Grantor Trusts

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Under the grantor trust rules of IRC §§671 through 679 a grantor is taxed on his or her share of a trust's income if certain powers over, or rights in, the trust are retained. This is also the case if the rights or powers are held by nonadverse parties, or by related or subordinate parties. However, the grantor is not taxed if the powers or interests he or she holds in the trust are subject to the approval of an adverse party. Other parties, including beneficiaries, may be treated as owners if they have the power to vest beneficial enjoyment of trust corpus or income in themselves.

If the grantor trust rules apply, then the grantor or other person will calculate his or her income tax liability by including those items of income, deduction, and credit attributable to any portion of the trust of which he or she is treated as the owner. The items are treated as if they had been received or paid directly by the grantor or other person. Any remaining items are subject to the regular trust and estate income tax rules.

A common example of a grantor trust is the revocable living trust. The grantor of a revocable living trust reserves the right to terminate the trust or to take back transferred property during his or her lifetime.

Grantor Trusts: Definitions

If the grantor trust rules apply, then the grantor or other person will calculate his or her income tax liability by including those items of income, deduction, and credit attributable to any portion of the trust of which he or she is treated as the owner. The items are treated as if they had been received or paid directly by the grantor or other person. Any remaining items are subject to the regular trust and estate income tax rules.

The types of powers or interests over a trust that can result in grantor trust status include the retention of a reversionary interest in trust income or property. Another is the power to control beneficial enjoyment of trust income or property. Similarly, the retention of certain administrative powers over a trust or the power to revoke a trust can result in grantor trust status. A grantor trust can also result if the grantor can benefit in certain ways from trust income.

Special rules govern foreign trusts with U.S. beneficiaries. A U.S. person who transfers property to a foreign trust is generally treated as the owner of the portion of the trust attributable to the property that he or she transferred if the trust portion has a U.S. beneficiary. The income generated by the property is taxed to the transferor. The U.S. grantor trust rules generally do not apply to any portion of a trust that would otherwise be deemed as being owned by a foreign person. Instead, the grantor trust rules generally apply only when their application results in amounts used to compute the income of a U.S. citizen or resident or a domestic corporation.

An investment trust having a single class of ownership interest that represents an undivided beneficial interest in the assets of the trust will be a grantor trust, if there is no power to vary the investment of the owners. This is a fixed investment trust. Alternatively, an investment trust with multiple classes of ownership interests, but no power to vary the investment of the owners will also be a grantor trust, if the trust was created to allow direct investment in the trust assets and the existence of multiple classes is incidental to that purpose. The beneficial owners of trust interests are treated as grantors. These investment trusts, that are not considered business entities for tax purposes, are classified as non-mortgage widely held fixed investment trusts (NMWHFITs) and widely held mortgage trusts (WHMTs).

The IRS has provided safe harbors under which modifications under forbearance programs arising from the COVID-19 emergency are not treated as manifesting a power to vary the investment. In addition, the following are not manifestations of a power to vary:

- certain COVID-19 related modifications of one or more real property leases (including modifications to the specific allocations of fixed rent in the lease agreements described in IRC §467 and the related regulations); and

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- certain acceptances of cash contributions that are made between March 27, 2020, and September 30, 2021, as a result of the trust experiencing financial hardship due to the COVID-19 emergency.

In order to better understand the rules relating to grantor trusts it is important to know the relevant terms. These terms include the following items.

Trust

A trust is an arrangement created during life, or at death by will, under which a trustee takes title to property to conserve and protect that property for beneficiaries. In general, they are subject to the same income taxes as individuals, and are taxed in much the same manner. However, in certain cases, a trust is not recognized as a separate tax entity (e.g., a grantor trust).

Grantor

The grantor of a trust includes any person who either creates a trust or directly or indirectly makes a gratuitous transfer of cash or other property to a trust. Partnerships, corporations and trusts that make gratuitous transfers to a trust may be grantors. When a person creates or funds a trust on behalf of another person, both persons are treated as grantors of the trust.

However, a person who creates a trust is not treated as an owner of any portion of the trust under the grantor trust rules if he or she did not make a gratuitous transfer to the trust. A person who funds a trust is not treated as an owner of any portion of the trust, if he or she is directly reimbursed for such amount within a reasonable period and does not make a gratuitous transfer to the trust. And, the status of the grantor is not imputed to a donor who makes a completed gift that is subsequently used by the donee to fund a trust.

A grantor also includes a person who acquires an interest in a trust from a grantor of the trust if the interest is in a fixed investment trust, a liquidating trust, or an environmental remediation trust.

Adverse Party

An adverse party is any person who has a substantial beneficial interest in the trust that would be adversely affected by the exercise or nonexercise of the power the grantor has over the trust. A trustee is not an adverse party merely because of his interest as trustee.

The treatment of a trustee as an adverse party or not is not always clear. For example, a trustee's moral duty to act in accordance with the best interests of the beneficiaries or his interest in earning trustee's fees was not treated as an adverse interest. However, a trustee with the power to distribute income or corpus to himself was an adverse party.

A grantor cannot avoid taxation simply by vesting the power of revocation in more than one person or a majority of a committee if less than all of the persons necessary to effect a revocation of the trust are adverse parties.

Nonadverse Party

A nonadverse party is any person who is not an adverse party.

Related or Subordinate Party

A related or subordinate party is any nonadverse party having any one of the following relationships to the grantor:

- a spouse, but only if living with the grantor;
- parents;
- children or other issue;
- brothers and sisters (including if by half blood);
- employees;
- a corporation or any employee of a corporation in which the grantor's stockholdings plus those of the trust have significant voting control; or a subordinate employee of a corporation in which the grantor is an executive.

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Note that a director of a corporation is not an employee merely because he is a director.

And, a related or subordinate party is presumed to be subservient to the grantor in determining whether or not to apply the grantor trust rules to a trust if the effect would be to treat a foreign person as an owner. Accordingly, a person related or subordinate to a foreign grantor would also not be treated as an owner of the trust.

Reversionary Interest

A reversionary interest is an interest that reverts back to the grantor of a trust after a beneficiary's interest has come to an end. For example, if a person gives a life interest in a trust property to his brother, and upon the brother's death the property is to revert back to the grantor.

The grantor of a trust is taxed as the owner of any portion of a trust in which he or his spouse has a reversionary interest if, at the inception of the trust, the value of that right exceeds five percent of the value of the portion of the trust over which the interest is retained. For further details on the application of the five-percent rule, see the discussion of this topic under **Grantor Trusts: General Rules**.

Grantor Trusts: General Rules

The grantor trust rules of IRC §§671 through 679 center on the types of powers or interests over a trust that can result in grantor trust status. These include:

- the power to control beneficial enjoyment of trust income or property;
- the retention of certain administrative powers over a trust;
- the power to revoke a trust; and
- the ways in which a grantor can benefit from trust income.

Power to Control Beneficial Enjoyment

A grantor is treated as the owner of any portion of a trust over which the grantor, a nonadverse party, or both, without the approval or consent of an adverse party, has a power to dispose of the beneficial enjoyment of the trust's income or corpus. A power to dispose includes a power that can affect the trust's beneficial enjoyment, whether the power is a fiduciary power, a power of appointment or any other power. For example, a grantor was treated as a trust's owner because he retained an unlimited power to sprinkle income among the trust's beneficiaries. Exceptions to this general rule allow the grantor or other persons to retain specific powers without resulting in grantor trust treatment. For example, a retained power to allocate income does not impose grantor trust treatment, if the power is limited by a reasonable standard.

This rule also applies to foreign trusts. So, if a nonresident alien creates a trust and retains the right to dispose of the beneficial enjoyment of the income and principal, he is treated as the owner of the trust. If the trust has an income beneficiary who is a U.S. resident, the beneficiary is not required to report any portion of the trust income.

If the grantor or a nonadverse party holds a power that is not excepted by statute and that affects the beneficial enjoyment of a trust's ordinary income, the grantor is treated as the owner of that income. For example, a grantor who held a power to sprinkle income among the trust's beneficiaries was treated as owner of the trust's ordinary income. If the grantor or a nonadverse party holds a power that is not excepted by statute and that affects the enjoyment of a trust's corpus, the grantor is treated as the owner of the income allocable to corpus, such as capital gains. If the exercise of that power affects future income distributions, the grantor is also required to report a trust's ordinary income. For example, a grantor who holds a power to sprinkle corpus is treated as the owner of both the trust's ordinary income and capital gains. If a grantor makes a demand loan to a trust, the grantor retains control over the corpus and income of the trust because of his ability to terminate the loan at any time. The income from the demand loan amount is taxed to the grantor.

A number of powers can be retained by any person, including the grantor, without causing the grantor to be treated as the owner of any portion of a trust. These include a power:

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- to apply income to support a dependent;
- to control beneficial enjoyment after the occurrence of an event that would not cause the grantor to be treated as the owner of the trust under the rules on reversionary interests;
- exercisable only by will. This exception does not apply to testamentary dispositions by the grantor or the grantor's spouse of:
  - income actually accumulated; or
  - income that may be accumulated without the approval or consent of an adverse party;
- the power to allocate among charitable beneficiaries or to an employee stock ownership plan;
- the power to invade the corpus if it affects the future income of the person receiving the distribution;

  The distribution of corpus must reduce the beneficiary's share of future income. This exception does not apply if any person has a power to add beneficiaries or to a class of beneficiaries designated to receive the income or corpus, unless it is to provide for after-born or after-adopted children. A beneficiary may, however, substitute other beneficiaries to succeed to his interest in the trust. Distributions need not be based on a reasonably definite standard. This exception also gives the grantor the limited power to transfer a remainderman's beneficial interest to an income beneficiary. The income beneficiary, however, must be entitled to receive the income from a portion of the corpus, even though that portion need not be physically segregated.
- the power to withhold income temporarily;
- a power either to distribute a trust's income to the current income beneficiaries or to accumulate income for future distribution does not result in grantor trust treatment, provided the accumulated income is ultimately payable:
  - to the beneficiary from whom it was withheld;
  - to the beneficiary's estate;
  - to the beneficiary's appointees under a power of appointment that does not exclude any person other than the beneficiary, his creditors, his estate, and creditors of his estate (the grantor may name any person in the trust instrument as an alternate taker in the event that the beneficiary fails to exercise this power); or
  - to the current income beneficiaries in shares irrevocably specified in the trust instrument provided the distribution occurs on termination of the trust or in conjunction with a distribution of corpus augmented by the accumulated income;
- the power to withhold income during a beneficiary's minority or disability;

  The accumulated income need not be ultimately payable to the beneficiary from whom it was withheld. This exception does not apply to any power over the beneficial enjoyment of the capital gains allocable to corpus. This exception also does not apply if any person has a power to add to the beneficiaries or to a class of beneficiaries designated to receive the income or corpus, unless it is to provide for after-born or after-adopted children. A beneficiary may, however, substitute other beneficiaries to succeed to his interest in the trust.
- the power to allocate receipts and disbursements between corpus and income even if the power is expressed in broad language.

With the exception of a power to apply income to support the grantor's dependents, it is immaterial whether these powers are exercisable in the holder's capacity as trustee.

Administrative Powers

The grantor is treated as a trust's owner if he/she or a nonadverse party, or both, retain certain administrative powers exercisable in a nonfiduciary capacity or primarily for the benefit of the grantor or the grantor's spouse. These powers include:

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- the power to deal with income or corpus for less than adequate and full consideration;
- the power to borrow the corpus or income directly or indirectly without adequate interest or security; and
- actual borrowing from the trust by the grantor or his spouse if there is inadequate security and interest.

The grantor is also treated as owner if any person has specified powers exercisable in a nonfiduciary capacity.

The existence of these powers can be established either by the terms of the trust instrument or by circumstances surrounding its administration. The grantor is also treated as a trust's owner if the grantor or the grantor's spouse has a power to amend the trust instrument by adding prohibited administrative powers.

In determining whether the prohibited powers exist, courts often focus primarily on the terms of the trust instrument. If the grantor does not retain a power to amend or revoke the trust, the grantor's ability to alter the trust's provisions is relinquished on its execution. Because state law imposes fiduciary obligations on the trustee to administer the trust in accordance with its terms for the benefit of its beneficiaries, the trustee's misadministration of the trust, which would ordinarily result in a grantor trust if done pursuant to the trust instrument, did not result in grantor trust treatment.

Power to Revoke

If a grantor or the spouse of a grantor has the right to revoke a trust or portion of a trust, the grantor is taxed on its income. The power to revoke may be held by the grantor, a nonadverse party or both. The grantor is taxed whether or not the power is actually exercised. The grantor is treated as holding a power or interest held by his spouse.

Wallace transferred property to a trust, the income and principal of which were held exclusively for the benefit of his children. The trust instrument provided that Wallace could revoke the trust at any time and reacquire the trust property. Wallace is taxed on the trust income, whether or not he actually exercises his power to revoke.

Whether a trust is revocable depends on the terms of the governing instrument as interpreted under state law. A trust established to hold securities on behalf of investors was treated as a revocable trust when the grantor could direct the trustee to distribute the securities to him or when a grantor owning a majority interest in the trust could direct the trustee to sell the securities and distribute the proceeds to him.

Jones transferred all 100 shares of his wholly owned corporation to a trust in exchange for 100 units of beneficial interest in the trust. The trust instrument provided that all income and corpus distributions would be paid to the beneficiaries based on their respective beneficial interests. The beneficiaries owning a majority interest in the trust could direct the trustee to sell all of the stock held in the trust and such a disposition would terminate the trust. Jones is treated as the owner of the trust so long as he owns a majority of the beneficial interests in the trust.

Five-Percent Rule

The grantor of a trust is taxed as the owner of any portion of a trust in which he or his spouse has a reversionary interest if, at the inception of the trust, the value of that right exceeds five percent of the value of the portion of the trust over which the interest is retained. The value of the interest is measured on the date that the transfer is made to the trust. In applying the five-percent test, the value of the grantor's reversionary interest is determined by assuming the maximum exercise of discretion in favor of the grantor. The reversionary interest is valued using tables issued by the IRS based on an interest rate equal to 120 percent of the federal mid-term rate in effect at the time of the valuation.

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Proposed regulations have been issued relating to actuarial tables used in valuing annuities, interests for life or terms of years, and remainder or reversionary interests.NPRM REG-122770-18. These regulations contain Table 2010CM that is based on data compiled from the 2010 census and will affect the valuation of lifetime and testamentary transfers of interests that are dependent on one or more measuring lives. The regulations will be effective, generally, for valuations occurring on or after the first day of the month following the date on which the Treasury Decision adopting these rules as final regulations is published in the Federal Register. The updated actuarial tables are available, free of charge, on the IRS website at https://www.irs.gov/retirement-plans/actuarial-tables. As proposed, Tables S and U(1) will no longer be published in the regulations and Tables B, D, F, J, and K, which are not based on mortality factors, will not be revised.

To avoid any potential adverse consequences resulting from the regulatory changes, the regulations provide certain transitional rules. For gift tax purposes, if the date of a transfer is on or after January 1, 2021, but before the applicability date of the Treasury Decision adopting the regulations as final regulations, the donor may choose to determine the value of the gift (and/or any applicable charitable deduction) under tables based on either Life Table 2000CM or Table 2010CM. Similarly, for estate tax purposes, if a decedent dies on or after January 1, 2021, but before the applicability date of the Treasury Decision adopting the regulations as final regulations, the value of any interest (and/or any applicable charitable deduction) may be determined in the discretion of the decedent's executor under tables based on either Life Table 2000CM or Table 2010CM. However, the Code Sec. 7520 interest rate to be utilized is the appropriate rate for the month in which the valuation date occurs, subject to the following special rule for certain charitable transfers.

In cases involving a charitable deduction, the transitional rule and those contained in Reg. §§1.7520-2(a)(2), 20.7520-2(a), and 25.7520-2(a)(2) dictate a somewhat different choice. Specifically, if the valuation date occurs on or after January 1, 2021, but before the applicability date of the Treasury Decision adopting the regulations as final regulations, and the executor or donor elects under Code Sec. 7520(a) to use theCode Sec. 7520 interest rate for a month that is prior to January 1, 2021, then the mortality experience contained in 2000CM must be used. If the executor or donor uses the Code Sec. 7520 interest rate for on or after January 1, 2021, but before the applicability date of the Treasury Decision adopting the regulations as final regulations, then the tables based on either Table 2000CM or Table 2010CM may be used. However, if the valuation date occurs on or after the applicability date of the Treasury Decision adopting the regulations as final regulations, the executor or donor must use the new mortality experience contained in Table 2010CM even if the use of a prior month's interest rate is elected.

In addition, the regulations no longer provide that the estate of a mentally incompetent decedent may elect to value the property interest included in his or her gross estate under the mortality table and interest rate in effect: (1) at the time the decedent became mentally incompetent; or (2) as of the decedent's date of death. Estates of decedents with a mental disability who die after the applicability date of the Treasury Decision adopting the regulations as final regulations will be required to use the mortality table and interest rate in effect on the decedent’s date of death or the alternate valuation date if elected.

If a grantor who retains a reversionary interest postpones the date specified for possession or enjoyment of the interest to return to him, the postponement is treated as a new transfer in trust occurring on the date of the postponement and running until the reversion takes place. However, if the original reversionary interest fell below the five-percent threshold, a postponement does not cause income earned during the life of the original interest to be taxed to the grantor.

Income for the benefit of grantor

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The grantor is treated as the owner of any portion of a trust if the income is, or in the discretion of the grantor or a nonadverse party, may be:

- distributed to the grantor or the grantor's spouse;
- held or accumulated for future distribution to the grantor; or
- applied to the payment of insurance policies on the life of the grantor or the grantor's spouse.

This rule applies when the income is distributable by the grantor, his spouse, a nonadverse party, or any combination thereof, without the approval or consent of an adverse party. For example, a family estate trust was subject to this rule because the income of the trust was distributable to the grantor or his spouse in the discretion of the grantor and a trustee (a nonadverse party) without the approval of an adverse party. All references to any power or interest held by the grantor include any power or interest held by the grantor's spouse if the spouse is living with the grantor when the power or interest is created.

The grantor is taxed as owner if the trust income is, or can be, applied in payment of the living expenses or debts of the grantor or his spouse, or is paid on behalf of the grantor or his spouse to another pursuant to the grantor's direction.

If the grantor or the trustee has discretion to treat capital gains as current income, and the grantor is entitled to current income, the grantor is currently taxable on the capital gains.

The grantor is not treated as owner if the income distribution is subject to the consent of an adverse party, or the grantor and his spouse are completely and permanently divested of any interest in the trust. An interest does not include the possibility that the grantor or his spouse might receive back from a beneficiary an interest in a trust by inheritance.

The grantor is taxed as the owner of the portion of the trust over which he retains any interest enabling him or his spouse to receive the income from that portion, either actually or constructively. So, if property is transferred to a trust under which the grantor reserves the excess of the trust principal over a specified amount, such as a charge secured by a lien on the excess and bearing interest, the grantor is taxed on the income attributable to the excess and not merely the interest payable on the amount retained. Also, when a trust was formed by a group of grantors reserving a right to the income, each grantor was chargeable with a share of the trust income in proportion to his respective contribution.

Each of the grantor trust rules is applied separately in determining whether the grantor is treated as the trust owner. Thus, a grantor is not treated as the owner of a trust when a power he retained to revoke the trust is exercisable only with the consent of an adverse party. However, if the trust also provides that the income or principal is distributable to the grantor in the discretion of the trustee (a nonadverse party), the grantor is treated as the owner and is taxable on that portion of the income.

Persons Other Than Grantor Treated as Owner

Any person, including a trust beneficiary, other than the grantor is treated as the owner of any portion of a trust if he or she:

- has a power, solely by himself or herself, to vest the corpus or income of the trust in himself or herself; or
- has previously modified or partially released such a power, and after the modification or release retains enough control to make the grantor taxed as the owner under the grantor trust rules if he or she possessed the power.

This rule does not apply if the grantor is treated as owner of the trust under the grantor trust rules or if the donee of the power renounces or disclaims it within a reasonable time after he learns of its existence. A trustee who retained ownership of a life insurance policy while the beneficiary was a minor was not treated as the owner of the trust, because the beneficiary became the owner of the policy upon reaching majority and the trustee could have received benefits under the policy only as trustee. However, trustees of a spendthrift trust who were also beneficiaries were treated as the owners of the trust income because they had complete discretion to pay the

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income to themselves or to accumulate it. It made no difference that the concurrence of two of the three trustees was needed to distribute income and that the income was not actually distributed.

The beneficiary of a trust was not treated as the owner of the trust when he had the power to remove the trustee without cause and to replace the trustee, because the replacement trustee would be required to meet strict requirements that diminished the likelihood that the replacement trustee would automatically accede to the beneficiary's demands.

The general rule for treating a person other than the grantor as the owner of a trust applies when the holder of a power exercisable solely by himself can, in a capacity other than as trustee or co-trustee, apply the income to the support or maintenance of a person whom the holder of the power is legally obligated to support. However, if the power enables the holder, in his capacity as trustee or co-trustee, to apply the income to discharge his support obligation, the general rule does not apply. The amounts actually applied to discharge the holder's support obligation are taxed to the holder of the power as if they were directly distributed to him.

EXAMPLE

A grandfather establishes a trust, the income of which is to be applied for the support of his minor grandchildren. The co-trustees are the parents of the minor grandchildren and have the discretion to apply the income for their support. Any amount distributed to the children is taxed to the parents as beneficiaries because it discharges their legal obligation of support as parents of the minor grandchildren.

A beneficiary of a trust that gives him a presently exercisable right to demand a withdrawal of corpus is taxable as the owner of the trust to the extent of his right to withdraw corpus. This type of trust is commonly called a *Crummey* trust, and is designed to obtain the gift tax annual exclusion for gifts of present interests.

Foreign Trusts

A foreign trust established by a U.S. transferor or by a nonresident alien who has a residency starting date within five years of a transfer to the trust is treated as a grantor trust for any tax year during which it has a U.S. beneficiary. However, this rule, like the rest of the grantor trust rules, does not apply to the extent it results in foreign persons being treated as owners of the trust. Only the portion of the trust attributable to property transferred by the U.S. transferor is treated as a grantor trust. Specified transactions are exempt from the recognition rule.

CAUTION

To close a potential loophole caused by the repeal of Code Sec. 958(b)(4) the IRS has finalized amendments to regulations under Code Sec. 672(f). Before the repeal of Code Sec. 958(b)(4) by the Tax Cuts and Jobs Act (P.L. 115-97) (TJCA) the portion of a trust's income that was treated as owned by a controlled foreign corporation (CFC) would generally have been taxable currently to the U.S. shareholders to the extent the trust's income constituted subpart F income of the CFC. After the repeal of Code Sec. 958(b)(4), however, a CFC may have no U.S. shareholders that would be subject to tax on their pro-rata share of its subpart F income under Code Sec. 951(a). Accordingly, this makes it possible to form a CFC to facilitate the tax-free accumulation of income in a trust for the benefit of U.S. persons and result in tax-free distributions from the trust to the U.S. beneficiaries. In such a case, none of the income or gain of the grantor trust would be taken into account by U.S. shareholders, despite constituting subpart F income, while distributions of income from the trust to its U.S. beneficiaries would not be subject to tax, and the throwback rules would be avoided entirely.

To prevent this possibility from occurring, the final amendments provide that the only CFCs taken into account for purposes of Code Sec. 672(f) are those that are CFCs without regard to downward attribution from foreign persons. These amendments are generally applicable to tax years of foreign corporations ending on or after October 1, 2019, and the tax years of U.S.

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shareholders in which or with which such tax years of foreign corporations end. They may also be applied by such taxpayers for tax years ending before October 1, 2019, provided that the taxpayer and any U.S. persons related (as defined under Code Secs. 267 or 707) to the taxpayer consistently apply such provisions with respect to all foreign corporations.

If the trustee irrevocably so elects, a trust is a foreign trust unless a U.S. court has primary jurisdiction over the trust's administration and one or more U.S. persons have control of all substantial trust decisions.

The transferor generally must be a U.S. person at the time of the transfer, unless he is a nonresident alien who becomes a U.S. person within five years of a transfer of property. A transfer by a nonresident alien does not result in grantor trust treatment. A transfer by a resident alien to a foreign trust results in grantor trust treatment. A U.S. person includes a citizen or resident of the United States, a domestic partnership, a domestic corporation and an estate or trust that is not a foreign estate or trust.

The grantor trust rule applies to transfers of property by U.S. persons whether the transfers are direct or indirect. Any amount paid to a U.S. person and derived directly or indirectly from a foreign trust of which the payer (nominee) is not the grantor is deemed in the year of payment to have been paid directly by the foreign trust.

Grantor trust treatment does not apply if there is consideration equal to at least the fair market value of the property transferred. Otherwise, it is irrelevant whether consideration is received upon the transfer, or whether the transfer is a sale or exchange. A transfer results if property is given to a foreign trust or if property is transferred to a foreign trust in a tax-free exchange.

A transfer of property to a qualified foreign employee trust or annuity plan, deferred payment plan, deferred compensation plan and employee nonexempt trust, as well as a trust that is determined by the IRS to qualify as a charitable trust is excepted from the grantor trust rules otherwise applicable for transfers to foreign trusts.

Intentionally Defective Grantor Trusts

The intentionally “defective" grantor trust (IDGT) is an income tax and estate planning technique that involves setting up a trust, typically for the benefit of a child, and purposely giving the parent-grantor a right or power over the trust property that will cause him or her to be taxed on the trust's income under the grantor trust rules. The end result is that the trust's income will be taxed at the parent-grantor's tax rates, which will presumably be lower than if the income had been taxed using the trust’s compressed tax rate schedule. However, the power must not be one that would cause the trust property to be included in the grantor's estate otherwise the overall tax efficiency of this strategy would be lost.

Another advantage of the IDGT is that, if the guidance in Rev. Rul. 2004-64 is followed, a grantor who pays the income tax attributable to inclusion of the trust's income in his or her taxable income is not deemed to have made a gift in the amount of the taxes paid because the grantor, rather than the trust, is responsible for payment of these taxes. If, however, the trust's governing instrument or local law requires the trust to reimburse the grantor for income taxes paid by the grantor on the trust's income, the full value of the trust's assets are includible in the grantor's gross estate because the grantor has retained the right to have trust property expended in discharge of the grantor's legal obligation. Alternatively, if the trust's governing instrument or local law provides that the trustee has only the discretion to reimburse the grantor for the taxes paid, regardless of whether that discretion is exercised, the mere existence of such discretion will not cause the trust's assets to be included in the grantor's gross estate. In the latter case, the presence of other facts, such as a pre-existing understanding or arrangement between the grantor and the trustee with respect to reimbursement may result in inclusion of the trust's assets in the grantor's estate.

In addition, a defective grantor trust can be used to provide further estate planning benefits through a sale of assets to the trust by removing those assets from the grantor's taxable estate without triggering income tax liability. This is because, as a grantor trust, no capital gain or interest income will be recognized by the grantor/seller since the trust and the grantor/seller are viewed as one taxpayer for income tax purposes.

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Grantor Trusts: Reporting Requirements

The grantor or other owner must report items of income, deduction and credit allocable to him on a separate sheet attached to Form 1041, U.S. Income Tax Return for Estates and Trusts, unless the grantor can elect one of two optional alternative reporting methods. The income, deductions and credits are used in determining whether the $600 gross income filing threshold has been met for the trust, even though they are not listed on Form 1041.

Items of income, deduction and credit that are attributable to any portion of an environmental remediation trust that is treated as owned by the grantor are also reported by the trust on a separate statement that is attached to the Form 1041, rather than on the Form 1041 itself. The trustee must also furnish to each grantor a statement that provides this information for the portion of the trust owned by the grantor.

Investment trusts, that are not considered business entities for tax purposes but are treated as grantor trusts, are classified into non-mortgage widely held fixed investment trusts (NMWHFITs) and widely held mortgage trusts (WHMTs). These trusts have specific reporting requirements, which include the reporting obligations of the trustees and middlemen of those trusts to communicate the necessary tax information to the beneficial owners of trust interests.

Alternative Reporting

If a trust is treated as owned entirely by one or more grantors or other persons, and is not subject to one of the specific limitations discussed below, the trustee may, but is not required to, use either of the two alternative reporting methods in lieu of the statement attached to Form 1041, U.S. Income Tax Return for Estates and Trusts.

Quinn, a U.S. citizen, creates an irrevocable trust that provides that the ordinary income is to be payable to her for life and that on her death the corpus is distributed to Doyle, an unrelated person. Except for the right to receive income, Quinn retains no right or power which would cause her to be treated as an owner under the grantor trust rules. Because Quinn has a right to receive income, she is treated as an owner of a portion of the trust. However, because the trust is not considered to be owned entirely by Quinn (the grantor) or another person, the trustee cannot use one of the alternative reporting methods.

When a trust is treated as owned entirely by one grantor or one other person, the trustee has a choice of either of the following two alternative reporting methods:

- providing the name and taxpayer identification number (TIN) of the grantor or other person treated as the owner of the trust, and the address of the trust, to all payors during the tax year; or
- providing the name, TIN, and address of the trust to all payors during the tax year.

PLANNING TIP

At least one reason to choose one of the alternative reporting methods rather than filing a Form 1041 is simplicity. For example, in the case of a revocable living trust, if the first alternative method is chosen there is nothing for the trustee to file with the IRS. In addition, the trustee would not have to obtain a taxpayer identification number (TIN) for the trust, because the trust could use the social security number (SSN) of the grantor. If the trust is revoked, no final Form 1041 would have to be filed because none was ever required. Payors, who might be hesitant about making payments to a trust and having to substitute the trust's TIN for the grantor's SSN, which would be necessary if the first alternative was not chosen, can continue to use the grantor's SSN as they did before the revocable living trust was established.

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The trustee cannot use the first alternative reporting method unless the grantor or other person who is treated as the owner of the trust provides to the trustee a complete Form W-9, Request for Taxpayer Identification Number and Certification, or acceptable substitute form that is signed under penalties of perjury.

Additionally, unless the grantor or other person treated as the owner of the trust is also the trustee or a co-trustee of the trust, the trustee using the first alternative method must provide the grantor or other person who is treated as the owner of the trust a statement that:

- shows all items of income, deduction and credit of the trust for the tax year;
- identifies the payer of each item of income;
- provides the grantor or other person treated as the owner of the trust with the information necessary to take the items into account in computing the grantor's or other person's taxable income; and
- informs the grantor or other person treated as the owner of the trust that the items of income, deduction and credit and other information shown on the statement must be included in computing the taxable income and credits of the grantor or other person on the income tax return of the grantor or other person.

The trustee is not required to file any type of return with the IRS under the first alternative method.

If the second alternative method is used, the trustee must file with the IRS the appropriate Forms 1099, reporting the income or gross proceeds paid to the trust during the tax year, and showing the trust as the payer and the grantor or other person treated as the owner of the trust as the payee. The trustee has the same obligations for filing the appropriate Forms 1099 as would a payer making reportable payments, except that the trustee must report each type of income in the aggregate, and each item of gross proceeds separately. The amounts that must be included on any Forms 1099 required to be filed by the trustee do not include any amounts that are reportable by the payer on any other information return. For example, when a trust owns an interest in a partnership, the trust's distributive share of the income and gain of the partnership is not includable on any Forms 1099 filed by the trustee, because the distributive share is reportable by the partnership on Schedule K-1, Partners Share of Income, Credits, Deductions, etc.

In addition, if the trustee and the grantor are not the same person, the trustee must also furnish to the grantor or other person who is treated as the owner of the trust a statement that:

- shows all items of income, deduction and credit of the trust for the tax year;
- provides the grantor or other person treated as the owner of the trust with the information necessary to take the items into account in computing the grantor's or other person's taxable income; and
- informs the grantor or other person treated as the owner of the trust that the items of income, deduction and credit and other information shown on the statement must be included in computing the taxable income and credits of the grantor or other person on the income tax return of the grantor or other person.

By furnishing the statement, the trustee satisfies the obligation to furnish statements to recipients with respect to the Forms 1099 filed by the trustee.

The trustee must give to all payors the name and the TIN that is provided on the Form W-9 filed by the grantor or other person. If the Form W-9 indicates that the grantor or other person is subject to backup withholding, the trustee must notify all payors of reportable interest and dividend payments of the requirement to backup withhold. If the Form W-9 indicates that the grantor or other person is not subject to backup withholding, the trustee does not have to notify the payors that backup withholding is not required. The trustee should not give the Form W-9 to a payer because the Form W-9 contains the address of the grantor or other person and the trustee is only required to furnish the address of the trust to all payors, not the address of the grantor or other person. The trustee acts as the agent of the grantor or other person for purposes of furnishing to the payors the information required for backup withholding. Thus, a payer can rely on the name and TIN provided to the payer by the trustee and, if given, on the trustee's statement that the grantor is subject to backup withholding. Whether

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a trustee is treated as a payer for purposes of backup withholding is determined under the backup withholding rules.

When a trust is treated as owned by two or more grantors or other persons, the trustee can use only the second alternative reporting method, by providing the name, TIN and address of the trust to all payers for the tax year. In addition, the trustee must also file with the IRS the appropriate Form 1099, subject to the requirements discussed above when information on the trust is furnished by the trustee to the payers. Similarly, the trustee must also provide to each grantor or other person treated as the owner of the trust the statement discussed above, with the additional specification that the statement show all items of income, deduction and credit or the trust for the tax year that is attributable to the portion of the trust that is treated as owned by the grantor or other person. By furnishing the statement, the trustee satisfies the obligation to furnish statements to recipients for Forms 1099 filed by the trustee.

A payor is any person who is required under the Code or regulations to make any type of information return, including Form 1099 or Schedule K-1, with respect to the trust for the tax year, including persons who make payments to the trust or who collect or otherwise act as middlemen with respect to payments on behalf of the trust. A broker is considered a payer for this purpose, while a customer is considered a payee. A trust that is treated as owned by a husband and wife who file jointly for the tax year is considered to be owned by one grantor for purposes of the alternative reporting methods.

The due date for any Forms 1099 required to be filed with the IRS by a trustee is the due date otherwise in effect for filing Forms 1099. The due date for the statement required to be furnished by a trustee to the grantor or other person who is treated as an owner of the trust is the due date of the trust's Form 1041, which is generally April 15th of the following tax year. The trustee must maintain in its records a copy of the statement furnished to the grantor or other person treated as an owner of the trust for a period of three years from the due date for furnishing the statement.

If a trust ceases to be treated as owned by the grantor or other person because of the death of the grantor or other person, the due date for the statement required to be furnished for the tax year ending with the death of the decedent shall be the date under IRC §6034A(a) that would apply if the decedent had lived throughout the decedent's last tax year. A trustee who fails to file a correct Form 1099 or to furnish a correct statement to a grantor or other person treated as an owner of the trust is subject to penalties for failure to file information statements.

A trust, or portion of a trust, that ceases to be treated as owned by a grantor or other person multiple ownersby reason of the death of the grantor or other person, must obtain a new TIN upon the death of the decedent, if the trust will continue after the death of the decedent. However, if there are multiple owners, the trust reports under the TIN assigned to the trust prior to the decedent's death, and the portion of the trust treated as owned by the decedent prior to the decedent's death continues to report under the TIN used for reporting by the other portions of the trust. If the trust was filing a Form 1041 pursuant to Reg. §1.671-4(a) during the life of the decedent, the due date of the Form 1041 for the tax year ending with the decedent's death is the 15th day of the fourth month following the close of the 12-month period that began with the first day of the decedent's tax year.

The alternative methods cannot be used by:

- a common trust;
- a trust that has its situs or any assets located outside the United States;
- a qualified Subchapter S trust;
- a trust all of which is treated as owned by one grantor or one other person whose tax year is a fiscal year;
- a trust all of which is treated as owned by one grantor or one other person who is not a U.S. person; or
- a trust all of which is treated as owned by two or more grantors or other persons, one of whom is not a U.S. person.

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The alternative methods also cannot be used by a trust that is treated as owned by one grantor or one other person if the grantor or other person is an exempt recipient for information reporting purposes. Nor can it be used by a trust treated as owned by two or more grantors or other persons if one or more grantors or other persons who are treated as owners are exempt recipients for information reporting purposes, unless at least one grantor or one other person who is treated as an owner of the trust is a person who is not an exempt recipient for information reporting purposes; and the trustee reports without regard to whether any of the grantors or other persons treated as owners of the trust are exempt recipients.

Recommended Topics

Explore this Topic

Also see

Trusts and Estates: Tax Return Filing and Payment Requirements

Key Primary Sources

1IRCIRC §671Trust Income, Deductions, and Credits Attributable to Grantor and Others as Substantial Owners

2IRCIRC §672Definitions and Rules

3IRCIRC §673Reversionary Interests

4IRCIRC §674Power to Control Beneficial Enjoyment

5IRCIRC §675Administrative Powers

6IRCIRC §676Power to Revoke

7IRCIRC §677Income for Benefit of Grantor

8IRCIRC §678Person other than Grantor Treated as Substantial Owner

9IRCIRC §679Foreign Trusts Having One or More United States Beneficiaries

10RegulationsReg. §1.671-2Applicable principles

11RegulationsReg. §1.671-3Attribution or inclusion of income, deductions, and credits against tax

12RegulationsReg. §1.671-4Method of reporting

13RegulationsReg. §1.672(f)-2Certain foreign corporations

14RegulationsReg. §1.674(a)-1Power to control beneficial enjoyment

15RegulationsReg. §1.674(b)-1Excepted powers exercisable by any person

16RegulationsReg. §1.674(d)-2Limitations on exceptions in section 674(b) and (d)

17RegulationsReg. §1.676(a)-1Power to revert title only after a period of time

18RegulationsReg. §1.677(a)-1Income for benefit of grantor; general rule

19RegulationsReg. §1.678(c)-1Trusts for Support

Client Letters

Re: Using Trusts--Meeting Tax and Non-Tax Goals

Practice Aids

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1Election/Compliance StatementTrust; Statement Reporting Grantor Trust Income, Deductions, and Credits--Reg. §1.671-4

News

WKUS_TAL_1334,WKUS_TAL_7249,WKUS_TAL_17987,WKUS_TAL_19512

Forms & Instructions

1Form1041Form 1041, U.S. Income Tax Return for Estates and Trusts

2Instructions1041Instructions for Form 1041

IRS Publications

1IRS Publication 559: Survivors, Executors, and AdministratorsSurvivors, Executors, and Administrators

CPE Courses

12 creditsPlanning with Intentionally Defective Grantor Trusts

22 creditsFederal Income Taxation of Trusts and Estates

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