The Estate Planner's Passthrough or Passback Entity of Choice – the Grantor Trust (Part One)

1. A Tree is not a Tree When You call it a Bush

One of the most popular passthrough entities used by sophisticated estate planners is the irrevocable grantor trust, set up during the grantor's lifetime. The importance of the grantor trust for estate planning purposes has been highlighted by the recent revenue ruling, 2008-22.

As a result of this revenue ruling, the next two columns explore the use of grantor trusts in estate planning, and the impact of the ruling on how to effectively establish these trusts for estate planning purposes.

2. Nature of the Grantor Trust

The term "grantor trust" describes a trust that has one or more characteristics described in Code sections 673 through 678. A grantor trust is not a separate taxable entity. Code §671. All items of income, deduction, and credit against tax are reported on the individual return of the grantor or, in limited situations, on the return of the individual possessing a grantor-type power over the trust described in Code section 678.

The grantor trust was initially established as a weapon of the courts (via common law dominion and control arguments) and the Internal Revenue Service against perceived income tax abuses. The rules essentially apply and treat the grantor as the owner of a trust for income tax purposes if the grantor (the "funder" of the trust) has sufficient dominion and control over the trust so that the grantor should, from a policy perspective, be treated as the owner.

Interestingly, the grantor trust concept allows for the creative use of estate tax strategies that incorporate the concept into the planning: it can shift the income tax burden away from the trust to the grantor of the trust.

3. Who is the Grantor – Substance Over Form

The term "grantor trust" is somewhat of a misnomer. The issue is not who is the creator, or "grantor," of a trust, but rather who contributes property to the trust or who has a withdrawal right over trust property. In the tax sense, the "grantor" is the contributor of funds (without adequate consideration) to the trust. Treas.Reg. §1.671-2(e) ("grantor" includes any person to the extent that person makes a gratuitous transfer of property to a trust).

4. The Straightforward Use of the Grantor Trust – the Living Trust

Grantor trust planning is used by the majority of estate planners, but perhaps without any forethought, in one common type of planning, the living trust. The living trust is a revocable trust established by the grantor and available for the grantor's benefit during the grantor's lifetime. It is a strategy intended to avoid probate, provide a mechanism to manage assets in the event of disability, prevent ancillary administration, and ensure privacy.

The living trust is a grantor trust under many sections of the Code, including sections 676, 674, 677, and 673. (Qualification under one section is sufficient.)

As a grantor trust, all taxable income is taxed to the grantor. There is no estate tax advantage because the trust is included in the grantor's estate under Code sections 2036 and 2038. Because the living trust is a grantor trust, typically with the grantor as the trustee, a separate taxpayer identification number need not be applied for; the grantor's social security number suffices.

5. The Necessary — The S Corporation Context

Grantor trusts are often used in the S corporation context to qualify trusts as shareholders. Only certain types of trusts are permissible S corporation shareholders. One permissible type is a grantor trust. (Two types not discussed here are qualified Subchapter S trusts and electing small business trusts. See Code §§1361(d), 1361(e).)

When a gifting trust or other type of trust will hold S corporation stock, qualifying as a grantor trust allows it to be a permissible shareholder. Living trusts are grantor trusts and therefore automatically qualify as S corporation shareholders.

Other trusts (gifting trusts, for example) need to have grantor trust specific provisions, such as the power to borrow without adequate security or the power to substitute assets of equivalent value.

When structuring a trust as a grantor trust to be a permitted shareholder of an S corporation, the entire trust, not merely a portion, must be deemed to be owned by one individual who is a citizen or resident of the United States. A withdrawal power limited to the "5 or 5" amount described in Code §2514(e) will not cause the entire trust to be treated as owned by the beneficiary if the value of the stock contributed to the trust exceeds the "5 or 5" amount. Likewise, a grantor-type power granted with respect to only a portion of the trust will not be sufficient to cause the entire trust to be treated as a grantor trust.

In the S corporation context, the deemed grantor of the trust will be taxable on the trust's pro rata share of S corporation income. This is true whether that income is distributed by the corporation to the trust or from the trust to the beneficiary. Therefore, the potential for unrealized income to the deemed grantor must be recognized. When the beneficiary is the deemed grantor, this problem may be mitigated by including in the trust express language that directs the trustee to distribute to the beneficiary an amount necessary to cover the beneficiary's increased income tax liability resulting from the trust's pro rata share of S corporation income. In the grantor retained annuity trust (GRAT) or sale to grantor trust strategy, there is an excellent interplay between this result and income tax basis planning. If the cash flow needed to sustain the GRAT or sale strategy is less than the S corporation earnings, the corporation should not distribute out all earnings. Undistributed earnings will increase the basis in the hands of the beneficiaries of the GRAT or grantor trust (a good result), even though the income tax on the earnings is paid by the grantor (a good result).

6. The Complicated — Grantor Trusts as Planning Strategies for Estate Tax Reduction

The most interesting use of grantor trusts in today's environment is as a positive means of estate tax reduction. In many situations it is advantageous to draft a trust so that the trust has one or more of the characteristics that create a grantor trust.

Importantly, the grantor must be okay with the concept that he or she will pay income tax on assets that may or may not be available for use by the grantor. Planners should pay attention to this concern — even if it is flawed on a cash flow basis — because it is perceived as important to most grantors.

For example, a grantor who has a $30 million taxable estate still may not feel that he or she is able to bear the "burden" of income taxes on income not received by the grantor. This conclusion, if not logically grounded on fact, is nevertheless real to the client, and planners need to plan for this reaction.

The estate tax strategies for which the grantor trust planning should be considered, to be discussed in part two to this article, include lifetime use of the applicable credit amount, the qualified personal residence trust, postmortem use of grantor trusts in the credit shelter trust context., grantor retained annuity trusts (GRATs), and sales to a grantor trust.

7. Drafting a Grantor Trust : Importance of Structuring the Provision

The practitioner should carefully consider which power to give to the grantor or other individual in order to make the trust a grantor trust. This consideration is particularly important to avoid adverse estate tax treatment of the trust. For example, making a gifting trust a grantor trust is a good result from an estate tax perspective; however, selecting a grantor trust power that includes the trust in the grantor's gross estate for estate tax purposes is a horrendous result for estate tax purposes.

8. Which "Bad" Power to Use: Revenue Ruling 2008-22

The provision most favored as a grantor trust provision, until recently, was the section 675(4)(C) power "to reacquire the trust corpus by substituting other property of an equivalent value." There are rulings that support the conclusion that this power, alone, is sufficient to create a grantor trust. See Pvt.Ltr.Ruls. 9352017 (Dec. 30, 1993), 9239015 (Sept. 25, 1992).

A concern exists as to whether this power creates a retained interest subject to estate tax inclusion under Code section 2036(a)(1) or section 2038. Specifically, because the power may be retained by the grantor in a non-fiduciary capacity, it looks like a retained power to alter or designate the beneficial interests under those sections.

However, that argument is tenuous at best. The Service discussed the argument recently in Revenue Ruling 2008-22 and provided guidelines as to how to avoid it where the substitution power was held by the grantor, but not as trustee. In that setting, the exact language of the Service's ruling is important:

> "A grantor's retained power, exercisable in a nonfiduciary capacity, to acquire property held in trust by substituting property of equivalent value will not, by itself, cause the value of the trust corpus to be includible in the grantor's gross estate under § 2036 or 2038, provided the trustee has a fiduciary obligation (under local law or the trust instrument) to ensure the grantor's compliance with the terms of this power by satisfying itself that the properties acquired and substituted by the grantor are in fact of equivalent value, and further provided that the substitution power cannot be exercised in a manner that can shift benefits among the trust beneficiaries. A substitution power cannot be exercised in a manner that can shift benefits if: (a) the trustee has both the power (under local law or the trust instrument) to reinvest the trust corpus and a duty of impartiality with respect to the trust beneficiaries; or (b) the nature of the trust's investments or the level of income produced by any or all of the trust's investments does not impact the respective interests of the beneficiaries, such as when the trust is administered as a unitrust (under local law or the trust instrument) or when distributions from the trust are limited to discretionary distributions of principal and income " (emphasis added and to be discussed in part two to the article).

If it becomes a concern, section 675(4) allows for the power to be exercisable "in a nonfiduciary capacity by any person without the approval of any person in a fiduciary capacity." Arguably, the power can be vested in one other than the grantor to put the property back in the grantor by having other property held by the grantor substituted into the trust.

9. Conclusion

The language of the Revenue Ruling provides current guidance to the practitioner in allowing the practitioner to draft a grantor trust provision that will not run afoul of the estate tax concerns. However, the Ruling is not a panacea. First, the highlighted provisions in the quoted language above is not as clear as practitioners would like. This will be discussed in the companion to this article. Also, this type of grantor trust power cannot be used in all grantor trust planning. For example, this power to reacquire cannot be used in a QPRT since the regulations provide that in a QPRT the residence cannot be reacquired by the grantor. Treas.Reg. §25.2702-5(c)(9). A different grantor trust power must be used.

The open issues to be discussed in part two to the article are: (1) is the 675 (4) power the grantor trust power that should be routinely used? (2) How are grantor trust provisions used effectively in the advanced estate tax planning strategies mentioned in section 6 of this article; and (3) How does one draft for the grantor trust power.