantor trust angst before crafting solutions. Otherwise, practitioners might head off on a path of turning off grantor trust status when the solution might be for the practitioner to have a tough conversation with the client about their overall estate plan, how much the children or other heirs are really getting, and what, if anything, should be done. The solution may not be restructuring a trust or estate plan, but rather reassessing how the client will interact with adult children and other beneficiaries.

If the client’s view of the beneficiaries of the trust has changed and is permanent and not merely the result of a current hurt or argument, perhaps the overall plan should be reassessed beyond issues arising from grantor trust angst. For example, if the client is upset with how much the child will be inheriting, it may be possible that a spouse or other person holds a power of appointment over trust assets that might redirect trust assets to modify the child’s rights, reduce the child’s ultimate benefit, or, if appropriate, cut the child out entirely. Thus, rather than tinkering with the tax status of the trust, use of powers of appointment in the instrument may better address the change in circumstances. And isn’t that one of the reasons that some trusts intentionally include broad powers of appointment?

All of that said, changing the grantor trust status might be just the thing that can help a family address strained family relationships. Perhaps the parent feels resentment because he is paying the income tax liability on assets held in a trust for the benefit of his adult children. Maybe the parent is tired of reaching out to the trustees asking for tax reimbursement. At the same time, the beneficiaries might be feeling like they have no real control over the assets in the trust or financial autonomy because grantor trust status pulls the grantor back into the activities of the trust on an annual basis (at least). Turning off grantor trust status could help to separate the financial fortunes of the beneficiaries from their parent once and for all. While it might not make much sense from a tax or planning perspective, it could be just the thing that help to heal family divisions.

Finally, a practitioner may need to consider whether a completely different course of action is preferable. Depending on the allocation of family wealth between trusts and non-trust assets, the client might simply revise his or her dispositive plan for non-trust assets. For example, the client might revise beneficiary designations for retirement plans, distributions under a will (and/or revocable trust) and thereby reduce the economic benefit to the errant heir without disrupting the trust. The benefit of this approach is that it does not require any tinkering with the trust plan, and perhaps quite importantly, it can be more easily done, and in the future undone, if the client’s feelings change back again.

## **Tax Reimbursement Clauses To the Rescue - Maybe**

One of the first steps in addressing a client's grantor trust angst is to determine whether the original trust instrument provided for a tax reimbursement clause. Such a clause could potentially present a simple solution to grantor trust angst. Note that commentators have different philosophical views on whether tax reimbursement clauses should always, sometimes, or never be included in trust agreements. Without comment on this debate, where such a clause is available, the practitioner should start by reviewing the specific clause to determine whether it could be used to address the client's grantor trust angst.

Tax reimbursement clauses are not all drafted the same way and it is very important to understand precisely what the provision in the trust document provides. If a tax reimbursement clause exists and permits the settlor to be reimbursed for the income taxes incurred on trust assets that might (not "will") solve the problem. Maybe!

Revenue Ruling 2004-64 provided that where the trust's governing instrument or applicable local law required the grantor to be reimbursed by the trust for the income tax payable by the trustor that is attributable to the trust's income, then the full value of the trust's assets is includible in the grantor's gross estate under I.R.C. § 2036(a)(1). However, the ruling added if the trust's governing instrument or applicable local law gives the trustee the discretion to reimburse the trustor for that portion of the trustor's income tax liability, the existence of that discretion, by itself (whether or not exercised), will not cause the value of the trust's assets to be includible in the trustor's gross estate. The ruling introduced a framework for state legislatures to apply when drafting a reimbursement power that would not trigger adverse tax consequences for trustors.

Where there is a tax reimbursement clause, the trustee may reimburse the settlor for income taxes incurred. In that case, why would your client have grantor trust angst in the first place? Consider:

- The client may not have realized that there was a tax reimbursement clause in that 90 page trust document they signed so many years ago. They may not have recalled that such a concept even existed. So, explaining the mechanism to the client may provide a solution (but read on!).
- Perhaps the client is tired of asking someone else for reimbursement or maybe grantor trust angst stems from other issues unrelated to the financial impact of paying the taxes on the income earned by the trust.
- The trustee may have advised the client that they will not make a tax reimbursement clause every year on a regular basis. While that may be prudent to serve the purpose of shifting wealth which was likely the original intent for the trust, such an explicit statement about not reimbursing the client for income taxes may be disconcerting to the client.

Where there is a tax reimbursement clause, the adviser should explain (ideally in writing) the uses and limitations of the clause. Be certain to explain the formalities of how it should be used. A practitioner should likely caution the client (again, ideally in writing) about how frequently and to what degree a tax reimbursement clause be used. If a client invokes a tax reimbursement clause regularly and continuously to receive funds to pay taxes on an annual or quarterly basis, such a pattern could be evidence of an implicit agreement between the client and the trustee. Such an implicit agreement might form the basis of a claim by the IRS that the client retained an interest in the trust that could cause estate tax inclusion.

Where a tax reimbursement clause is regularly invoked, the risk of exposure could be even greater when the trustee is an individual who has a close personal relationship with the client and the family. It might look more like there is an implicit agreement allowing the client to retain the right to reimbursement if Uncle Joe is the trustee rather than an institutional trustee. However, an institutional trustee might be more cautious and selective in reimbursing the client and might even deny the request on occasion. Such a denial might lessen the risks of estate tax inclusion but might heighten the client's grantor trust angst.

In evaluating a request for tax reimbursement, the trustee owes fiduciary obligation to act in the best interests of the trust beneficiaries. Regardless of the relationship between the trustee and the grantor, the trustee is required to consider the needs of the trust beneficiaries when deciding whether to reimburse the grantor. The practitioner should communicate all of this to the client, preferably in writing, and make clear that a tax reimbursement mechanism, even if included in the instrument, may not be a complete remedy for grantor trust angst.

## Other Ways to Address Grantor Trust Angst – Without Turning Off Grantor Trust Status

There are special trusts that allow distributions to be made directly to the settlor. Such mechanisms may provide necessary cash flow to help the settlor meet the tax costs and soothe that grantor trust angst. Consider the following opportunities:

- A Domestic Asset Protection Trust ("DAPT") is a particular kind of grantor trust which provides that the settlor is a beneficiary of the trust. Distributions from a DAPT may be made to the settlor in accordance with the terms of the trust agreement, to assist the settlor in defraying the tax burden on trust income. Practitioners should exercise caution however when evaluating whether distributions should be made. Confirm what (if any) restrictions may exist on the settlor's right to distributions. By way of example, some DAPTs intentionally prohibit the settlor from receiving any benefit for 10 years (or ten years plus one day) after funding or formation in an effort to keep assets out of the reach of

bankruptcy proceedings. In some cases, a DAPT might restrict distributions unless the settlor dips below a certain net worth or finalizes a divorce proceeding. The practitioner should confirm that distributions to the settlor are permissible under the terms of the trust instrument.

- A hybrid-DAPT differs from a domestic asset protection trust in that the settlor isn't initially named as a beneficiary. Instead, the trust instrument includes a mechanism by which the settlor can be added as a beneficiary. In such situations, the practitioner would need to evaluate whether the parameters set forth in the trust instrument have been met to allow the settlor to be added as a beneficiary. A hybrid-DAPT must be situated in a jurisdiction that permits asset protection trusts before triggering the mechanism to add the settlor as a beneficiary. Prior to triggering the mechanism to add the settlor as a beneficiary, the practitioner should consider whether it might create a liability exposure or increased tax risk.
- Some trusts are drafted with a special power of appointment wherein a person in a non-fiduciary capacity may exercise a limited or special power of appointment to direct the trustee to pay money to the settlor. Such powers could be exercised to provide the necessary funds to the settlor in order to satisfy taxes resulting from the income earned by the trust.

For some of our clients, the grantor trust might own interests in a family business which had been gifted and/or sold to the trust. Often the settlor continues to provide services to the family business. In such cases, the practitioner should confirm that the business is paying the settlor an arm's-length compensation for any services the settlor provides. To the extent that the settlor was not receiving reasonable compensation for services rendered, the business might assure that payments for services are being made at a fair market price. Such an action could help solve some of the cash flow pressure the settlor is feeling.

The structure of a grantor trust may offer sufficient flexibility to deal with grantor trust angst without turning off grantor trust status. Recall that transactions between the grantor and the grantor trust are disregarded for income tax purposes pursuant to Rev. Rul. 85-13. This provides significant opportunities to move liquidity between the trust and the grantor to enable the grantor to pay the income taxes. The following is a non-exhaustive list of options that might be considered:

- If the settlor sold assets to the trust for a note, perhaps the trust can make a principal payment to pay down the note owed. This might provide some measure of relief to the settlor.
- A grantor can sell illiquid assets to the grantor trust in exchange for cash. Such a transaction will not trigger an income tax event but can provide necessary cash for the grantor.

- The trustee may be able to loan cash to the grantor, under the general loan powers included within the trust instrument. Prior to lending funds to the grantor, the trustee must balance the needs of trust beneficiaries and the investment allocation of the trust. If the settlor is not a beneficiary of the trust the trustee may only be able to make a loan to the settlor that constitutes a reasonable investment of the trust. If that is the case, then the trustee should demonstrate due diligence, arm's length collateral and loan terms, and consider other factors. Such a loan should be documented with a fully executed promissory note.
- The trust may contain a special grantor trust power requiring the trustee or a person acting in a non-fiduciary capacity to lend to the settlor without adequate security. Increasingly, such provisions have been intentionally added to trusts not only to support grantor trust status but also to facilitate funding cash needs of the settlor. The practitioner should caution the client that adequate interest should be charged in order to reduce the risk of the IRS arguing that a no or low interest loan demonstrates a retained right the settlor had in trust assets thereby causing estate inclusion.
- The trust may permit the settlor to substitute assets in the trust for personal assets of equivalent value. Similar in many ways to a sale, a power of substitution (or swap power) may permit the settlor to access liquidity inside the trust to pay income taxes. Pursuant to Rev. Rul. 2008-22, even though the settlor's power to swap is exercisable in a non-fiduciary capacity, the trustee has a fiduciary obligation to the trust beneficiaries to ensure that the assets swapped have equivalent value. The practitioner might need to guide the client and the trustee to obtain one or more qualified appraisals and/or possibly structure the swap with a defined valuation adjustment mechanism, e.g., like a Wandry clause, so that an adjustment can be made. Consideration should also be given to reporting such a swap as a non-gift transaction on the settlor's gift tax return. Note that some commentators have suggested that swapping assets regularly or even too frequently could suggest an implied agreement to access trust assets. Similar ancillary considerations might be relevant to the sale discussed above and other options.
- Consider whether distributions can be made to the grantor's spouse if the spouse is a beneficiary of the trust. Such distributions must be made within the guidelines of what distribution rights the spouse has under the trust instrument. Practitioners may wish to exercise caution in recommending this approach, particularly where distributions are made to a spouse in order to satisfy the debts of the original grantor.

Note that not all grantor trust powers can even be turned off. Generally speaking, where a trust owns a life insurance policy on the life of the grantor and the trustee has the discretion to use trust income to pay premiums on such policy, such policy may need to be transferred out of the trust before grantor trust status can be turned off. Where the grantor's spouse is a primary beneficiary of a grantor trust, turning off grantor trust status may be prohibitively challenging.

**Advance Thoughts to Consider When Turning off Grantor Trust Status Might be an Option**

Perhaps the trust agreement can include a provision that allows for grantor trust status to be toggled off automatically before the occurrence of a specific event or after a period of time.

Alternatively, the trust instrument may include the option for a trust protector or other individual acting in a non-fiduciary capacity to have overarching authority to turn off grantor trust status. Note that, to the extent that a trust protector is considered to be acting in a fiduciary capacity either by operation of the trust instrument or as a matter of state law, the trust protector may be given the opportunity to name someone who can act in a non-fiduciary capacity to turn off grantor trust status. Consider the following sample draft provision:

> The Trust Protector acting in a non-fiduciary capacity is hereby granted the power to take any such actions as may be necessary or advisable to eliminate the federal income tax status of this trust, or any part thereof, as a grantor trust, i.e., to convert this trust, in whole or part into a non-grantor trust. If the Trust Protector is acting in a fiduciary capacity for any Trust hereunder, then the Trust Protector shall have the power, through a written document, to appoint an individual to serve in a non-fiduciary capacity that can take such actions to convert this trust, in whole or part into a non-grantor trust, and if such an individual is appointed then any reference to the Trust Protector in this paragraph shall apply to such individual. These powers may include by way of example and not limitation the power to prohibit the Trustee from paying for life insurance premiums on the life of the Grantor or the Grantor's spouse on life insurance held in this trust, eliminating the right of any person to loan funds to the Grantor without adequate security, the right of any person acting in a non-fiduciary capacity to add a charitable beneficiary, the right of the Grantor to swap or substitute assets in this Trust, etc., provided, however, this may not be achieved by removing the spouse as beneficiary but solely by adding a requirement that an adverse party approve any distributions to the spouse.
>
> The Trust Protector may, but shall not be required to, consider any negative tax consequences including but not limited to the negative consequences of the loss of a power to substitute on the loss of possible basis adjustments, the triggering of tax gain on the conversion of the trust from a grantor trust to a non-grantor trust, or the tax consequence of a sale of assets to the trust by the Grantor. The Trust Protector shall have no liability whatsoever for acting or not acting pursuant to this power. This provision shall not permit the Trust Protector to modify the rights of the

Grantor's spouse under a trust intended to qualify for the marital deduction. This provision shall not permit the Trust Protector to modify the grantor trust status of a grantor trust holding S corporation stock (but the trust protector may divide the trust into separate trusts with one or more of such separate trusts holding S corporation stock and being characterized as a QSST or ESBT).

## Quantify and evaluate the income tax implications of turning off grantor trust status

To the extent that the liabilities in the trust exceed the basis of assets in the trust, turning off grantor trust status can create an income recognition event (i.e., a deemed sale).[15] If the grantor receives no consideration upon the conversion from grantor trust to nongrantor trust, then the conversion will be treated as a gift for income tax purposes.[16]

## Practical Actions Steps to Consider

While the steps will vary depending on the circumstances, consider the following possible steps:

1. Create and review financial forecasts for the settlor to quantify the real exposure to income taxes from trust assets. Start with a new realistic budget. Is the exposure problematic or is the concern over continued grantor trust status indicative of a different underlying issue, e.g., displeasure with trust beneficiaries? Tackle the real problem.
2. Once you've ascertained that the problem is the income tax burn to the settlor, review the trust document thoroughly to identify every conceivable way for more cash can be directed back to the settlor before evaluating how grantor trust status might be turned off.
3. Consider as many options with the client as might be relevant to achieving the client's actual goal. Consider the least invasive option to more radical options and let the client make the final selection.
4. Consider documenting in writing to the client the benefits and especially the potential negative consequences of whatever action is being contemplated. Also, consider documenting to the client what steps may be necessary to proceed and who will be responsible for each of those steps.

[15] See Treas. Reg. Sect. 1.1001-2(c) Example 5.
[16] CCA 200923024.