

Estate Planning

Practical Solutions to Common Issues

A monthly conversation for practitioners seeking a pragmatic approach to common client concerns featuring:



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- If you have questions, please email the panel. All emails are listed on near the end of the slide deck.

**I Have A Grantor Trust And Am Tired Of
Paying The Income Tax On Trust Income.
What Can I Do?**

Meet the Presenters



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Structure a Trust to Allow Settlor to Retain a “Grantor Trust Power”

- 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:
 - 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:
 - IRC Sect. 675(4)(A) – power to vote the stock of entity in which grantor retains voting control
- IRC Sect. 676 – power of grantor (or spouse) to revoke
- 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

With limited exceptions, the following trusts will usually be “grantor” trusts:

- Spousal Lifetime Access Trusts (“SLATs”) or “Spousal Access Trusts” are grantor trusts pursuant to IRC Sect. 674.
- Life Insurance Trusts are grantor trusts pursuant to IRC Sect. 677.
- Retained Interest Trusts, such as: Living Trusts, Grantor Retained Annuity Trusts (GRAT), and Qualified Personal Residence Trusts (QPRT) are grantor trusts under one or both of IRC Sect 673 and 674.

Addressing the Payment of Taxes on the Income Earned by the Grantor Trust

- Requirement of grantor to continue to pay the income taxes due on income earned by assets in the trust is a feature and not a bug
- Rev. Rul. 2004-64 - grantor not 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
- Trust increased by income received from assets in the trust
- Grantor's estate reduced by income tax payments
- GENERALLY - Trust is not reduced by the income tax that would be due on trust income

Tax Reimbursement Clauses – Cannot be Mandatory / Must be Discretionary

- 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.

Some Benefits of a Grantor Trust

Grantor trusts are disregarded for income tax purposes, so, the following transactions between the grantor and the trust will also be disregarded:

- 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

POLLING QUESTION #1

When setting up plans for my clients:

- a. I love recommending grantor trusts
- b. Grantor trusts are great but nongrantor trusts are also really important in planning
- c. What's a grantor trust?

Filing Income Tax Returns for the Trust

- Treas. Reg Sect. 1.671-4(b)(2)(ii) provides that - trustee is not required to file a Form 1041
- Trustee required to provide a statement to the grantor with sufficient information for the grantor to file an individual income tax return
- Such a statement should include: income, deductions, and tax credits of the trust, and identifying sources of income, along with any other information that would permit the grantor to report the income flowing from the trust to the grantor
- Alternatively, the Trustee may use the Form 1041 reporting all items of income and issuing an income statement to the grantor.
- Non-grantor trusts need to file Forms 1041 for gross income over \$600 or any taxable income

Avoid Self-Help or DIY Solutions for Solving “Grantor Trust Angst” – Risks Inclusion of Grantor Trust Assets in Grantor’s Estate

- NO tax reimbursement clause but Trustee has been reimbursing the settlor for income taxes anyway
- Tax reimbursement clause exercised excessively, inappropriately, or regularly
- NO provision allowing for loans to the settlor but loans have been made anyway
- Excessive distributions from a SLAT to settlor’s spouse made regularly and beyond the distribution standards set forth in the trust agreement
- Distributions from a SLAT to the beneficiary-spouse are traceable to the settlor’s tax costs or the settlor’s living expenses

Cash-Flow Analysis

- Prepare a cash-flow analysis to support the planning if possible
- If no cash flow analysis had been prepared originally, it's probably a good idea to prepare a cash-flow analysis once the settlor expresses angst over paying income taxes on income of the trust

Other Ways to Help the Grantor Satisfy Obligations to Pay Income Taxes on the Income Earned by the Assets in the Grantor Trust

- Remember 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 in order to enable the grantor to pay the income taxes:
 - Sell illiquid assets for cash
 - The trust may be able to loan cash to the grantor – be sure to charge adequate interest
 - Substitution of assets in the trust
 - Consider whether distributions can be made to the grantor's spouse – but this must be done strategically

POLLING QUESTION #2

When working with clients who are contemplating a swap of assets with their grantor trust:

- a. I like to use formulas to ensure that the value of the assets swapped are equivalent
- b. I think the client should disclose the swap on a gift tax return
- c. I think swaps are really important for achieving a basis step up on low basis assets
- d. All of the above
- e. None of the above

Financial Analysis: Is there A Real Problem?

- Determine whether the problem is temporary or permanent – best not to solve a temporary problem with a permanent solution
 - Sudden or unexpected medical expenses
 - Increased lifestyle expenses from purchase of substantial new residence
 - Reduction in cash flow from retirement or other event
 - Trust assets generating significantly more income than had originally been projected, squeezing the grantor's personal cash flow
- Once issue is identified – consider whether conditions are temporary or permanent
- Evaluate options 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).

When Grantor Trust Angst Arises from Personal Feelings and Family Dynamics

- “Those darn kids are already getting more than they deserve, I’m sick of paying the taxes for them too!”
- Consider changes to will or revocable trust to change disposition of non-trust assets
- Consider that turning off grantor trust status can be the thing that saves the family despite the drawbacks

Trusts for Which the Settlor May Receive Distributions

- A Domestic Asset Protection Trust (“DAPT”) is a particular kind of grantor trust which provides that the settlor is a beneficiary of the trust.
- A hybrid-DAPT differs from a domestic asset protection trust in that the settlor isn’t initially named as a beneficiary.
- For DAPTs / hybrid-DAPT – determine whether triggering the mechanism to add the settlor as a beneficiary might create a liability exposure or increased tax risk.
 - Does the trust contain a special power of appointment wherein a person in a non-fiduciary capacity may direct trustee to pay money to the settlor

Other Options for Getting Funds to Settlor to Pay Taxes

- If Note outstanding – perhaps trust can pay down principal owed to grantor
- Grantor can sell illiquid assets to the grantor trust in exchange for cash
- Loan to grantor under the general loan powers included within the trust instrument BUT
 - Trustee must balance the needs of trust beneficiaries and the investment allocation of the trust
 - Trustee may only be able to make a loan to the settlor that constitutes a reasonable investment of the trust by demonstrating due diligence, arm's length collateral and loan terms
 - Loan should be documented with a fully executed promissory note
- Does trust 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?
- NOTE: 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.
- Swap illiquid assets for cash in the trust

Distributions to Grantor's Spouse?

- Is grantor a beneficiary of the trust?
- Distributions made within guidelines of distribution rights under trust agreement
- Distributions should not be traceable to tax cost owed by grantor – should be demonstrably for spouse's benefit

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.

POLLING QUESTION #3

When a client wants to turn off grantor trust status, I would:

- a. Provide an instrument to the client so that they can turn off grantor trust status by themselves
- b. Outline the benefits of and the drawbacks of turning off grantor trust status in a writing, provided to the client
- c. Calculate the possible income tax liability triggered when grantor trust status is turned off and advise the client
- d. Response A only
- e. Response B and C

Consider the Income Tax Implications of Turning Off Grantor Trust Status

- Treas. Reg. Sect. 1.1001-2(c) Example 5 – Potential income recognition / gain triggering where trust liabilities exceed the basis of assets in the trust, turning off grantor trust status can create an income recognition event (i.e. a deemed sale).
- CCA 200923024 – where 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
- Advise (in writing) client about loss of power to substitute assets in order to achieve possible basis adjustments
- Consider whether a special ESBT or QSST election to qualify as an S corporation shareholder is required and determine the tax consequences of such an election

Toggling off Grantor Trust Status

Turning off grantor trust status can be tricky where trust owns life insurance on grantor's life or where spouse is a beneficiary of the trust

- Possibly terminate life insurance policy or transfer to another trust
- Consider requiring adverse party to approve distributions to spouse

Be sure to run through list of grantor trust powers and turn each power off, by way of example:

- Prohibit the Trustee from paying for life insurance premiums on life insurance policy insuring the life of grantor or grantor's spouse
- Eliminate right to loan funds without adequate security
- Remove power to add charitable beneficiary
- Rescind right of grantor to swap or substitute assets

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

- Perhaps trust agreement might include an automatic toggle on happening of an event or after a period of time
- Grant authority to individual acting in a non-fiduciary capacity to turn off grantor trust status
- Individual with authority to turn off grantor trust status should not be a fiduciary – perhaps trust protector (acting in fiduciary capacity) has power to appoint an individual who can act in a non-fiduciary capacity

Additional Information

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