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Folks:

**Take-Away:** There does not seem to be a consensus if a *grantor* Trust is to be treated as a separate legal entity or not. The Courts apparently are not really sure. This decision can have tax implications when a *grantor* Trust ceases to be a *grantor* Trust.

**Background:** One of the claimed features of a *grantor* Trust is that the *grantor* tax consequences can be 'toggled' on or off with the release or addition of a specified power held by the grantor. But 'toggling' the Trust is something that the IRS does not like.

**Grantor as Owner:** The Tax Court came to the conclusion in *Mandorin v. Commissioner, 84 Tax Court 667 (1985)* that under IRC 671, the grantor/settlor of a *grantor* Trust should be treated as the *owner* of the Trust's assets, as opposed to simply being attributed income, gain, loss or deduction from the Trust itself. This appears to be the consensus view of most Courts when it comes to a *grantor* Trust. However, a couple of other federal courts have adopted the *tax attribution theory,* under which a *grantor* Trust is treated as a *separate legal entity*. Thus, there is some debate who the owner of the Trust assets is when it is a *grantor* Trust.

**Trust as Owner:** The second view of a *grantor* Trust is based on the language of IRC 671, which provides, part:

> *"[w]here it is specified in this subpart that the grantor or another person shall be treated as the owner of any portion of a trust, there shall then be included in computing the taxable income and credits of the grantor or the other person those items of income, deductions, and credits against tax of the trust which are* ***attributable to that portion of the trust*** *to the extent that such*

*items would be taken into account under this chapter in computing taxable income or credits against the tax of the individual."*

Under the *tax attribution theory,* the *grantor* Trust remains a separate tax entity and remains the owner of the Trust assets, but the Trust's income, loss and deductions are *attributed* to the grantor. Only a couple of Courts have formally adopted this *tax attribution theory* of a *grantor* Trust. *Rothstein v. United States, 735 F.2d 704 (2nd Circuit, 1984); Textron v. Commissioner, 117 Tax Court 67 (2001).*

**Transfers on Conversions:** Another conclusion in the *Mandorin* decision was that the 'split second' when the *grantor* Trust ceases to be a *grantor* Trust, e.g., the settlor's retained power to substitute assets of equivalent value is released, there is then a *transfer* (or disposition) of Trust assets from the grantor to the now non-grantor Trust. Consequently, tax outcomes will result when one tax entity (the grantor) transfers assets to another entity (the non-grantor Trust.)

**Conversion to a Non-Grantor Trust:** When a *grantor* Trust becomes a non-grantor Trust, if the Trust's assets include encumbered property, the grantor recognizes gain to the extent that the liability exceeds the grantor's adjusted basis in the property. An extension of this rule is that if a *grantor* Trust issued a note to its grantor in exchange for property, e.g., the common sale to an IDGT in exchange for an installment Note, then the grantor will be considered to have realized gain (but not loss) if the Note remains outstanding on that conversion.

**Sale to an IDGT:** The common estate planning strategy is the sale of an appreciated asset by the grantor to an intentionally defective *grantor* Trust (or IDGT.) The sale is made to the *grantor* Trust in exchange, often, for an installment promissory Note given back to the grantor from the Trust. The sale to the Trust does not trigger an immediate recognition of capital gains, since the transaction is treated as between the same taxpayers (the

grantor is both buyer and seller.) At the same time, the appreciating asset is removed from the grantor's taxable estate for estate tax purposes. As such, the *grantor* Trust will often have debt (owed to the grantor) when there is a sale to an IDGT.

> **Gain Recognition:** If the reasoning of the *Mandorin* case if followed, and the *grantor* holds the *grantor* Trust's Note immediately before the Trust ceases to be a *grantor* Trust, then the grantor will be considered to have realized gain or loss on the conversion of the Trust to a non-grantor Trust, e.g., when its *grantor* Trust status is 'toggled' off. However, the recognition of the gain might be deferred under IRC 453, but any loss will be disallowed due to the related-party loss rules. [IRC 267.] Although not expressly stated in the *Mandorin* decision, if a *grantor* Trust had no outstanding liabilities when it converts (or 'toggled off') to become a non-grantor Trust, the conversion should be free of income tax consequence; thus, if the Trust has no liabilities, the transfer cannot be treated as 'sale' because the grantor receives no consideration on the conversion.
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> **Example:** Bert sold his highly appreciated closely-held business interest to a *grantor* Trust in exchange for an installment Note. The closely-held business generates significant S distributions to its shareholders, including the *grantor* Trust. Bert complains to his advisors about paying the income taxes on the Trust's S distribution income. Bert is thinking about surrendering/releasing his retained authority under the Trust instrument to substitute assets of equivalent value. If Bert releases that power of substitution the Trust will cease to be taxed as a *grantor* Trust. However, Bert's release of that retained power of substitution under the Trust will trigger significant tax liability for Bert. Better the trustee reimburses Bert's income tax liability associated with the *grantor* Trust as opposed to formally terminating its *grantor* Trust status.

**Toggling *Grantor* Trust Status:** When a Trust is drafted with the intent that it is to be a *grantor* Trust, usually there is also the desire to have the

flexibility to turn-off its *grantor* Trust status later without much complication. Accordingly, the Trust instrument usually incorporates certain powers that involve either (i) the grantor's borrowing power, (ii) the substitution of assets for equivalent value power, or (iii) an independent trustee's power to add one or more charitable organizations s beneficiaries. The power to borrow from the Trust without adequate interest or security will cause the Trust to be classified as a *grantor* Trust. [IRC 675(2).] The power to reacquire the trust assets by substituting other property of equivalent value also can cause the Trust to be classified as a *grantor* Trust. [IRC 675(4)(C).] This flexibility to release or disclaim one of these retained powers, or the ability of a trust director to add or remove one of these powers to a non-grantor Trust, or 'toggling' the *grantor* Trust status on or off, is often 'pitched' as one of the benefits to a *grantor* Trust.

While 'toggling' does provide incredible flexibility to a *grantor* Trust about who (or what) pays the Trust's income taxes, it should also be noted that the IRS views frequent 'toggling' between *grantor* and non-grantor trust as a *transaction of interest* that is subject to reporting to the IRS. [Notice 2007-73.] In short, the IRS does not like frequent 'toggling' of a Trust's *grantor* Trust status.

**Conclusion:** The flexibility associated with a *grantor* Trust is extremely important for estate and tax planning. "Toggling" its *grantor* Trust classification is the feature that makes a *grantor* Trust so popular. The concern is that the Courts are not entirely clear whether the Trust, or its settlor, is the owner of its assets, which can make the tax consequences of 'toggling' uncertain.

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