Folks:

Take-Away: A Trust can be classified for many different reasons, or provisions, as a *grantor* Trust, which may or may not be in the settlor's best interest.

Background: *Grantor* trusts are in the news these days for a variety of reasons. Many married individuals are currently pondering the adoption of a spousal lifetime access Trust (SLAT) to exploit their large applicable exemption amount before the exemption sunsets in 2026; a SLAT is by definition a *grantor* Trust, which presents potential income tax problems for the SLAT's settlor. At the same time Treasury's 2025 Budget Proposals, which were released in March, make it clear that the IRS would like to get rid of *grantor* Trusts, or drastically curtail their use (or, according to the *Greenbook,* their abuse.)

Short History: The *grantor* Trust rules were added to the Tax Code in 1923 to deter individuals from abusing the progressivity of the U.S. federal income tax system. These rules worked well to keep taxpayers from shifting their taxable income to multiple trusts with their own tax filing obligations. However, starting with the 1986 Tax Act, that all changed, and their effectiveness when in the opposite direction. The 1986 Tax Act dramatically compressed the income tax rates faced by irrevocable Trusts, but not so much for individuals. In effect, this change in the income taxation of irrevocable Trusts 'flipped the script' and caused individuals to intentionally create, not avoid, a *grantor* Trust to exploit the rules to shift taxable income *away* from the Trust and to the Trust's grantor/settlor.

***Grantor* Trust Definition:** A *grantor* Trust is a Trust in which the grantor/settlor is treated as the owner of the trust property for U.S. income tax purposes. [IRC 671.] In short, the Trust is disregarded for income tax

purposes, which means the Trust does not exist as a separate income tax paying entity for income tax purposes in the eyes of the IRS. However, the trust assets are not treated as owned by the grantor/settlor for federal estate tax purposes, thus avoiding federal estate taxes on the grantor/settlor's death. With the classification as a *grantor* Trust: (i) transactions between the grantor/settlor and the *grantor* Trust are also disregarded and not recognized for income tax purposes, i.e., moving assets between the two without any gain recognition; and (ii) all items of income, deduction, and credits of the Trust are reported on the grantor/settlor's individual income tax return, presumably exposed to marginally lower income tax rates than the Trust itself would have faced. [Revenue Ruling 85-13.]

> **Shifting Income Taxes:** In 2024, when an irrevocable Trust accumulates its income above $15,200, that excess income is taxed at the highest marginal federal income tax rate of 37%. In contrast, a single individual taxpayer will reach their highest marginal federal income tax rate with their income above $609,350. Accordingly, with the compressed income tax rates faced by irrevocable Trusts, it should come as no surprise that there is considerable interest in shifting taxable income to the Trust's grantor/settlor with the use of a *grantor* Trust. Assets grow 'tax-free' inside the Trust (ignoring that the settlor is paying the tax liability.)

> **No Gift Tax:** Adding to the perceived income tax benefit of a *grantor* Trust is the position taken by the IRS in 2004, that the grantor/settlor's payment of the *grantor* Trust's income tax liability is not a taxable gift by the grantor/settlor to the trust beneficiaries. Thus, without using the grantor/settlor's transfer tax exemption, by paying the Trust's tax liability, the grantor/settlor moves more assets away from their estate for estate tax purposes, while not making a taxable gift.

Consequently, the question sometimes asked by a prospective settlor is: *How do I make the irrevocable Trust to which I plan to make gifts classified*

as grantor Trust?

Making a Trust a *Grantor* Trust: The *grantor* Trust rules are currently located in IRC Sections 671 to 679. These Tax Code sections provide many ways how a Trust can either intentionally be made into a *grantor* Trust, or inadvertently cause the Trust fall into that classification (which may come as a surprise to its settlor.)

> **IRC 671- Income Shifting Rule:** This Section effectively shifts Trust income to the grantor by treating the grantor as the owner of the Trust's property when the *grantor* Trust rules apply to the Trust.
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> **IRC 672- Definitions:** Lists of definitions and general rules are in this Section.
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> > **IRC 672(e)- SLATs:** One key *grantor* Trust rule, especially for those who are considering the creation and funding of a SLAT, is IRC 672(e), which provides that grantor/settlor is treated as holding any power or interest in the Trust that is held by their **spouse** for purposes of the *grantor* Trust rules. [IRC 672(e)(1).] Thus, if the spouses for whom a SLAT was prepared later divorce, the SLAT's settlor will continue to be liable for the SLAT's income tax liability even though the settlor's spouse is no longer the SLAT's beneficiary. Not a happy situation for the grantor/settlor to be in, paying income taxes of the Trust when the grantor/settlor no longer has indirect access through the former or late spouse.
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> **IRC 673- Reversionary Interest:** If the grantor/settlor retains a reversionary interest in the Trust's property, that retained reversionary interest will cause the Trust to be classified as a *grantor* Trust. For example, if I create a discretionary Trust for the benefit of my mother who lives on a fixed income, naming myself as the remainder beneficiary of that Trust upon my mother's death, then the Trust is a *grantor* Trust, and I will be taxed on the Trust's income.

IRC 674(a)- Power of Distribution or Control: If the grantor/settlor, or another who is a **nonadverse person**, holds a power of distribution to control the beneficial enjoyment of the corpus or income of the Trust **without the approval of an *adverse party*,** will be treated as the owner of the Trust. Since this provision would normally cause most Trusts to be classified as a *grantor* Trust, IRC 674(b) identifies several exceptions to this general rule.

IRC 674(b) Exceptions: IRC 674(b) identifies several exceptions to IRC 674(a)'s *grantor* Trust classification, for powers:
(1) to apply trust income to support a dependent;
(2) affecting the beneficial enjoyment but only after occurrence of an event;
(3) exercisable by Will only;
(4) to allocate income or corpus among charitable beneficiaries;
(5) to distribute corpus;
(6) to withhold income temporarily;
(7) to withhold income during a beneficiary's disability; and
(8) to allocate between income and principal.

IRC 675- Administrative Powers: This Section identifies several administrative powers that, if held by the grantor/settlor, will cause *grantor* Trust status. This is the section most often relied upon when the grantor/settlor intentionally creates a Trust that falls within the *grantor* Trust classification. These powers include:

IRC 675(1)-Deal for Less than Adequate Consideration: The power to deal with the Trust for less than adequate and full consideration;

IRC 675(2)-Borrow Income or Principal: The power to borrow Trust principal or income **without** adequate interest *or* security;

IRC 675(3)- Borrow if Loan is Not Timely Repaid: The power to borrow Trust funds (unless repaid before the close of the taxable

year and the borrowing or loan has adequate interest and security); this provision is sometimes used to 'toggle on and off' it *grantor* Trust status by the grantor/settlor simply by repaying the loan in full before then end of the Trust's taxable year- if any of the loan remains outstanding, it's a *grantor* Trust, and if fully repaid by year's end, it is not so classified;

IRC 675(4)- Prohibited Administrative Powers: Retained some general powers of administration which include:

(i) **Voting:** the power to vote or direct the vote of a corporation owned by the Trust (IRC 675(4)(A);]

(ii) **Control investments:** the power to control the investments of the Trust [IRC 675(4)(B);]

(iii) **Reacquire Trust Assets:** the power to reacquire the Trust's corpus by substituting other property of equivalent value [IRC 675(4)(C).] It is this last retained power, often referred to as the *swap power,* that is frequently used by the settlor to intentionally make the Trust a *grantor* Trust for income tax purposes.

What needs to be remembered is that it is the mere presence of one of these retained powers by the settlor will cause the Trust to be a *grantor* Trust, whether the grantor/settlor exercises the retained administrative power.

IRC 676- Revocation: If the grantor/settlor retains the power to revoke title to the Trust's property, the Trust will be a *grantor* Trust. This provision thus covers the conventional revocable grantor Trust that is used in most estate plans.

IRC 677(a)(1) and (2)- Trust for Spouse: This provision provides that the Trust will be treated as a *grantor* Trust if the income of the Trust may be distributed or accumulated to be distributed in the future to the grantor/settlor or to his/her spouse. As noted earlier, the *grantor* Trust status occurs when the Trust is initially created; that status is

not ‘turned off’ merely because the spouses later divorce, or the beneficiary-spouse dies. Consequently, the rule becomes problematic for the spouse-settlor who creates the SLAT, since the *grantor* Trust status cannot later be ‘turned off’ either by the grantor/settlor through a relinquishment of retained powers, or a decision made by the Trustee. This is why, if divorce or death are major concerns to the SLAT’s settlor, it would be wise to make distributions to or for the benefit of the beneficiary-spouse subject to the consent of an *adverse person,* e.g., a remainder beneficiary of the SLAT who holds an economic interest contrary to their parent (the Trust’s beneficiary.)

IRC 677(a)(3)- Life Insurance: *Grantor* Trust status also arises if income from the Trust is used to pay premiums on a life insurance policy on the life of the grantor/settlor or his/her spouse. This means that an irrevocable life insurance trust (ILIT) usually falls within the *grantor* Trust classification.

IRC 678- Beneficiary as Grantor: This Section is sometimes infrequently referred to as a *beneficiary defective income trust,* or BDIT sophisticated planning strategy. *Grantor* Trust status will apply to the person other than the grantor/settlor, when that person, other than the grantor/settlor, has sole power to vest the corpus or the income from the Trust in the person’s own self.

Example: Grandma creates an irrevocable Trust for her son and grandchildren. Grandma funds the Trust with $5,000. Son, as the beneficiary, possesses the full right to withdraw the $5,000 seed-contribution that Grandma made to the Trust. Son is treated as the grantor of the Trust, even though he did not create the Trust, nor did he retain any rights in the Trust. The Trust is a *grantor* Trust as to Son. Son then sells appreciated assets to the Trust, of which grandchildren/children are the discretionary beneficiaries. Son will not incur any capital gain when his appreciated assets are sold to the Trust, since Son is treated, for tax purposes, as dealing with

himself. As Son pays the income taxes incurred by the *grantor* Trust in the years to come, he will not be treated as having made taxable gifts to the Trust or its beneficiaries, i.e., his children. However, this 'other' person [Son] will not be treated as the grantor of the Trust if the grantor/settlor [Grandma] also qualifies as the owner of the Trust's property under the other *grantor* Trust rules covered earlier, such as Grandma being able to borrow from the Trust with less than adequate interest or security for that loan.

IRC 679- Foreign Trusts: This Section provides complex rules to require a non-U.S. Trust to be treated as a *grantor* Trust. It provides rules for foreign trusts that have one or more beneficiaries who are domiciled in the U.S. Instead of specifying any powers that the grantor/settlor retains over Trust's property, IRC 679 treats the non-U.S. Trust as a *grantor* Trust *if* the Trust has a U.S. beneficiary.

Conclusion: The *grantor* Trust income tax rules take a 'sweeping approach,' by which I mean that if the grantor/settlor retains almost any amount of power over property transferred to the Trust, that transfer will be considered incomplete, which will in turn lead to the grantor/settlor being taxed on the Trust's income. In contrast, the estate tax rules are much 'narrower' which require the grantor/settlor to retain much greater power over the property transferred to the irrevocable Trust to be included in the grantor/settlor's taxable estate under IRC 2036, 2037, or 2038. This 'mismatch' is why a *grantor* Trust is a popular estate planning tool that is used to save income taxes yet avoid, or possibly reduce, federal estate taxes, and which explains why Treasury views the aggressive use of a *grantor* Trust as 'abusive.'

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