

GRANTOR TRUSTS: THE MVP OF THE IRC

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I. INTRODUCTION

Since the passage of the Tax Cuts and Jobs Act of 2017 (TCJA), taxpayers have enjoyed the benefit of increased exclusion amounts for the combined gift and estate tax, and the generation-skipping transfer (GST) tax (collectively referred to herein as transfer taxes).¹ The terms “lifetime exclusion” or “exclusion amount” generally refer to the amount that an individual can give or pass on to others during one’s lifetime or at death without triggering the payment of transfer tax, currently at a rate of 40%.² This ever-changing exclusion amount has been a huge focus for wealthy families, tax and estate planning practitioners, and Congress over the last few decades.³

We live in an era of a heightened “bonus exclusion,” where the current exclusion is at an all-time nominal high (since the introduction of the estate tax in 1916) of \$12.06 million in 2022, going to \$12.92 million per person for 2023.⁴ Like most of the individual tax benefits under the TCJA, this increased exclusion amount is scheduled to sunset after December 31, 2025, reverting to pre-TCJA amounts.⁵ When Joe Biden won the Presidency in 2020 and the Senate flipped to a very narrow Democratic majority in 2021, including any tie-breaking vote by Vice President Kamala Harris, the planning community was upended.⁶ It was fully expected, based on then Candidate Biden’s platform and comments made by the Biden-appointed Secretary of the Treasury, Janet Yellen, that any tax package proposed by a Biden Administration would include some form of reduction of this bonus

1. See Tax Cuts and Jobs Act of 2017, Pub. L. No. 115-97, 131 Stat. 2054 (2017). The exclusion amount applicable to gift and estate, and GST tax is \$10 million, indexed to inflation, and \$12.06 million in 2022 and going to \$12.92 million in 2023. See Rev. Proc. 2021-45, 2021-48 I.R.B. 764, Rev. Proc. 2022-38, 2022-45 I.R.B. 1. After December 31, 2025, the gift and estate, and GST tax exclusion amounts are scheduled to revert to the pre-TCJA amount of \$5 million, indexed to inflation. See I.R.C. §§ 2010, 2505, 2631.

2. I.R.C. § 2001(b) (providing the computation of estate tax); *id.* § 2001(c) (providing the estate tax rate schedule (40% tax rate)); *id.* § 2503 (gift taxes); *id.* § 2641(b) (providing the tax rate for GST tax). These taxes do not apply to the transfer of money or other property to an organization described in paragraph (4), (5), or (6) of § 501(c) and are exempt from tax under I.R.C. § 501(a), for the use of such organization. *Id.* §§ 501(c)(4)–(6).

3. See *What’s New—Estate and Gift Tax*, IRS (Nov. 15, 2021), <https://www.irs.gov/businesses/small-businesses-self-employed/whats-new-estate-and-gift-tax#:~:text=The%20annual%20exclusion%20for%20gifts,the%20annual%20exclusion%20is%20%2416%2C000> [<https://perma.cc/R2AP-Y8LX>].

4. See Tax Cuts and Jobs Act of 2017, Pub. L. No. 115-97, 131 Stat. 2054 (2017).

5. I.R.C. § 1(j)(1).

6. Paul Sullivan, *It May be Time to Start Worrying About the Estate Tax*, N.Y. TIMES (Mar. 18, 2021), <https://www.nytimes.com/2021/03/12/business/estate-tax.html> [<https://perma.cc/C9PC-XGFJ>].

exclusion, or an earlier sunset.⁷ Exclusion reduction, as well as fear of elimination of the “step-up” in basis at death rule under Section 1014 of the Internal Revenue Code (the Code), was fully anticipated by taxpayers and resulted in a flurry of anxious tax consulting and planning at the end of 2020.⁸

While everyone was focused on the exclusion and basis planning, Democrats in Congress, with the support of the Biden Administration, also had plans to make substantial changes to the grantor trust rules under Subpart E of Part I of Subchapter J of the Code. Many of these proposed changes seemed to come out of left field.⁹ On September 13, 2021, the House Ways and Means Committee introduced a bill known as the Build Back Better Act (BBBA), which threatened to effectively gut the efficacy of grantor trust planning.¹⁰ The bill itself was expected; it included some ideas from the Obama Administration’s General Explanations of the Administration’s Fiscal Year 2015 Revenue Proposals (the 2015 Green Book), as well as revenue-raising provisions needed to pay for both the bill and COVID-19 relief stimulus packages enacted in 2020 and 2021.¹¹ What was not predicted by most were the proposed changes to the grantor trust rules.¹²

These proposals were, without a doubt, more profound than a proposed rollback of the gift, estate, and GST tax exclusion amounts because the sheer broad design of a grantor trust generates endless planning opportunities for families of wealth.¹³ Once a taxpayer uses all of his or her gift tax exclusion amount, planning techniques involving the use of grantor trusts can take wealth transfer into “extra innings,” because they offer opportunities to shift additional wealth without the use of the exclusion.¹⁴ Arguably, there is no better estate planning tool than a properly structured irrevocable grantor trust to transfer wealth from a grantor’s taxable balance sheet to the non-taxable side of the family’s balance sheet.¹⁵ This is why grantor trusts are the most valuable player of the Internal Revenue Code for purposes of wealth transfer.¹⁶ The possibilities are almost limitless.¹⁷

7. *Id.*

8. I.R.C. § 1014(a) (providing instructions on adjustments of income tax in the “hands of a person acquiring the property from a decedent or to whom the property passed from a decedent ...”).

9. *See* Sullivan, *supra* note 6.

10. In fairness, the proposals were not entirely out of left field. Potential rollbacks to the efficacy of grantor trusts have been made in various Green Book proposals by the Obama Administration, as detailed in this Article. Build Back Better Act, H.R. 5376, 117th Cong. (2021).

11. *See id.*

12. *See* Sullivan, *supra* note 6.

13. *See* Brandon D. Hamm & Alexander J. Wolf, *A Primer On Grantor Trusts*, KOLEY JESSEN 5, 5–10 (Oct. 2016), <https://www.koleyjessen.com/assets/htmldocuments/wp-content/uploads/TNL-0916b.pdf> [<https://perma.cc/43NZ-GDFB>].

14. *See id.*

15. *See id.*

16. *See* Diana S.C. Zeydel et al., *Portability or No: The Death of the Credit-Shelter Trust?*, 118 J. TAX’N 231, 245 (2013).

17. *See id.*

This Article briefly reviews the grantor trust rules contained in Subpart E of the Code, and specifically focuses on the current legislative standing of grantor trusts, as well as some of the more detailed nuances of grantor trust planning.¹⁸ Some of these special considerations are techniques such as: (1) terminating grantor trust status; (2) “togglng” grantor trust status on and off; (3) income tax consequences of terminating grantor trust status; (4) the efficacy of tax reimbursement clauses; and (5) other special considerations.¹⁹

II. GRANTOR TRUST STATUS

A. Definition of a Grantor Trust

A grantor trust is generally defined as any trust that under Sections 671 through 677 and Section 679 of the Code is taxed as if owned in whole or in part by the trust’s creator (referred to herein as a grantor).²⁰ The trust’s grantor can be defined as a person who directly or indirectly makes a gratuitous transfer of cash or other property to a trust.²¹

Unlike estates and non-grantor trusts, which are subject to U.S. income taxes or pass through income to their beneficiaries, the income of grantor trusts is taxed to the grantor, or another party who is deemed to own the assets of a trust.²² A grantor (or third party) is required to include in his, her, or its individual income tax computations those items of income, deductions, and credits allocable to any portion of a trust that such grantor or third party is deemed to own under the grantor trust rules.²³ These items are reported on that taxpayer’s own income tax return.²⁴ In other words, it is as if the grantor received such income, deduction or credits directly, and the general rules of trust taxation are disregarded.²⁵

18. See generally Stephen T. Dyer, *Planning With Grantor Trusts*, SALT LAKE EST. PLAN. COUNCIL (Nov. 15, 2018), <https://www.saltlakeestateplanners.org/assets/Councils/SaltLake-UT/library/Dyer-SLEPC%202018%20Outline-Planning%20With%20Grantor%20Trusts.pdf> [https://perma.cc/B4D2-LEW5] (offering a detailed discussion of the grantor trust rules under Subpart E of Part I of Subchapter J of the Code).

19. See *id.*

20. I.R.C. §§ 671–679. Section 678 of the Code contains provisions for a trust that is taxed as if owned in whole or in part by someone other than the grantor of the trust (Section 678 Trust). *Id.* § 678.

21. A trust can make “a gratuitous transfer of property to another trust, [and] the grantor of the transferor trust will generally be treated as the grantor of the transferee trust,” though an exception exists for exercising a general power of appointment. Treas. Reg. § 1.671-2(e)(2)(i). Additionally, beneficiaries can also be grantors for income tax purposes based on certain contributions and powers over trust assets. *Id.* (“A gratuitous transfer is any transfer other than a transfer for fair market value.”).

22. I.R.C. §§ 671–679.

23. See *id.*

24. Treas. Reg. § 1.671-1(d) (stating that grantor trust rules do not apply to charitable remainder trusts or pooled income trusts).

25. I.R.C. § 671.

B. Grantor Trust Powers

Sections 671 through 677 of the Code provide special rules under the terms of which, if these rules apply, trust income is taxed to the grantor.²⁶ These “anti-abuse rules” provide that if certain powers or interests, commonly referred to as grantor trust “triggers,” are retained by a grantor, such grantor has exerted so much control over the trust as to cause that grantor to be treated as the income tax owner of the trust assets.²⁷ The following is a summary of the relevant Code provisions.²⁸

Section 671 provides that a grantor must include in the computation of taxable income all items of income, deductions, and credits against tax of the trust attributable to the portion of the trust over which the grantor or such other person is deemed to be the owner.²⁹

Section 672 covers many of the key definitions and exceptions that govern the grantor trust rules in Subpart E of the Code.³⁰ This section defines “adverse party” as any person who has a beneficial interest in the trust, which includes a power of appointment, whose interest is substantial, and whose interest would be adversely affected by the exercise or non-exercise of the power held by the grantor or a non-adverse party.³¹ This section further defines a “non-adverse party” as anyone who is not an adverse party.³²

Section 672(d) provides that a person shall be considered to have a power described under Subpart E, “even though the exercise of the power is subject to a precedent giving of notice or takes effect only on the expiration of a certain period after the exercise of the power.”³³ Section 672(e) provides what are considered the “spousal attribution rules,” so that a grantor is treated as holding any power or interest held by the grantor’s spouse, if the spouse was married to the grantor at the time of the creation of such power or interest.³⁴ For purposes of this Code subsection, an individual legally separated from his or her spouse under a decree of divorce or of separate maintenance is not considered married.³⁵

Section 673 provides that a grantor is the owner of a trust if the grantor has a reversionary interest, which is the right to have property be repaid to the grantor after a certain period or event.³⁶ To be a grantor trust, the value

26. *Id.* §§ 671–679.

27. *Id.*

28. *Id.*; *see infra* text accompanying notes 29–61.

29. I.R.C. § 671; *see* Treas. Reg. § 1.671-1, -2.

30. I.R.C. § 672.

31. *Id.*

32. *Id.* § 672(a)–(b); Treas. Reg. §§ 1.672(a)-1, 1.672(b)-1.

33. I.R.C. § 672(d).

34. This can also apply to a person who becomes a spouse after the creation of the power but only with respect to periods after the marriage. *Id.* § 672(e)(1)(A)–(B).

35. *Id.* § 672(e)(2).

36. *Id.* § 673; *see id.* § 2037 (explaining the use of a reversion may risk estate tax inclusion because of similar test upon the death of a taxpayer).

of the reversionary interest must exceed 5% of the value of the trust at the time the trust is created for any transfers to trusts made after March 1, 1986.³⁷ Similar to Section 2037 of the Code, which includes in the value of the gross estate certain transfers taking effect at death, the 5% test applies at the inception of the trust, while the estate tax rules governing Section 2037 applies the test immediately prior to the death of the grantor-decedent.³⁸

Section 674 provides that a grantor is the owner of any portion of a trust over which the grantor retains a power of disposition.³⁹ Generally, the power of disposition is any power that can affect beneficial enjoyment, and that power can be held by the grantor or a non-adverse party.⁴⁰ There are several exceptions to this, including the trustee's power to distribute or accumulate income subject to a "reasonably definite external" standard.⁴¹

Section 675 provides that a trust is a grantor trust if the grantor or non-adverse party has certain administrative powers over the trust that can be exercised without consent of an adverse party.⁴² Under Section 675(1), if a grantor, non-adverse party, or both, can acquire property from the trust for less than full and adequate consideration without consent of an adverse party, the trust will also be taxed as a grantor trust.⁴³ This power under Section 675(1) is not widely used in irrevocable trusts because it can be viewed as power to revoke the trust, which could in turn cause inclusion of assets in the grantor's estate under Section 2038.⁴⁴

Section 675(2) provides that the trust will also be taxed as a grantor trust if the grantor or a non-adverse party has the power to borrow trust property without adequate interest or security.⁴⁵ This does not generally apply where a trustee other than a grantor has an authorized general lending power to make loans to any person without regard to interest or security, a provision that is sometimes included under general trustee powers provisions in a trust agreement.⁴⁶

The actual borrowing of trust property (directly or indirectly) without adequate interest or security will cause the trust to be taxed as a grantor trust if the grantor actually borrows from the trust and does not repay the loan and interest thereon before the beginning of the next taxable year under Section

37. An Act to reform the internal revenue laws of the United States, Pub. L. No. 99-514, 100 Stat. 2085. For transfers made to a trust on or before March 1, 1986, the grantor was treated as the owner unless the reversionary interest would not vest in present possession within a term of ten years or within the life of the income beneficiary. *Id.* § 673(a).

38. I.R.C. § 2037.

39. *Id.* § 674(a).

40. *Id.*

41. *Id.* § 674(b)-(d).

42. *Id.* § 675(1).

43. *Id.*

44. *Id.* §§ 675(1), 2038(a).

45. *Id.* § 675(2).

46. *Id.*

675(3).⁴⁷ This does not apply if the loan is made for adequate interest and security and the loan is made by an independent trustee.⁴⁸ An independent trustee is defined as a trustee who is not a related or subordinate party, as defined in Section 672(c), as to the grantor, the grantor's spouse, or any of the grantor's issue.⁴⁹

Finally, Section 675(4) provides a list of general powers of administration that will cause a trust to be treated as a grantor trust.⁵⁰ Under Section 675(4)(A) through (C), if the grantor or a non-adverse party has the power to vote stock, control investments, or substitute property without the consent of a trustee, the trust is a grantor trust.⁵¹

The power to reacquire the trust corpus by substituting other property of an equivalent fair market value (FMV) is, in our experience, by far the most popular trigger contained in trust agreements to intentionally cause an irrevocable trust to be taxed as a grantor trust, and is commonly referred to as a "swap power."⁵² This trigger has been favorably cited in Revenue Ruling 2008-22, where the IRS stated that the 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 Sections 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.⁵³

Under Section 676, if a grantor or non-adverse party, or both, has the power to revest title to property held in trust in the grantor, the trust will be taxed as a grantor trust.⁵⁴ This trigger may also cause inclusion of the trust's assets in the grantor's estate under Section 2038 as a revocable transfer.⁵⁵

Section 677 provides that if the trust agreement contains the power to use income for the benefit of the grantor or grantor's spouse and such power is exercisable by the grantor, a non-adverse party, or both, without the

47. *Id.* § 675(3).

48. *Id.* §§ 672(c), 675(3).

49. I.R.C. § 672(c).

50. *Id.* § 675(4).

51. *Id.* § 675(4)(A)–(C).

52. Treas. Reg. §§ 20.2031-1(b), 25.2512-1; I.R.C. § 675(4); Rev. Rul. 2008-22, 2008-1 C.B. 796. "Fair market value" for transfer tax purposes is defined as "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts." *Frequently Asked Questions on Gift Taxes*, IRS, <https://www.irs.gov/businesses/small-businesses-self-employed/frequently-asked-questions-on-gift-taxes> (last visited Oct. 13, 2022) [perma.cc/5AGX-CD93].

53. Rev. Rul. 2008-22, 2008-1 C.B. 796.

54. I.R.C. § 676.

55. *Id.* §§ 676, 2038.

consent or approval of any adverse party, then the trust will be taxed as a grantor trust.⁵⁶ This applies whether the income may be used, is actually used, or used directly or indirectly for the benefit of the spouse.⁵⁷ Additionally, if income, without the consent of an adverse party or at the discretion of the grantor and non-adverse party, can be used to pay premiums on life insurance policies on the life of the grantor or the grantor's spouse, the trust will be treated as a grantor trust.⁵⁸

A trust may, under Section 678, be deemed to be a grantor trust as to an individual or individuals other than the grantor.⁵⁹ Additionally, there are rules that provide that a trust may be a partial grantor trust depending on the triggers used to create the trust and very specific facts.⁶⁰ Finally under Section 679, a U.S. person who transfers property to a foreign trust with U.S. beneficiaries will be treated as the owner of the trust for income tax purposes.⁶¹

It should go without saying that, when creating an "intentionally defective grantor trust" (as the term goes) practitioners must always be cognizant of the powers or triggers that they include in trusts to ensure that those trusts are taxed as intended by the client.⁶² The most common powers included in a trust agreement to deliberately trigger grantor trust tax treatment are the powers to: (1) substitute assets (Section 675(4)); (2) use trust income to pay premiums for insurance policies on the life of the grantor or the grantor's spouse (Section 677(a)(3)); (3) make loans to the grantor without adequate security (Section 675(2)); and (4) add charitable beneficiaries (Section 674).⁶³

Though any one of these four would be sufficient for an irrevocable trust to be treated as a grantor trust, some practitioners include more than one, any or all of which can be surrendered by the grantor at any time.⁶⁴

C. Why Grantor Trusts Are the "Most Valuable Player" of the Internal Revenue Code

The ability to shift the income tax burden from the effective owner(s) of trust assets (the trustee or beneficiaries) to a deemed owner with no economic

56. *Id.* § 677(a).

57. *Id.*

58. *Id.* § 677(a)(3).

59. *Id.* § 678(a).

60. Treas. Reg. § 1.671-3.

61. I.R.C. § 679.

62. *See id.* §§ 674, 675, 677(a)(3).

63. *See id.* §§ 674, 675, 677(a)(3); Dyer, *supra* note 18.

64. *See* I.R.C. §§ 674, 675(2), 675(4), 677(a)(3).

interest in the trust (the grantor) is what creates such valuable planning options.⁶⁵

Grantor trusts have several important features.⁶⁶ First, the grantor's payment of any tax attributable to trust income is not considered a gift for gift tax purposes.⁶⁷ This treatment of those payments allows the grantor to pay the trust's income tax burden, which is effectively a transfer tax-free gift to the trust.⁶⁸ For practical purposes, this benefits not only the trust beneficiaries (who in most cases are less wealthy than the grantor) but also the grantor (because paying the tax reduces their gross estate for estate tax purposes with no transfer tax consequence).⁶⁹

Second, the assets of an irrevocable grantor trust—both the amount gifted and the future appreciation—should not be included in the grantor's estate for U.S. estate tax purposes. Meanwhile, the trust grows free of income and transfer taxes. Assets gifted to such a trust would, to the extent the gift constitutes a taxable gift, reduce the grantor's available future gift and estate tax exclusion.⁷⁰ The grantor's retention of many of the powers enumerated in Section II.B above alone would not cause the trust assets to be included in the grantor's estate under Sections 2036, 2037, or 2038.⁷¹

Third, because the grantor and the trust are the same taxpayer for income tax purposes, when the grantor sells appreciated assets to a grantor trust for FMV, the sale would not trigger capital gains tax.⁷² This feature is the basis behind "installment sale" planning, whereby a grantor sells assets to a grantor trust in exchange for a term promissory note usually based on the Applicable Federal Rate (AFR).⁷³ This exchange does not result in any capital gains realization to the grantor at the time of the sale, and as long as the assets sold appreciate at a rate greater than the interest due on the note, the technique

65. See Jonathan G. Blattmachr et. al., *A Beneficiary as Trust Owner: Decoding Section 678*, 35 ACTEC J. 106, 106 (2009).

66. *Id.*

67. Rev. Rul. 2004-64, 2004-2 C.B. 7 (IRS ruled that the grantor's payment of the income taxes attributable to the inclusion of the trust income in their taxable income is not a gift to the trust beneficiaries because the grantor, not the trust, is liable for the tax).

68. See *id.*

69. See Blattmachr et. al., *supra* note 65.

70. See *Saving the Basis Step-Up When Planning to Reduce Estate Taxes*, BARCLAY DAMON LLP (Apr. 12, 2022), <https://www.barclaydamon.com/blog-post/saving-the-basis-step-up-when-planning-to-reduce-estate-taxes> [<https://perma.cc/E3G5-P8KR>].

71. I.R.C. §§ 2036–2038; see discussion *supra* Section II.B.

72. Treas. Reg. § 1.1001-2(c); Rev. Rul. 85-13, 1985-1 C.B. 184. In 2022, the capital gains tax rate is 20% and taxpayers may also be subject to an additional 3.8% net investment income tax under I.R.C. Section 1411. I.R.C. § 1411.

73. I.R.C. § 7872. The AFR is the minimum interest rate required for intra family loans under I.R.C. Section 7872, though the grantor and trustee of the grantor trust may use a higher interest rate if bargained for at arm's length. *Id.* AFR, published monthly by the IRS, are based on the average yield to maturity on U.S. Treasury obligations of comparable maturity during a thirty-day period prior to the determination. See e.g. Rev. Rul. 2022-18. Taxpayers who make loans at a rate below the AFR for the term of the loan are deemed to have made a taxable gift of an amount equal to the spread between the interest rate charged and the AFR. I.R.C. § 7872(b).

will result in the effective transfer of that excess appreciation free of gift tax for the benefit of the trust's beneficiaries (almost always members of future generations).⁷⁴

Finally, one of the most common grantor trust powers allows a grantor to "swap" or "substitute" assets of the trust without triggering a realization event in exchange for her own assets so long as such assets are of equivalent FMV.⁷⁵ The grantor of a trust may choose to exercise this power for a variety of reasons, including: (1) shifting higher basis assets into the trust in exchange for lower basis assets that would presumably qualify for a step-up in income tax basis at death under Section 1014 of the Code, (2) getting access to cash or marketable securities held in the trust, (3) putting a highly illiquid asset in the trust to discourage frivolous spending by beneficiaries, and (4) diversifying the assets held in the trust.⁷⁶

At the grantor's death, the power(s) that caused the trust to be taxed as a grantor trust as to that grantor no longer exist, so the trust ceases to be a grantor trust as to the deceased grantor.⁷⁷ Therefore, the benefits attached to grantor status also end at that time.⁷⁸ Additionally, in most cases, the grantor's death should not result in an income tax recognition event.⁷⁹

The following case study, presented in Exhibit A, illustrates the power that an irrevocable grantor trust has over an irrevocable non-grantor trust.⁸⁰ This scenario envisions that a parent, James, creates a trust for his child, Mary.⁸¹ This scenario assumes that James uses \$5 million of his U.S. gift tax exclusion and his U.S. GST tax exemption amounts to create a dynasty trust that will last as long as Texas law allows.⁸² Texas does not have a state

74. See David T. Lewis & Maureen C. Lanning, *Sale to Intentionally Defective Grantor Trust for Promissory Note*, VA. STATE BAR TR. & EST. SECTION, <https://www.vsb.org/site/sections/trustsandestates/sale-to-intentionally-defective-grantor-trust-for-promissory-note> (last visited Nov. 13, 2022) [<https://perma.cc/H5FD-BBWR>].

75. I.R.C. § 675(4)(C).

76. See *id.* § 1014.

77. See Christopher D. Wright, *Tax Implications of Terminating Grantor Trust Status*, MARKS PANETH ACCT. & ADVISORS (June 28, 2021), <https://www.markspaneth.com/insights/category/articles/tax-implications-of-terminating-grantor-trust-status#:~:text=Grantor%20trust%20status%20automatically%20terminates,of%20the%20date%20of%20death> [<https://perma.cc/ZC68-4853>].

78. See *id.*

79. See *id.*; but see *Madorin v. Comm'r*, 84 T.C. 667, 667 (1985); Treas. Reg. § 1.1001-2(c); Rev. Rul. 77-402, 1977-2 C.B. 222 (showing that when grantor trust status terminates during the grantor's lifetime the grantor is deemed to have transferred to the trust all of the assets in the trust and all of the liabilities of the trust); Treas. Reg. § 1.1001-2(a)(1) (illustrating that if liabilities deemed transferred to the trust exceed the basis of the assets deemed transferred to the trust, the grantor will recognize gain on the difference).

80. Author's original case study; see *infra* Exhibit A.

81. Author's original case study; see *infra* Exhibit A.

82. TEX. PROP. CODE ANN. § 112.036 (Texas's perpetuities period, as it applies to non-charitable trusts, now has a fixed 300-year time limit for trusts that became irrevocable on or after September 1, 2021, and a special carve-out of a 100-year fixed term limit for real property assets held in trust).

income tax.⁸³ By using a grantor trust, James is able to transfer 18.3% more to Mary than if he had taken no action, and approximately 13% more to his descendants than if he created a non-grantor trust that paid its own tax liability or passed on tax burden to the descendants through distributions reported on a Schedule K-1 issued by the trust.⁸⁴

As one can see, grantor trusts can provide seemingly endless opportunities for shifting wealth tax efficiently.⁸⁵ A dynastic intentionally defective grantor trust (IDGT), similar to the trust that James created in the case study, allows the grantor to continue to pay the income tax liability, thus allowing the trust to grow and compound tax-free.⁸⁶

The phrase “intentionally defective” refers to any trust that intentionally includes a trigger under Subpart E that causes the trust to be taxed to the grantor or grantors.⁸⁷ Though these trusts may come under many names and acronyms, these vehicles are all intentionally defective grantor trusts that are tailored to suit the grantor’s specific wealth transfer needs.⁸⁸ In many cases, an IDGT may refer to a dynastic trust created by the grantor for the benefit of the grantor’s descendants.⁸⁹

Such IDGTs may employ a variety of grantor trust triggers, but many practitioners choose to use the trigger under Section 675(4)(C) (the “power of substitution”), which provides for a power of administration in a nonfiduciary capacity by any person without the approval or consent of any person in a fiduciary capacity to reacquire the trust corpus by substituting other property of an equivalent value.⁹⁰ As discussed later, this provision is relatively easy to draft and identify.⁹¹ A practitioner may include other additional triggers depending on the needs of the grantor.⁹²

There are a few additional intentionally defective trusts that are often used to achieve a grantor’s specific objectives.⁹³ Irrevocable life insurance trusts (ILITs) allow a grantor trust to own life insurance on the life of the insured (e.g., the grantor, the grantor’s spouse), and the trust makes the

83. Nikki Laing, *An Income Tax by Any Other Name Is Still an Income Tax: The Constitutionality of the Texas “Margin” Tax As Applied to Partnerships and Other Unincorporated Associations*, 62 BAYLOR L. REV. 573, 582 (2010).

84. Author’s original case study; *see infra* Exhibit A.

85. Author’s original case study; *see infra* Exhibit A.

86. *Grantor Trusts*, KLENK L., <https://www.klenklaw.com/practices/irrevocable-trusts/grantor-trusts/> (last visited Nov. 13, 2022) (a detailed discussion of the various “types” of grantor trusts available is beyond the scope of this Article, but this paragraph provides a brief mention of the grantor trusts that are most commonly used) [<https://perma.cc/Y3BW-79SR>].

87. Julia Kagan, *Intentionally Defective Grantor Trust*, INVESTOPEDIA (Nov. 18, 2020), <https://www.investopedia.com/terms/i/igdt.asp> [<https://perma.cc/4A6C-TSCK>].

88. *See id.*

89. *See id.*

90. I.R.C. § 675(4)(C).

91. *See id.*

92. *See id.*

93. *See infra* text accompanying notes 94–139.

premium payments directly.⁹⁴ Under Section 677(a)(3), the trustee is authorized to use trust income to pay the insurance policy premiums.⁹⁵ The trust is entitled to the death benefit and has access to the policy's cash surrender value, if any.⁹⁶ When the insured dies, the death benefits are paid to the trust and the assets should not be subject to estate tax as they would have been had the grantor died owning the insurance policy outright.⁹⁷ Spousal lifetime access trusts (SLATs) allow a grantor-spouse to create a completed-gift dynastic IDGT where the other spouse can be a permissible beneficiary and the assets will not be included in either spouse's estate for U.S. estate tax purposes.⁹⁸ A SLAT relies on Section 677(a) of the Code, which provides that the grantor is treated as the owner of any portion of the trust whose income without the approval or consent of any adverse party (in the discretion of the grantor or a non-adverse party, or both) *may be* distributed to the grantor or grantor's spouse, or held or accumulated for future distribution to the grantor or the grantor's spouse.⁹⁹

Well-drafted grantor retained annuity trusts (GRATs) allow the grantor to transfer assets to a GRAT at today's FMV while the grantor retains the right to an annuity stream over the initial term of the GRAT with no gift tax consequence.¹⁰⁰ Any assets left at the end of the GRAT term are distributed to the trust's remainder beneficiaries free of gift tax.¹⁰¹ There are also qualified personal residence trusts (QPRTs), which are grantor trusts by nature (because of the grantor's retained right to live in the residence—an income interest—rent-free) and allow a grantor to remove a personal residence from his or her estate while reducing the amount of gift tax that would otherwise be assessed on such a transfer.¹⁰² Beneficiary defective inheritor's trusts (BDITs) and beneficiary defective owner's trusts (BDOTs), which rely on Section 678 of the Code, are grantor trusts to a beneficiary, but not the grantor of the trust.¹⁰³ Section 678 provides that a person other than the grantor is treated as the owner of any portion of a trust where such person has the power exercisable solely by herself to vest the corpus or the income in herself or if they have previously partially released or modified the power,

94. See I.R.C. § 677(a)(3) (explaining how ILITs intentionally trigger grantor trust status, which allows the trustee to use trust income to pay policy premiums).

95. *Id.*

96. *Id.*; Carole Jacobs, *What Is an Irrevocable Life Insurance Trust (ILIT)?*, NORTHWESTERN MUTUAL (June 27, 2022), <https://www.northwesternmutual.com/life-and-money/what-is-an-irrevocable-life-insurance-trust/> [<https://perma.cc/AJ2C-SWB8>].

97. *Id.*

98. *Id.* § 677.

99. *Id.* § 677(a).

100. *Id.* § 2702.

101. See *id.*

102. James P. King, *The ABCs of QPRTs*, J. ACCT. (Oct. 1, 2006), <https://www.journalofaccountancy.com/issues/2006/oct/theabcsofqprts.html> [<https://perma.cc/F4Z9-NKN3>].

103. I.R.C. § 678.

and after this release or modification retains control within Section 671 to 677.¹⁰⁴

We occasionally see spousal lifetime access trusts that, as the name suggests, name a spouse as a beneficiary and usually makes a trust a grantor trust, but if drafted to include adverse parties as trustees, render them non-grantor trusts.¹⁰⁵ That decision is sometimes made to allow taxpayers to multiply the capital gains tax exclusions available to separate taxpayers owning qualified small business stock, as defined in Section 1202 of the Code.¹⁰⁶

As discussed, one of the most effective wealth transfer techniques is an installment sale of appreciated assets to an IDGT for FMV, which relies on the disregarded nature of transactions between a grantor and a grantor trust.¹⁰⁷ Simply stated, a grantor makes an arm's-length sale of assets to a properly funded and credit-worthy grantor trust in exchange for a term promissory note bearing interest at the AFR, usually with a balloon payment when the note matures.¹⁰⁸ The trust retains the purchased asset and any appreciation on the asset, less the interest and principal payments on the corresponding note.¹⁰⁹ The value ascribed to transfers into the trust may also be eligible for valuation discounts as reflected in a qualified appraisal.¹¹⁰

Discounting, one of the most powerful tools in the estate planner's toolbox, generally refers to the theory that the value of closely held interests is usually lower than the value of publicly traded interests.¹¹¹ This is because closely held interests are typically difficult to liquidate freely without incurring high costs (lack of marketability), and the inability to control the management or direction of the entity (lack of control).¹¹² Values of interests in closely held businesses can likewise be discounted for lack of marketability when they are subject to restrictions.¹¹³

104. I.R.C. § 678(a)(1), (a)(2).

105. Arielle M. Prangner, *Implications of Termination of Grantor Trust Status*, 13 EST. PLAN. & CMTY. PROP. L. J. 443, 457 (2021).

106. See I.R.C. § 1202.

107. See Dyer, *supra* note 18.

108. *Id.*

109. *Id.*

110. See Justin P. Randome & Vinu Satchit, *Valuation Discounts for Estate and Gift Taxes*, J. ACCT. (July 1, 2009), <https://www.journalofaccountancy.com/issues/2009/jul/20091463.html> [<https://perma.cc/TM8P-2M6A>].

111. *Id.*

112. *Id.*

113. Est. of Jones v. Comm'r, 118 T.C.M. (CCH) 143, *29 (2019); see also Kelly M. Perez, *Keeping up with the Joneses: A Fresh Perspective on Tax-Affecting*, 13 EST. PLAN. & CMTY. PROP. L. J. 417, 428 (2021) (explaining that discounts for a lack of marketability are usually based on comparisons of the restricted stock of public companies or with share price differences pre and post-IPO, while discounts for a lack of control in a privately-owned entity are generally based on comparisons of share prices to net asset value per share of publicly traded closed-end investment funds, or, for real estate assets, real estate limited partnerships or investment trusts).

That reduction in the value of the exchange would reduce the face value of the promissory note a grantor receives from the trust.¹¹⁴ The trust would make annual interest payments based on a lower value making the interest payments lower.¹¹⁵ This reduces the value of the obligation the trust has to the grantor, meaning the trust is not as depleted.¹¹⁶ The beneficiaries will have access to relatively more wealth because the trust has been allowed to grow and compound at a faster rate.¹¹⁷ Similar to a GRAT, assets remaining in the trust after the note is fully satisfied are held in a trust for the benefit of the beneficiaries, gift-, and in many cases GST-, tax free.¹¹⁸

The following example, presented in Exhibit B, illustrates the power of a successful installment sale to a grantor trust.¹¹⁹ In this scenario, the grantor funds a GST-exempt IDGT in cash with her entire gift tax and GST exclusion amounts of \$12.06 million in 2022.¹²⁰ She later sells a limited partner interest in her family limited partnership (FLP) to the IDGT initially worth \$108.54 million to the trust.¹²¹ Such interest qualifies for certain valuation discounts of 30% (according to a qualified appraisal prepared by a qualified appraiser), so that the FMV on the date of transfer and as reported for gift tax purposes is \$75.978 million.¹²² In return, the grantor receives a nine-year interest only promissory note.¹²³ Assume the FLP appreciates at an annual rate of 6.12%, and the cash gift appreciates at a rate of 2.15%.¹²⁴ The grantor receives interest payments annually, in this case based on the mid-term AFR for November 2022 of 3.97%, and a balloon payment of the face amount of the note at the end of the note term.¹²⁵ The original gift and all appreciation remain in the trust, so that the estimated value of the trust after the note is fully paid is \$43,195,343.¹²⁶ In other words, after nine years the grantor was able to transfer \$43 million of value to her loved ones, while only using \$12.06 million of gift and GST exclusion making no gift tax payment and

114. David T. Lewis & Maureen C. Lanning, *Sale to Intentionally Defective Grantor Trust for Promissory Note*, V.A. STATE BAR, <https://www.vsb.org/site/sections/trustsandestates/sale-to-intentionally-defective-grantor-trust-for-promissory-note> (last visited Sept. 10, 2022) [<https://perma.cc/H3WS-HF6F>].

115. *See id.*

116. *See id.*

117. *See id.*

118. *Id.*

119. Author's original example; *see infra* Exhibit B.

120. Author's original example; *see infra* Exhibit B; Sara Wells, *IRS Announces Increased Gift and Estate Tax Exemption Amounts*, MORGAN LEWIS (Nov. 16, 2021), <https://www.morganlewis.com/pubs/2021/11/irs-announces-increased-gift-and-estate-tax-exemption-amounts> [<https://perma.cc/WU9J-S68S>].

121. Author's original example; *see infra* Exhibit B.

122. Author's original example; *see infra* Exhibit B.

123. Author's original example; *see infra* Exhibit B.

124. Author's original example; *see infra* Exhibit B. In this case, the cash gift is invested in a conservative portfolio of 100% fixed income without alternative investments (yield of 1.20%, expected appreciation of -0.05%, volatility of 3.25%, geometric appreciation of -0.10% and a 30% annual turnover rate).

125. Author's original example; *see infra* Exhibit B.

126. Author's original example; *see infra* Exhibit B.

removing the asset and appreciation from her estate for estate tax purposes at death.¹²⁷ Additionally, when assets are sold to a GST exempt trust, the trust remains wholly GST exempt with an inclusion ratio of zero.¹²⁸ Finally, the interest payments made from the trust to the grantor are not recognized by either party for income tax purposes.¹²⁹

Even when a taxpayer exhausts all of his or her lifetime gift tax exclusion amount, or chooses not to use it in its entirety, assets can still be transferred out of the estate by using an assortment of grantor trust techniques.¹³⁰ For the ultra-wealthy, a \$26 million combined gift and GST tax exemption amount is a mere drop in the bucket in the context of their fortunes, and if they wish to continue to transfer assets off of their taxable balance sheet, they often rely on grantor trust planning.¹³¹ Used in conjunction with appropriate valuation discounts to reduce the FMV of the asset upon transfer, it is a grand slam.¹³²

III. CURRENT STATE OF GRANTOR TRUSTS

The transfer tax system was created to stymie dynastic accumulation of inherited wealth and as a source of governmental funding, but creative estate and income tax planning practitioners have used tools contained in the Code to allow America's wealthiest families to transfer assets to the next generation while minimizing, if not wholly eliminating, the payment of any transfer tax.¹³³ Families such as the Waltons, the Kochs, and the Marses are well known for their highly effective use of grantor trust planning, which has become more popular over the last few decades.¹³⁴ Phil Knight, co-founder of Nike, was the focus of a highly publicized article in *Business Week* titled, "The Hidden Ways the Ultra Rich Pass Wealth to Their Heirs Tax Free," for

127. Author's original example; see *infra* Exhibit B.

128. An inclusion ratio is the fraction of a distribution from an individual or trust that is subject to GST tax. An inclusion ratio of zero (0) means the entire distribution is exempt from GST tax, while an inclusion ratio of one (1) means the entire distribution is subject to GST tax. I.R.C. § 2642; Treas. Reg. § 26.2642-1.

129. Author's original example; see *infra* Exhibit B.

130. See Wells, *supra* note 120.

131. See Ashlea Ebeling, *New Higher Estate And Gift Tax Limits For 2022: Couples Can Pass On \$720,000 More Tax Free*, FORBES (Nov. 11, 2021), <https://www.forbes.com/sites/ashleaebeling/2021/11/11/new-higher-estate-and-gift-tax-limits-for-2022-couples-can-pass-on-720000-more-tax-free/?sh=3471b822174f> [<https://perma.cc/BQ2N-X5R7>].

132. See Veronica Karas, *Valuation Discounts for Gift and Estate Tax Savings*, CAPTRUST (Aug. 11, 2021), <https://www.captrust.com/valuation-discounts-for-gift-and-estate-tax-savings/> [<https://perma.cc/4JHJ-FDJG>].

133. Darien B. Jacobson et al., *The Estate Tax: Ninety Years and Counting*, STAT. OF INCOME BULL. (2007), <https://www.irs.gov/pub/irs-soi/ninetyestate.pdf> [<https://perma.cc/LB74-L8RM>].

134. *Walton v. Comm'r*, 115 T.C. 589, 602–03 (2000) (allows the grantor to retain a qualified interest that is equal to the property transferred, resulting in a gift valuation of zero to the remainder beneficiaries); see generally *The Walton GRAT*, FORBES (May 14, 2001), <https://www.forbes.com/forbes/2001/0514/248s01.html?sh=7fc1780e2cc9> (mentioning that the Walton family has a grantor retained annuity trust named after them, "The Walton GRAT") [<https://perma.cc/VBH7-PF6B>].

his suspected transfer of an estimated \$9.3 billion in assets to (or in trust for) his descendants.¹³⁵ The article detailed that this was accomplished using grantor trust planning techniques such as GRATs and installment sale transactions with IDGTs.¹³⁶

According to the Pew Research Center, most Americans think there is too much economic inequality in the country, and nearly half say addressing inequality would require significant changes to the economic system.¹³⁷ Still, relative to other issues, reducing economic inequality does not rank high on the public's list of priorities for the U.S. government to address.¹³⁸ This so-called "wealth gap," along with recent media coverage of these wealth transfer techniques, may account for the increased focus by the current Administration and members of Congress on curbing the use of these perceived tax loopholes.¹³⁹

A. Obama Administration

1. Fiscal Year 2015 Green Book

In March 2014, the Obama Administration released its Fiscal Year (FY) 2015 Budget, and the Treasury Department released the General Explanations of the Administration's Fiscal Year 2015 Revenue Proposals (commonly referred to as the Treasury "Green Book").¹⁴⁰ The Green Book explains the revenue proposals in the President's annual budget and is often thought of as a wish list for the Administration's fiscal year.¹⁴¹ It contains proposals that are not yet a part of any bill.¹⁴² It serves as a guide to Congress and taxpayers by describing current law, proposing changes, explaining the

135. Ben Steverman et al., *The Hidden Ways the Ultrarich Pass Wealth to Their Heirs Tax-Free*, BUSINESSWEEK (Oct. 21, 2021), <https://www.bloomberg.com/features/how-billionaires-pass-wealth-to-heirs-tax-free-2021/> [https://perma.cc/CEE7-ZWLG].

136. *Id.*

137. Juliana Horowitz et al., *Most Americans Say There is Too Much Economic Inequality in the U.S., but Fewer Than Half Call It a Top Priority*, PEW RSCH. CTR. (Jan. 9, 2020), <https://www.pewresearch.org/social-trends/2020/01/09/most-americans-say-there-is-too-much-economic-inequality-in-the-u-s-but-fewer-than-half-call-it-a-top-priority/> [https://perma.cc/39BV-Q2VF].

138. *Id.*

139. See Seth Hanlon & Galen Hendricks, *Addressing Tax System Failings That Favor Billionaires and Corporations*, CTR. FOR AM. PROGRESS (Sept. 3, 2021), <https://www.americanprogress.org/article/addressing-tax-system-failings-favor-billionaires-corporations/> [https://perma.cc/CB65-SZQ8].

140. See generally *General Explanations of the Administration's Fiscal Year 2015 Revenue Proposals*, U.S. DEP'T OF THE TREAS. (Mar. 2014), <https://home.treasury.gov/system/files/131/General-Explanations-FY2015.pdf> (providing general explanations for the Administration's Fiscal Year 2015 Revenue Proposals) [https://perma.cc/L3SW-5EK6].

141. Richard Shapiro et al., *Treasury Releases Its 2023 Revenue Proposals*, EISNER AMPER (Apr. 5, 2022), <https://www.eisneramper.com/green-book-proposal-2023-0422/> [https://perma.cc/YLY7-4TME].

142. *Id.*

reasoning behind such changes, and includes the Treasury's revenue projections.¹⁴³

In the FY 2015 Green Book, the Obama Administration repeated a proposal first seen in its FY 2013 Green Book regarding grantor trusts.¹⁴⁴ The proposal would have effectively ended the use of grantor trusts by requiring the assets in any trust treated as a grantor trust to be *included* in the grantor's estate for U.S. estate tax purposes.¹⁴⁵ The 2015 Green Book provides, "[T]he lack of coordination between the income and transfer tax rules applicable to a grantor trust creates opportunities to structure transactions between the deemed owner and the trust that can result in the transfer of significant wealth by the deemed owner without transfer tax consequences."¹⁴⁶

The proposed change, as described in the 2015 Green Book, was:

If a person who is a deemed owner under the grantor trust rules of all or a portion of a trust engages in a transaction with that trust that constitutes a sale, exchange, or comparable transaction that is disregarded for income tax purposes by reason of the person's treatment as a deemed owner of the trust, then the portion of the trust attributable to the property received by the trust in that transaction (including all retained income therefrom, appreciation thereon, and reinvestments thereof, net of the amount of the consideration received by the person in that transaction) will be subject to estate tax as part of the gross estate of the deemed owner, will be subject to gift tax at any time during the deemed owner's life when his or her treatment as a deemed owner of the trust is terminated, and will be treated as a gift by the deemed owner to the extent any distribution is made to another person (except in discharge of the deemed owner's obligation to the distributee) during the life of the deemed owner. The proposal would reduce the amount subject to transfer tax by any portion of that amount that was treated as a prior taxable gift by the deemed owner. The transfer tax imposed by this proposal would be payable from the trust.

The proposal would not have changed the treatment of any trust that is already includable in the grantor's gross estate under existing provisions of the Internal Revenue Code, [including revocable trusts, grantor retained income trusts ("GRITs"), GRATs, personal residence trusts ("PRT"), and QPRTs]. Similarly, it would not apply to any trust having the exclusive purpose of paying deferred compensation under a nonqualified deferred

143. Treasury releases 'FY23 Green Book' describing President Biden's tax proposals for businesses, PWC (Apr. 4, 2022), <https://www.pwc.com/us/en/services/tax/library/treasury-releases-fy23-green-book.html> [https://perma.cc/GMW8-L7BP].

144. See Obama Administration Releases "Green Book" Budget Proposal For FY 2015, BROKERS' SERV. MKTG. GRP. (Apr. 22, 2014), <https://www.bsmg.net/2014/04/22/obama-administration-releases-green-book-budget-proposal-fy-2015-2/> [https://perma.cc/HVJ8-54EH]; U.S. DEP'T OF THE TREAS., *supra* note 140, at 166.

145. See U.S. DEP'T OF THE TREAS., *supra* note 140, at 140.

146. *Id.*

compensation plan if the assets of such trust are available to satisfy claims of general creditors of the grantor [*i.e.*, rabbi trusts].¹⁴⁷

A new law would not have applied to any irrevocable trust whose only assets typically consist of one or more life insurance policies on the life of the grantor or the grantor's spouse.¹⁴⁸ The exceptions to the proposal listed in the second paragraph were not contained in the initial proposal in the FY 2013 Green Book.¹⁴⁹ According to the 2015 Green Book, the effective date for any such changes would have been the date of enactment, and regulatory authority would be granted, including the ability to create exceptions to the provisions.¹⁵⁰

B. For the 99.5 Percent Act

On January 31, 2019, Senator Bernie Sanders (I-Vermont) and Senator Sheldon Whitehouse (D-Rhode Island) introduced a bill titled "For the 99.5 Percent Act," which was a collection of legislative proposals they and other Democrats recommended concerning U.S. transfer taxes and grantor trust income tax issues.¹⁵¹ As one of the most outspoken senators regarding the perceived increasing wealth gap in the U.S., Senator Sanders aimed to dramatically expand the reach of the estate tax and curb the use of certain wealth planning techniques, including grantor trusts.¹⁵²

Perhaps drawing on the Obama Administration for inspiration, Section 8 of the For the 99.5% Act repeated its Green Book proposals regarding grantor trusts and provided statutory language for those proposals.¹⁵³ The bill would have added a new Chapter 16 and a single Section 2901 to the Code.¹⁵⁴ Section 2901 would apply to any portion of a trust if the grantor is the deemed owner of that portion, or a person other than the grantor who is the deemed owner of that portion, if that person "engages in a sale, exchange, or comparable transaction with the trust that is disregarded for purposes of Subtitle A [the income tax subtitle]," to the extent of "the portion of the trust

147. *Id.*

148. *See id.*

149. *See id.*; *see generally* *General Explanations of the Administration's Fiscal Year 2013 Revenue Proposals*, U.S. DEP'T OF THE TREAS. (Feb. 2012), <https://home.treasury.gov/system/files/131/General-Explanations-FY2013.pdf> (providing general explanations for the Administration's Fiscal Year 2013 Revenue Proposals) [<https://perma.cc/PD7C-3X5S>].

150. *See* U.S. DEP'T OF THE TREAS., *supra* note 140, at 167.

151. For the 99.8 Percent Act, S. 309, 116th Cong. (2019) (the bill was read twice and referred to the U.S. Senate Committee on Finance); For the 99.5 Percent Act, S. 994, 117th Cong. (2021).

152. *See Sanders Introduces Estate Tax Reform to Combat Inequality*, BERNIE SANDERS U.S. SENATOR FOR VT. (Jan. 31, 2019), <https://www.sanders.senate.gov/press-releases/sanders-introduces-estate-tax-reform-to-combat-inequality-2/> [<https://perma.cc/RB7M-869E>].

153. *See* For the 99.8 Percent Act, S. 309 § 8, 116th Cong. (2019); For the 99.5 Percent Act, S. 994, 117th Cong. (2021).

154. *See* For the 99.8 Percent Act, S. 309 § 8, 116th Cong. (2019); For the 99.5 Percent Act, S. 994, 117th Cong. (2021).

attributable to the property received by the trust in such transaction, including all retained income therefrom, appreciation thereon, and reinvestments thereof, net of the amount of the consideration received by the person in that transaction.”¹⁵⁵

Importantly, this new Section 2901 would have included the assets of such portion in the gross estate of the deemed owner for U.S. estate tax purposes, subject to gift tax, any distribution from such portion to one or more beneficiaries during the deemed owner’s life, and treated as a gift subject to gift tax the assets of such portion at any time during the deemed owner’s life that the deemed owner ceases to be treated as an owner of such portion for income tax purposes.¹⁵⁶ Section 2901 would have reduced the amount thereby subject to estate or gift tax by “the value of any transfer by gift by the deemed owner to the trust previously taken into account by the deemed owner under [C]hapter 12.”¹⁵⁷ This would have effectively constituted a reduction by the amount reported as a gift.¹⁵⁸ In other words, Section 2901 “freezes” the amount excluded from its reach at its initial gift tax value (thus targeting “leveraged” transfers).¹⁵⁹

Proposed Section 2901 provided that it:

[S]hall not apply to— (1) any trust that is includible in the gross estate of the deemed owner (without regard to [Section 2901]), and (2) any other type of trust that the Secretary determines by regulations or other guidance does not have as a significant purpose the avoidance of transfer taxes.¹⁶⁰

It would have also provided that “[a]ny tax imposed pursuant to [S]ubsection (a) shall be a liability of the trust.”¹⁶¹ It does not specify whether any such tax would be calculated at the average or marginal tax rate.¹⁶² Section 2901 would have applied to trusts created on or after the date of the bill’s enactment, any portion of a trust attributable to a contribution on or after the date of enactment to a trust created before the date of enactment, and any portion of a trust created before the date of enactment if a transaction described under the new section occurred on or after the date of enactment.¹⁶³

155. For the 99.8 Percent Act, S. 309 § 8, 116th Cong. (2019).

156. See For the 99.8 Percent Act, S. 309 § 8, 116th Cong. (2019); For the 99.5 Percent Act, S. 994, 117th Cong. (2021).

157. For the 99.8 Percent Act, S. 309 § 8, 116th Cong. (2019).

158. *Id.*

159. See *id.*

160. *Id.* § 8(a) (suggesting amendment to I.R.C. § 2901(c)).

161. For the 99.5 Percent Act, S. 994, 117th Cong. § 8(a) (suggesting an amendment to I.R.C. § 2901(f)) (as introduced in Senate March 25, 2021).

162. *Id.*

163. *Id.* § 8(c).

The For the 99.5% Act would have also clarified that assets held in a grantor trust will not receive a step-up in income tax basis upon death unless the property is includible in the gross estate of the transferor.¹⁶⁴

With respect to GRATs, the For the 99.5% Act would have required that a GRAT have a minimum initial term of ten years and a maximum term of the life expectancy of the annuitant plus ten years.¹⁶⁵ The initial term is the annuity phase during which annuity payments are made to the grantor.¹⁶⁶ The remainder interest could not have been less than an amount equal to the greater of 25% of the FMV of the trust assets or \$500,000.¹⁶⁷ The vast majority of GRATs are designed to “zero out” the remainder interest (taxable gift) and involve short initial GRAT terms.¹⁶⁸ “Rolling GRAT” strategies are often used when a taxpayer creates GRATs with short (e.g., two-year) terms.¹⁶⁹ These two techniques would have been eliminated as viable alternatives.¹⁷⁰ The GRAT transfer rules would have been effective for transfers made after the date of enactment.¹⁷¹

C. Biden Administration

1. Fiscal Year 2022 Green Book

Similar to the Obama Administration’s revenue proposals, the Biden Administration’s FY 2022 Green Book, published in the spring of 2021 sought to make significant changes to the transfer tax system, though it did not directly target grantor trusts the way the BBBA would, as introduced in the late summer.¹⁷²

One notable provision of the FY 2022 Green Book targeted transfers to trusts, including grantor trusts.¹⁷³ Under current law, Section 1015 of the Code provides that lifetime gifts and transfers of assets at death do not trigger gain, and that “the basis shall be the same as it would be in the hands of the donor or the last preceding owner by whom it was not acquired by gift.”¹⁷⁴ Gift recipients receive this “carryover” income tax basis in the asset, which

164. *Id.* § 8(a) (suggesting amendment to I.R.C. § 2901(f)(2)).

165. *Id.* § 7(a)(4) (suggesting amendment to I.R.C. § 2702(b)(2)(A)).

166. *See id.*

167. *Id.*

168. *See* David K. Johns & Julia Griffith McVey, *Short-Term GRATs*, 2 CONTINUING L. EDUC. COLO., INC., § 33.2.3 (7th ed. 2022).

169. *See id.*

170. *See id.*

171. For the 99.5 Percent Act, S. 994, 117th Cong. § 7(d) (as introduced in Senate March 25, 2021).

172. *See generally* *General Explanations of the Administration’s Fiscal Year 2022 Revenue Proposals*, U.S. DEP’T TREAS. 62–63 (May 2021), <https://home.treasury.gov/system/files/131/General-Explanations-FY2022.pdf> (providing general explanations for the Administration’s Fiscal Year 2022 Revenue Proposals) [<https://perma.cc/HD8V-BEUV>].

173. *Id.*

174. I.R.C. § 1015(a).

allows them to defer gain recognition until a later taxable transfer, such as a sale or other type of exchange.¹⁷⁵ Section 1014 of the Code provides that appreciated inherited assets receive a stepped-up basis to FMV as of the decedent's death, which allows the beneficiaries to avoid capital gains tax on any appreciation.¹⁷⁶ The 2022 Green Book proposed to change these rules so that gifts and bequests of appreciated assets would trigger recognition of gain, which would be taxable to the transferor.¹⁷⁷ Beneficiaries would receive the assets with a stepped-up basis, but as a result of the payment of capital gains tax at the time of the gift or bequest.¹⁷⁸ The Green Book proposal did not specify whether transactions currently disregarded for income tax purposes, such as an installment sale between a grantor and an irrevocable grantor trust, would constitute "transfers."¹⁷⁹

Additionally, if the FY 2022 Green Book's proposals had been enacted, in-kind transfers of appreciated property to or from trusts would have triggered realization of gain.¹⁸⁰ The Green Book contained an exclusion for transfers to a revocable grantor trust, but that trust's transfer of an appreciated asset to any person other than the donor or the donor's U.S. spouse would have triggered a gain.¹⁸¹ Realization of gain on revocable trust assets also would have been triggered at the donor's death, or when the trust became irrevocable.¹⁸²

Though the Biden Administration's FY 2022 Green Book outlined and detailed the above suggested changes—which would apply to most transfers in trust, whether the recipient is a grantor or non-grantor trust—it did not include some of the more targeted strikes on grantor trusts as came to be seen in the BBBA introduced several months later.¹⁸³

2. Build Back Better Act Bill, September 13, 2021

The initial version of the BBBA bill, introduced by the House Ways and Means Committee, contained the most significant legislative attack on grantor trusts since Code Sections 671 through 679 were enacted.¹⁸⁴ The provisions of the bill aimed to not only curb the use of grantor trusts, but to

175. *Id.*

176. *Id.* § 1014(e).

177. *See* U.S. DEP'T OF THE TREAS., *supra* note 172 (tax would be deductible by a decedent's estate on an estate tax return, if any).

178. *See id.*

179. *See id.*

180. *See id.*

181. *See id.*

182. *Id.*

183. *See id.*; H.R. Rep. No. 117-130 (2021) (signed into law as Inflation Reduction Act of 2022, Pub. L. No. 117-169, 136 Stat. 1818).

184. *See id.*

end future transfer tax-efficient planning with virtually all irrevocable grantor trusts.¹⁸⁵

a. Income Tax Provisions

BBBA would have added a new Section 1062 to the Code, which would have required gain to be realized on any sales between a grantor and a grantor trust.¹⁸⁶ New Section 1062 also would have disallowed the realization of any loss on such sales.¹⁸⁷ It appeared that the receipt of interest on loans between a grantor and a grantor trust would have continued to be income tax free, but this was not entirely clear.¹⁸⁸ It was also unclear how a grantor's exercise of a power to substitute assets of an equivalent value under Section 675(4) would have been treated.¹⁸⁹ Under current law, these substitutions are not recognized for income tax purposes.¹⁹⁰ If these provisions had gone into effect, many grantors would have relinquished this power to avoid the potential tax consequences.¹⁹¹

The grantor trust provisions under the BBBA bill would have applied to grantor trusts created on or after the date the Act was enacted.¹⁹² Existing irrevocable trusts would have been "grandfathered," but if a contribution were later made to a grandfathered trust, that part of the trust would have been subject to the BBBA bill, which did not contain a definition of "contribution."¹⁹³

b. Gift and Estate Tax Provisions

The BBBA bill would have added new Section 2901 to the Code, which would have contained three provisions relating to gift and estate tax.¹⁹⁴ First, at death, if a decedent were a deemed owner of a grantor trust, the assets of such trust would have been part of his gross estate for estate tax purposes.¹⁹⁵ Second, distributions from an irrevocable grantor trust to anyone other than the grantor, the grantor's spouse, or to discharge a debt of the grantor, would have been deemed a taxable gift from the grantor to the receiving party.¹⁹⁶

185. *Id.*

186. *Tax News Update*, ERNST & YOUNG LLP (Sept. 17, 2021), <https://taxnews.ey.com/news/2021-1696-build-back-better-tax-proposals-would-affect-higher-income-individuals-as-well-as-trusts-and-estates> [<https://perma.cc/YP6U-KKEQ>].

187. *Id.*

188. *Id.*

189. I.R.C. § 675(4).

190. *See id.*

191. *See id.*

192. *See* ERNST & YOUNG LLP, *supra* note 186 (this does not include revocable trusts).

193. *See id.*

194. *Id.*

195. *Id.*

196. *Id.*

Third, cessation of grantor trust status during a grantor's life would have been treated as a taxable gift by the grantor of all the trust assets.¹⁹⁷

Similar to the income tax provisions, these gift and estate provisions would have applied to trusts created on or after the date the BBBA bill was enacted—other than revocable trusts—or to that portion of a grandfathered trust attributable to contributions made after that date.¹⁹⁸

One can see how this bill would have eliminated future transfer tax-efficient planning with virtually all irrevocable grantor trusts, including IDGTs, SLATs, ILITs, GRATs, and BDITs/BDOTs, and made obsolete installment sale transactions between a grantor and grantor trusts, as well as exchanges of property for basis shifting.¹⁹⁹ These changes would have raised an estimated \$7.9 billion of revenue over a ten-year period, according to the score from the Congressional Budget Office.²⁰⁰

Arguably, this was the first time in recent history where such far-reaching changes to the grantor trust rules had made it into a bill with a meaningful likelihood of passage, given the Democrats' nominal control of both the House of Representatives and Senate.²⁰¹

It is no exaggeration to say that wealthy taxpayers and their advisors were in an anxiety-fueled frenzy over the potential changes to the grantor trust rules contained in the initial version of the BBBA bill, whose text left many unanswered questions, such as whether certain exceptions would be made for planning currently in existence and how the changes would affect “grandfathered” trusts.²⁰² For example, with an installment sale, would the trust have to pay the remaining principal balance and any accrued interest before the BBBA bill went into effect?²⁰³ Would it have made sense to turn off grantor trust status immediately (prior to any effective date)?²⁰⁴

Trade and industry groups quickly mobilized to request clarification and carveouts or exceptions.²⁰⁵ Take ILITs as an example.²⁰⁶ Generally speaking, a grantor creates an ILIT and makes annual gifts to the ILIT to enable the

197. *Id.*

198. *Id.*

199. See *The House Democrats' Tax Plan—The Time for Estate Planning is Now*, MORGAN LEWIS (Sept. 20, 2021), <https://www.morganlewis.com/pubs/2021/09/the-house-democrats-tax-plan-the-time-for-estate-planning-is-now> [<https://perma.cc/R8L6-2KYU>].

200. See ERNST & YOUNG LLP, *supra* note 186.

201. See MORGAN LEWIS, *supra* note 199.

202. Alan Glassman, *One More Scary Estate Tax Change and New Action Items for Many Affluent Taxpayers*, FORBES (Oct. 6, 2021), <https://www.forbes.com/sites/alongassman/2021/10/06/one-more-scary-estate-tax-change-and-new-action-items-for-many-affluent-taxpayers/?sh=48aa625d125f> [<https://perma.cc/KCQ4-WR3X>].

203. Author's original hypothetical.

204. Author's original hypothetical.

205. Jonathan Curry, *How Industry Pushback Sank the Grantor Trust Changes—For Now*, TAX NOTES (Jan. 27, 2022), <https://www.taxnotes.com/insurance-expert/legislation-and-lawmaking/how-industry-pushback-sank-grantor-trust-changes-now/2022/01/26/7d40j> [<https://perma.cc/NTZ9-3U9U>].

206. *Id.*

trustee to pay the policy premium.²⁰⁷ The annual gifts typically qualify for the annual exclusion from gift tax, and the trust is usually a grantor trust because the trust agreement permits the trustee to use the income of the trust to pay those premiums.²⁰⁸ Under the initial BBBA bill, additional contributions by the grantor to an ILIT to pay for subsequent annual policy premium payments may have caused a portion of the ILIT to be included in the grantor's estate.²⁰⁹ The BBBA bill did not contain any exceptions for ILITs that win existence at the time of the bill's introduction and being annually funded.²¹⁰

For forty-five days—until the introduction of a revised BBBA bill on October 28, 2021—the estate planning world was turned upside down.²¹¹ Ultimately, the initial proposed changes did not survive.²¹² The revised bill, introduced in the House on October 28, 2021 and even as revised on November 3, 2021, removed these grantor trust provisions; this is perhaps because of industry pressure, the lack of time for the drafters to fully flesh out the myriad potential issues to address, or perhaps because of wavering support from certain members of Congress in both chambers.²¹³

3. Fiscal Year 2023 Green Book

The Biden Administration's 2023 Green Book (FY 2023), which was released in March 2022, essentially provides that the Administration's proposed revenue proposals use a baseline that incorporates all revenue provisions of Title XIII of H.R. 5376 (BBBA as passed by the House of Representatives on November 19, 2021), other than the state and local tax (SALT) proposal.²¹⁴ This budget package assumes the enactment, unchanged, of the revenue provisions in the November 19 version of the BBBA bill.²¹⁵ Many of these proposals were described in the FY 2022 Green

207. *See id.*

208. Adam Abrahams, *Irrevocable Life Insurance Trusts: An Effective Estate Tax Reduction Technique (Part 2)*, ABA TAX TIMES 1, 10 (2014), https://www.americanbar.org/content/dam/aba/publishing/aba_tax_times/14win/0-vol33no2-completeissue.pdf [<https://perma.cc/433N-H46V>].

209. *See* Curry, *supra* note 205.

210. *See id.*

211. *See id.*

212. *See id.*

213. James Dougherty & Marissa Dungey, *Latest Update on the Build Back Better Act for Estate Planners*, WEALTHMANAGEMENT.COM (Nov. 10, 2021), <https://www.wealthmanagement.com/estate-planning/latest-update-build-back-better-act-estate-planners> (H.R. 5376 passed the House of Representatives on November 19, 2021 by a vote of 220 to 213 but has never gotten a Senate vote) [<https://perma.cc/9XAP-SRE9>].

214. *See generally* General Explanations of the Administration's Fiscal Year 2023 Revenue Proposals, U.S. DEP'T OF THE TREAS. 62–63 (Mar. 2022), <https://home.treasury.gov/system/files/131/General-Explanations-FY2023.pdf> (providing a general explanation of the Administration's Fiscal Year 2023 Revenue Proposals) [<https://perma.cc/8G2D-B3NX>].

215. *Id.*

Book and were considered but not included in the House-passed version of the BBBA bill.²¹⁶

4. Inflation Reduction Act

On August 12, 2022, the House passed the Inflation Reduction Act of 2022, which had passed the Senate five days earlier.²¹⁷ The bill was signed into law by President Biden on August 16, 2022.²¹⁸ The bill is projected to spend approximately \$437 billion on energy, climate, and health subsidies, while raising approximately \$740 billion in revenue over a ten-year period.²¹⁹ This bill imposes an alternative minimum tax of 15% of the average annual adjusted financial statement income of domestic corporations (excluding Subchapter S corporations, regulated investment companies, and real estate investment trusts) that exceed \$1 billion over a specified three-year period.²²⁰ This minimum tax is effective in taxable years beginning after December 31, 2022.²²¹ The bill also imposes a 1% excise tax on the FMV of stock repurchased by a domestic corporation after 2022, with certain exceptions.²²² Notably, the Inflation Reduction Act did not include provisions that would affect grantor trust planning or the current state of transfer tax planning more broadly.²²³

5. Future of Grantor Trusts

Though the Inflation Reduction Act did not include any direct modifications to grantor trust planning, the changes contained in the initial BBBA bill can be characterized as “too close for comfort.”²²⁴ The power of grantor trust planning has become more publicized over recent years, and it is highly possible that we will see other serious attempts to enact some of these changes.²²⁵ Those potential future iterations may address some of the unanswered questions that the original BBBA bill raised.²²⁶ That being said, at the moment, taxpayers who create and fund irrevocable grantor trusts remain able to transfer more wealth to their families than those who use

216. *See id.*

217. Inflation Reduction Act of 2022, H.R. 5376, 117th Cong. (2021).

218. *Id.*

219. *Id.*

220. *Id.* § 10101.

221. *Id.*

222. *Id.* § 4501.

223. *See id.*

224. *See id.*; I.R.C. §§ 441–483.

225. *See* Michael J. Skeary, *The Power of Trust Decanting: The Authority for the Power, Its Scope, and the Fiduciary Duty and Tax Implications of Its Use*, 32 PROB. & PROP. 22, 23–25 (2018).

226. *See* Inflation Reduction Act of 2022, H.R. 5376, 117th Cong. (2021).

irrevocable non-grantor trusts, so it still makes sense to consider the use of grantor trusts until such time as the law makes it unattractive to do so.²²⁷

IV. RELATED ISSUES

Grantor trusts are complicated, complex, and confusing.²²⁸ Yankees legend, the great Yogi Berra, is said to have once mused, “You’ve got to be very careful if you don’t know where you are going, because you might not get there.”²²⁹ This quote is appropriate for grantor trust planning.²³⁰ Notwithstanding the traps, pitfalls and other thorny issues when analyzing which grantor trust powers to include in a trust instrument, there are other more nuanced special considerations for grantor trust planning.²³¹ Many practitioners have written about these finer points, and what you will find is that in many cases there is not necessarily a bright line rule.²³²

A. Releasing and “Toggling” Grantor Trust Status

1. Releasing Grantor Trust Status During Lifetime

Two of the most common questions during a grantor’s life with respect to grantor trusts are: (1) “how does a grantor turn off grantor trust status” so that he or she is no longer responsible for the income tax liability for the trust and (2) “once turned off, can grantor trust status be turned back on?”²³³ The latter action is referred to as “toggling” grantor trust status, though this term could be construed to mean changing the trust’s status from grantor to non-grantor trust multiple times depending on the tax positions of the grantor and beneficiaries, and other factors.²³⁴ The initial version of the BBBA bill brought these key questions back into the spotlight.²³⁵

First, it is absolutely paramount that a drafting attorney fully appreciate Subpart E (Code Sections 671–679) in its entirety.²³⁶ As mentioned earlier, many attorneys tend to use the same grantor trust powers in all of their trust agreements where it makes sense, but sometimes there are other provisions

227. See Paul C. Lau et al., *Tackling Taxes: A Fresh Look at Net Investment Income Tax for Trusts*, 92 TAXES: THE TAX MAG. 13, 16–18 (2014).

228. Author’s original thought.

229. Nate Scott, *The 50 greatest Yogi Berra quotes*, USA TODAY: FOR THE WIN (Mar. 28, 2019), <https://ftw.usatoday.com/2019/03/the-50-greatest-yogi-berra-quotes> [<https://perma.cc/96HG-NYX3>].

230. See *id.*

231. See Paul C. Lau et al., *supra* note 227, at 17.

232. See *id.*

233. See Stan Miller & D. Scott Schrader, *Tax Burning: An Overlooked Technique for Reducing an Estate*, 7 J. PRAC. EST. PLAN. 15, 15–66 (2005).

234. See *id.*

235. H.R. Rep. No. 117-130 (2021) (signed into law as Inflation Reduction Act of 2022, Pub. L. No. 117-169, 136 Stat. 1818).

236. See I.R.C. §§ 671–679.

in the trust agreement that, unbeknownst to the attorney, will cause the trust to be considered a grantor trust.²³⁷ Additionally, turning off a grantor trust power can be done knowingly or unknowingly, and may have serious tax consequences, especially if there are certain outstanding transactions between the grantor and the grantor trust, such as remaining payments on an installment sale promissory note or leases with a QPRT.²³⁸

When a grantor trust power is intentionally included, the trust agreement should include very clear provisions that allow that power to be terminated.²³⁹ However, depending on the type of power included, many practitioners do not include specific provisions for turning off grantor trust status, an omission that can cause problems when, for whatever reason, the grantor decides that he or she no longer wants the trust to be considered a grantor trust.²⁴⁰ Some practitioners, on the other hand, opt to include a completely separate section of the trust agreement that affirmatively states: (1) that the trust is intended to be a grantor trust under a specific or multiple provisions of the Code and (2) how to terminate such grantor trust status during the grantor's lifetime.²⁴¹ Certain powers require that the grantor must be the one to relinquish a power, while others may require that a trustee or other powerholders act.²⁴² These subtle variations signal that a critical component of grantor trust planning is to fully understand the triggers, who has responsibility for them, and how they can be turned off.²⁴³

Take the example in *Millstein v. Millstein*.²⁴⁴ The taxpayer in this case, Norman Millstein, was the grantor of two IDGTs that he created for the benefit of his children in 1987 and 1989.²⁴⁵ One of the grantor's children, Kevan Millstein, was the trustee of both trusts.²⁴⁶ It appeared that the grantor had no mechanism available to him under the trust agreements that allowed him to terminate grantor status independently.²⁴⁷ In 2010, the grantor requested a reimbursement from the trustee for the taxes paid on the taxable income generated by the two trusts.²⁴⁸ There was a short-term agreement between the grantor and trustee for a few years that helped the grantor defray some of the expense, and in 2014 the trustee was able to end the grantor's tax liability as to one of the IDGTs, leaving the grantor burdened with the

237. See Edwin P. Morrow III et al., *The Art of Using Trusts to Avoid Utah Income Tax*, 31 UTAH BAR J. 22, 30 (2018).

238. See Prangner, *supra* note 105, at 457, 471–72, 479.

239. See Gregory V. Gadarian & Sarah H. Singer, *Grantor Trust Rules*, 24 ALI-CLE EST. PLAN. COURSE MATERIAL J. 25, 25–33 (2018).

240. See *id.*

241. See *id.*

242. See *id.*

243. See *id.*

244. See *Millstein v. Millstein*, 2018 WL3005347 *1, *1 (Ohio Ct. App. 2018).

245. *Id.*

246. *Id.*

247. *Id.* (noting that the grantor did not attach the trust agreements to the petition).

248. *Id.*

liability for the other IDGT.²⁴⁹ The grantor subsequently filed a petition in the Cuyahoga (Ohio) County Court of Common Pleas for equitable relief to have one IDGT reimburse him for over one million dollars and the other reimburse him for previous taxes paid over one million dollars, requesting the court enter an order for “equitable reimbursement of income taxes” from the two trusts.²⁵⁰

The trustee and beneficiaries argued that the grantor lacked standing as he was not a relevant party to the trust and that there was no recognizable claim under Ohio law.²⁵¹ Pursuant to the Ohio Trust Code, only a trustee or beneficiary may commence a proceeding to approve or disapprove a proposed modification.²⁵² The Ohio Trust Code specifically limits a grantor's ability to commence a proceeding to approve a proposed modification or termination of a trust to certain situations involving the consent of the trust's beneficiaries under the Ohio Trust Code.²⁵³ Though not raised in *Millstein*, a trustee should also consider that the payment of the income tax liability by the trust or the reimbursement of such payments to the grantor is most likely not in the best interest of the beneficiaries, to whom a trustee has a fiduciary duty.²⁵⁴ A trustee has no such duty to a grantor.²⁵⁵

The trial court dismissed the grantor's petition, and the appellate court upheld the trial court on the grounds of failure to state a claim upon which relief could be granted.²⁵⁶ The grantor could not seek to modify the trust to achieve his tax objectives because he was not a trustee nor a beneficiary.²⁵⁷ The court found that Norman admitted that he established the trusts in a manner that was intended to allow him to personally take advantage of tax deductions and credits derived from the trust investments and that he is responsible for taxable income.²⁵⁸ Norman had not alleged that Kevan or any of the other parties named in this suit have taken any action inconsistent with the terms of the trust that Norman created.²⁵⁹ The court specifically noted that, “[n]o court may employ equitable principles to circumvent valid legislative enactments,” and that the situation in which the grantor found himself was of his own making.²⁶⁰ *Millstein* makes it abundantly clear that there must always be an explicit mechanism for terminating grantor trust status.²⁶¹

249. *Id.*

250. *Id.*

251. *Id.*

252. *Id.*

253. *Id.*; Ohio Rev. Code §§ 5804.10; 5804.16; 5804.11.

254. Rev. Rul. 2004-64, 2004-2 C.B. 7.

255. *Id.*

256. See *Millstein*, 2018 WL3005347 at *2.

257. *Id.* at *3.

258. *Id.*

259. *Id.*

260. *Id.*

261. See *id.*

As mentioned earlier, many practitioners rely on the power to substitute assets of equivalent FMV under Section 675(4) to intentionally cause a trust to be taxed to the grantor.²⁶² Generally, you will see provisions in that Section that permit a grantor to “turn off” or relinquish the power.²⁶³

Power to Substitute Assets: Grantor shall have the power, at any time or from time to time, without the consent or approval of Trustee or any other person, to acquire or reacquire part or all of any asset owned by any trust created under this trust agreement by substituting another asset or other assets having an equivalent fair market value at the time of such substitution. Although this power is exercisable by Grantor in a non-fiduciary capacity without the consent of Trustee, Grantor shall have the power to substitute assets of a trust for other assets only to the extent that Trustee believes such other assets to be of equivalent fair market value at the time of such substitution. Trustee shall not be liable to any person by reason of Trustee’s good faith determination of the fair market value of the substituted assets.

Grantor may disclaim the power to acquire or reacquire assets of any trust created hereunder at any time by delivering a written notice of disclaimer of the power reserved to Grantor under this [S]ection of the Trust Agreement to the Trustee of such trust. Such disclaimer shall include the specific date that the disclaimer becomes effective and shall be signed by the Grantor. If the Grantor disclaims this power, Grantor will not thereafter possess any power to acquire or reacquire any of the assets of such trust. Trustee, however, shall always retain the right to sell any assets of any such trust to any person (including grantor) if the Trustee, in the exercise of the Trustee’s discretion, determines it is in the best interest of any trust to do so.²⁶⁴

A power to trigger grantor trust status under Section 675(4)—the power to substitute assets—is easily identified, and the ability for the grantor to give up the power is clearly delineated in the paragraphs above.²⁶⁵ A drafter can also include provisions that allow another individual to exercise or release this power for the grantor if the grantor is incapacitated.²⁶⁶ Additionally, a drafter can include an independent party, such as an independent trustee or special trustee, to certify the equivalent FMV of the trust assets in question being exchanged if the grantor is also serving as a trustee.²⁶⁷

262. See discussion *supra* Section IV.A.1 (noting that this power is generally selected because arguably it is one of the easier provisions to draft, to identify in a trust agreement, and to release; also, it has been cited favorably in Rev. Rul. 2008–22); see I.R.C. § 675(4).

263. See I.R.C. § 675.

264. Author’s example provision; *id.* § 675(4).

265. See *supra* Section IV.A.1; see I.R.C. § 675(4).

266. I.R.C. § 675(4).

267. See *id.* § 675.

Another common grantor trust power is the power exercisable by the grantor, or a non-adverse party, to add beneficiaries, such as charitable organizations, to the trust.²⁶⁸ From a practical standpoint, this can create issues for any trustee (corporate or individual) if the trust agreement and the grantor's intent are not clear.²⁶⁹ A trustee must fully understand his, her, or its fiduciary duties with respect to investing and distributions to two different classes of beneficiaries, making this approach to create a grantor trust not as straightforward as it may initially appear and potentially causing problems in the actual administration of the trust.²⁷⁰

Below is an example of a clause empowering a powerholder to add a charitable organization as a beneficiary under a trust.²⁷¹

Power to Add and Remove Beneficiaries: During grantor's lifetime (and except as provided otherwise), the Powerholder (as defined below), acting in her individual capacity and not in any fiduciary capacity, shall have the power to add or remove one or more charitable organizations described in Sections 170(c) and 2055(a) of the Code as beneficiaries of any one or more of the trusts created under this trust agreement.

Any person holding the power to add or remove beneficiaries pursuant to this article shall be referred to as the "Powerholder." [Person A] shall be the initial Powerholder. In the event [Person A] dies, becomes incapacitated or releases the power to add or remove beneficiaries, [Person B] shall serve as Powerholder. If [Person B] dies, becomes incapacitated or releases the power to add or remove beneficiaries, or if any successor Powerholder dies, becomes incapacitated or releases the power to add or remove beneficiaries, the Powerholder last serving may appoint a successor by a signed, acknowledged instrument delivered to the Trustee which may be executed before a vacancy occurs to be effective at such times as needed, provided that the Powerholder shall be a non-adverse party as that term is defined in Section 672(b) of the Code and provided further that grantor, grantor's spouse and grantor's descendants shall not serve as the Powerholder. If a successor Powerholder is not so appointed, or if all of the Powerholders release their right to appoint a successor Powerholder, no successor Powerholder shall serve hereunder. A Powerholder shall accept their office by signed, acknowledged instrument delivered to the Trustee.

Exercise or Release of Power: The Powerholder may exercise or release the powers granted under this article by written instrument that identifies the trust created hereunder to which the exercise or release of the

268. *Id.* § 674.

269. *See id.*

270. *Id.*

271. Author's original example. In this example, the term "powerholder" is used to describe the individual or corporation (the non-adverse party) who has been granted the power and authority to add a charitable organization as described in Section 170(c) to a trust agreement pursuant to Section 674. I.R.C. §§ 170(c), 674.

power relates and is signed, acknowledged and delivered to the Trustee then serving. The exercise or release of the powers granted shall be irrevocable.

Termination. The powers granted to the Powerholder under this article terminate on the grantor's death.²⁷²

These provisions should not be viewed in a vacuum, but must be viewed as part of the trust agreement as a whole.²⁷³ For example, the drafting attorney should include detailed provisions on notice, how distributions can be made to, or withheld from, the charity, the standard or duty of care of any party related to this power, any limitations on liability or indemnification, and compensation provisions for parties who may never have to act or who, conversely, could play a very large role in the administration of the trust.²⁷⁴ This example includes provisions for succession of the powerholder.²⁷⁵ Similar considerations are also necessary for the individual or corporation, sometimes called a Special Trustee, who is then tasked to make distributions to a charitable organization once a powerholder adds a beneficiary.²⁷⁶

If the document is silent as to how to terminate grantor trust status, the grantor may be required to rely on mechanisms for modification under state law, judicial modification (as what was requested in *Millstein*), or decanting the trust assets into a non-grantor trust, depending on whether decanting is possible under the terms of the trust or pursuant to local law.²⁷⁷ Keep in mind, however, that sometimes a grantor may have to rely on a trustee or other party to initiate a decanting as is the case in Texas where an authorized trustee has the power to decant.²⁷⁸

2. Toggling Between Grantor Trust and Non-grantor Trust Status

It is important to draft a power that can be released or relinquished, but does it make sense to include an option for the grantor trust status of a trust be “turned back on”?²⁷⁹ Grantors may be comfortable with the idea of paying tax on the trust's income initially, but then circumstances, such as an unexpectedly large tax burden, could arise, leading to a grantor's second-guessing the decision to create a grantor trust, and he or she may wish to convert the trust to a non-grantor trust so as to avoid further payments of

272. Author's original example; see I.R.C. §§ 170(c), 672(b), 2055(a).

273. See I.R.C. § 674.

274. Author's original example.

275. See discussion *supra* Section IV.A.1.

276. See I.R.C. § 674.

277. See e.g. TEX. PROP. CODE ANN. § 112.071.

278. See *id.* §§ 112.071–.081.

279. Author's original thought.

tax attributable to the trust's income.²⁸⁰ Then, the grantor could have estate planning regret and wish to turn grantor status back on, for example, if she later desired to sell appreciated assets to the trust in exchange for a promissory note and receive disregarded tax treatment for income tax purposes or to use the power to substitute assets of equivalent FMV for basis planning purposes.²⁸¹

Having the ability to restore to the trust powers that would allow the trust to be considered a grantor trust again would most likely be considered a power to amend the trust, causing the trust to be taxed as a grantor trust anyway.²⁸² That is why, if such a power were to be included in an instrument, it would make sense to give this type of power to a third party and not have the grantor retain it.²⁸³ Furthermore, there is the metaphysical argument that if a grantor can resurrect a power, he or she never surrendered it in the first place.²⁸⁴ Additionally, because there do not seem to be any other restrictions on who can hold the power to relinquish or reinstate grantor trust status, the grantor's spouse or other relative may be able to hold this power.²⁸⁵ For example, there is not a requirement that the holder of this power be a "non-adverse" party as defined in the Code.²⁸⁶

Additionally, there are other mechanisms to convert a non-grantor trust into a grantor trust, such as: the appointment of a related or subordinate trustee, which would cause a trust to be treated as a grantor trust, under Section 674; the actual borrowing of trust corpus by the grantor, under Section 675(3); or the payment of the grantor's legal support obligations, under Section 677(b).²⁸⁷ These actions alone should not result in taxable income to the deemed transferee.²⁸⁸

An important consideration, though, is not necessarily whether a grantor can toggle, but how the IRS views attempts to toggle.²⁸⁹ The IRS issued Notice 2007-73 in 2007, labeling a toggling grantor trust transaction as a

280. See Elliott Manning & Jerome M. Hesch, *Deferred Payment Sales to Grantor Trusts, GRATs and Net Gifts: Income and Transfer Tax Elements*, 24 TAX MGMT. EST., GIFTS & TR. J. 3, 23–24 (1999).

281. See *id.*

282. *Id.*; Jonathan G. Blattmachr et al., *Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor's Death*, 97 J. TAX'N 149, 152 (2002).

283. Blattmachr, *supra* note 282.

284. See *id.*

285. See Jeanne L. Newlon, *Developments Involving Grantor Trusts*, ALI-ABA EST. PLAN. COURSE MATERIALS J. 27, 41 (2010), https://www.venable.com/-/media/files/publications/2010/08/developments-involving-grantor-trusts/files/developments-involving-grantor-trusts/fileattachment/newlongrantor_trusts.pdf [<https://perma.cc/DUP3-BHZR>].

286. *Id.*

287. *Id.* at 51.

288. Rev. Rul. 85-13, 1985-1 C.B. 184; Chief Counsel Advice 2009-23024 (Dec. 31, 2008); see also Newlon, *supra* note 285, at 51.

289. Kelly M. Perez et al., *Ghosts of Grantor Trusts Past, Present and Future*, MD. STATE BAR ASS'N SECTION OF TAX'N L., ADVANCED TAX INST. (Nov. 9, 2021) (a presentation explaining IRS Notice 2007-73).

reportable transaction of interest.²⁹⁰ The Notice discusses two types of transactions that occur in a short time frame (about thirty days apart).²⁹¹ The grantor argued that turning off, and then turning back on, grantor trust status by way of the swap power results in a tax consequence that could not be achieved without the toggling on and off of grantor trust status.²⁹² Here, the transaction is intended to generate a tax loss to the grantor that is not a real economic loss, or to avoid the recognition of gain.²⁹³ Explanation of Transaction Variation One in Notice 2007-73:

[G]rantor purchases four options, the values of which are expected to move inversely in relation to at least one of the other options so that there will be two options with a gain and two options with a loss that substantially offsets the gain. The grantor then transfers the four options and a small amount of cash to a trust. The grantor retains a noncontingent reversionary interest in the trust, giving another beneficiary a short-term unitrust interest. The remainder interest is structured to have a value, as determined under [S]ection 7520, that equals the [FMV] of the options. The grantor also [has a swap power under] . . . [S]ection 675(4) that will become effective on a specified date in the future. The reversionary interest and the power of substitution cause the trust to be a grantor trust

After the trust is funded, the grantor sells the remainder interest to an unrelated person for the [FMV] of the remainder interest, which is equal to the [FMV] of the options. The grantor claims that the basis in the remainder interest is determined by allocating a portion of all of the trust assets to the remainder interest, which results in no gain recognized in the sale of the remainder interest. The buyer gives the grantor a note, cash, or other consideration for the remainder interest. The grantor claims that the grantor trust status has terminated as a result of the sale of the remainder interest.

Once the substitution power becomes effective, the grantor claims that the trust becomes a grantor trust again. At that time, the loss options are closed out and grantor recognizes the loss. The grantor calculates the loss based on the difference between the amount realized and the original basis in the loss options, even though the grantor already used a portion of the basis to eliminate the grantor's gain on [the] sale of the remainder interest.

290. I.R.S. Notice 2007-73, 2007-2 C.B. 545. "The new reportable transaction category Transaction of Interest (TOI) is defined as a transaction that the IRS and the Treasury Department believe is a transaction that has the potential for tax avoidance or evasion," however, more information is needed to officially determine the transaction as "tax avoidance." *Transactions of Interest*, IRS (Nov. 30, 2021), <https://www.irs.gov/businesses/corporations/transactions-of-interest> [<https://perma.cc/K4QA-6HHL>]. "The TOI category of reportable transactions will apply to transactions entered into on or after November 2, 2006." *Id.*

291. *Internal Revenue Bulletin: 2001-36*, IRS (Sept. 4, 2007), https://www.irs.gov/irb/2007-36_IRB [<https://perma.cc/NJ74-2YS4>].

292. *Id.*

293. *Id.*

The buyer then purchases the unitrust interest from the beneficiary for the actuarial value of that interest, which equals or approximates the amount of cash the grantor contributed to the trust. The buyer now owns the unitrust interest and the remainder interest in the trust, resulting in the effective termination of the trust by operation of law. The buyer's basis in the gain options and the cash is claimed to be equal to the amount the buyer paid for the two separate interests. The grantor does not treat the termination of the trust as a taxable disposition by the grantor of the assets in the trust.

The buyer then sells the gain options and recognizes gain only to the extent that the amount realized exceeds the basis the buyer allocated to the gain options. Such gain ends up being minimal because of the structure of the transaction. If the buyer purchased the remainder interest with a note, the buyer uses the proceeds from the gain options to repay the note.²⁹⁴

Explanation of Transaction Variation Two in Notice 2007-73:

The facts in the second variation are the same, except the grantor contributes cash or marketable securities to the trust with a basis equal to [FMV]. Before the date on which the substitution power becomes effective, the grantor sells the remainder interest in the trust to the buyer for an amount equal to its [FMV]. The grantor does not recognize any gain (or very little gain or a loss). Again the grantor claims the sale terminates the grantor trust status of the trust. After the substitution power becomes effective, the grantor substitutes appreciated property for the liquid assets owned by the trust. The [FMV] of the appreciated property equals the [FMV] of the liquid assets. Then, the grantor claims that once the substitution power becomes effective, the grantor trust status is restarted. Thus the grantor does not recognize gain on the substitution.

Then the buyer purchases the unitrust interest from the beneficiary, and the trust terminates by operation of law. The grantor does not treat the termination as a disposition. The buyer takes a basis in the trust assets equal to the amount the buyer paid for the interests in the trust.²⁹⁵

How this Notice should be analyzed and considered in one's own grantor trust planning is unclear.²⁹⁶ It provides that "transactions that are the same as, or substantially similar to, the transactions described in this notice are identified as transactions of interest" that require disclosure.²⁹⁷ The situations described in this notice are complex, and may not apply to the typical grantor trusts that most practitioners are drafting on a daily basis.²⁹⁸

294. Newlon, *supra* note 285, at 41-42.

295. *Id.* at 42.

296. *See id.*

297. I.R.S. Notice 2007-73, 2007-2 C.B. 545.

298. *Id.*

Nor do the reasons for substituting assets in the Notice, such as tax loss harvesting, apply to all grantors, as some may have simply turned off grantor status because of a lack of liquidity to pay the related tax liability.²⁹⁹ However, the Notice does alert planners that they should have conversations with grantors about the grantor's intentions concerning the grantor trusts they create and whether their intentions could lead to a perceived abusive situation.³⁰⁰

3. Income Tax Consequences of Turning Grantor Status Off

Grantor trust status terminates on the death of the grantor.³⁰¹ At such time, the power(s) that caused the trust to be taxed as a grantor trust as to that grantor no longer exist, so the trust ceases to be a grantor trust as to the deceased grantor.³⁰² Therefore, the benefits attached to grantor trust status also end at that time.³⁰³ In most cases, the grantor's death should not result in an income tax recognition event.³⁰⁴

Grantor trust status can end during a grantor's life in various situations, including if the powers or beneficial interests that cause income tax inclusion are relinquished by the person who holds such powers or interests.³⁰⁵ Another example is if certain triggering events occur, such as when the initial GRAT term ends, and the grantor no longer receives annuity payments from the GRAT.³⁰⁶

When grantor trust status ends during the grantor's lifetime, the grantor is deemed to have transferred to the trust all of the assets in, and all of the liabilities of, the trust at the moment it becomes a non-grantor trust.³⁰⁷ In the year of the termination, the grantor is taxed on the income of the trust up to the date of the grantor trust termination, and the trust becomes its own taxpayer for the remainder of the year.³⁰⁸ As mentioned earlier in this Article, if the liabilities deemed transferred to the trust exceed the basis of the assets deemed transferred, the grantor will recognize gain on the difference, though if the liability was incurred by reason of the acquisition of the property, the liability will not be included in the amount realized.³⁰⁹ This generally applies to partnership interests.³¹⁰ Additionally, if the trust owes a debt to the grantor,

299. *Id.*

300. *Id.*

301. Treas. Reg. § 1.1001-2(c) (1980).

302. *Id.*

303. *Id.*

304. *Id.*; Rev. Rul. 77-402, 1977-2 C.B. 222.

305. Treas. Reg. § 1.1001-2(c) (1980); Prangner, *supra* note 105, at 479.

306. Prangner, *supra* note 105, at 480.

307. Treas. Reg. § 1.1001-2(c) (1980); Madorin v. Comm'r, 84 T.C. 667, 673 (1985).

308. Prangner, *supra* note 105, at 464.

309. See *supra* note 79 accompanying text; Treas. Reg. § 1.1001-2(a)(1) (1980).

310. Treas. Reg. § 1.1001-2(a)(1) (1980).

such as remaining payments on an installment note, the grantor may also recognize capital gain because the trust may have received the asset from the grantor in exchange for the debt to the grantor.³¹¹

However, because the grantor trust is a disregarded entity for income tax purposes, many practitioners maintain that any liabilities between the grantor and the grantor trust should be disregarded.³¹² A review of the following example in Treasury Regulation Section 1.1001-2(c) is helpful:

Example 5: In 1975, C, an individual, creates T, an irrevocable trust. Due to certain powers expressly retained by C, T is a “grantor trust” for purposes of subpart E of part 1 of subchapter J of the [Code] and therefore C is treated as the owner of the entire trust. T purchases an interest in P, a partnership. C, as the owner of T, deducts the distributive share of partnership losses attributable to the partnership interest held by T. In 1978, when the adjusted basis of the partnership interest held by T is \$1,200, C renounces the powers previously and expressly retained that initially resulted in T being classified as a grantor trust. Consequently, T ceases to be a grantor trust and C is no longer considered to be the owner of the trust. At the time of the renunciation all of P’s liabilities are liabilities on which none of the partners have assumed any personal liability and the proportionate share of which of the interest held by T is \$11,000. Since prior to the renunciation C was the owner of all the entire trust, C was considered the owner of all the trust property for Federal income tax purposes, including the partnership interest. Since C was considered to be the owner of the partnership interest, C not T, was considered to be the partner in P during the time T was a “grantor trust.” However, at the time C renounced the powers that gave rise to T’s classification as a grantor trust, T no longer qualified as a grantor trust with the result that C was no longer considered to be the owner of the trust and trust property for Federal income tax purposes. Consequently, at that time, C is considered to have transferred ownership of the interest in P to T, now a separate taxable entity, independent of its grantor C. On the transfer, C’s share of partnership liabilities (\$11,000) is treated as money received. Accordingly, C’s amount realized is \$11,000 and C’s gain realized is \$9,800 (\$11,000-\$1,200).³¹³

B. Tax Reimbursement Clauses

One of the initial considerations in determining whether a grantor trust is a good fit for a client is ensuring that the grantor has sufficient liquidity to pay the taxes due on income attributable to any grantor trust of which she may own or is a deemed owner.³¹⁴ In addition to proper financial cash flow planning for a client, including a tax reimbursement clause in grantor trusts

311. *Id.*

312. *Id.* § 1.1001-2(a)(3).

313. *Id.* § 1.1001-2(c).

314. See Newlon, *supra* note 285, at 38.

can provide needed flexibility to grantors worried about having sufficient cash to pay taxes due on trust income.³¹⁵ In essence, a tax reimbursement clause provides a mechanism for the trust to provide funds to the grantor to enable them to pay the trust's income tax liability in any given year.³¹⁶ However, as one can see, especially as highlighted in *Millstein*, the trustee has fiduciary duties to the beneficiaries of the trust and must keep their best interests above the interests of the grantor.³¹⁷ Depleting trust assets to reimburse a tax liability owed by the grantor by way of reimbursement is generally not in the best interests of the beneficiaries.³¹⁸

The following is an example of tax reimbursement language:

During the Grantor's lifetime, the Independent Trustee may, in the Independent Trustee's sole and absolute discretion, reimburse Grantor for any amount of Grantor's personal income tax liability that is attributable to the income, capital gains, deductions and credits from a trust created hereunder being deemed a "grantor trust" with respect to Grantor. The Independent Trustee may pay Grantor directly or may pay the reimbursement amount to an appropriate taxing authority on Grantor's behalf, in the Independent Trustee's sole and absolute discretion. The Independent Trustee shall not, at any time or times, enter into or carry out any understanding or pre-existing arrangement with Grantor regarding the Independent Trustee's exercise of the discretion granted to the Independent Trustee under this paragraph.³¹⁹

As discussed previously, the grantor's payment of income tax liability for the trust is not considered a taxable gift to the trust.³²⁰ In Revenue Ruling 2004-64, the IRS clarified the circumstances in which a tax reimbursement clause may cause inclusion in a grantor's estate for U.S. estate tax purposes.³²¹ In this Revenue Ruling, the IRS distinguished between mandatory and discretionary reimbursement provisions.³²² If the trust instrument or local law requires the trust to reimburse the grantor for the income tax attributable to the inclusion of the trust's income in the grantor's taxable income, then Section 2036(a)(1) will cause the full value of the trust to be included in the grantor's gross estate because the grantor has retained the right to have trust income expended in discharge of their legal obligation.³²³ If the mandatory reimbursement provision is included in local law provisions, the IRS indicated that estate tax inclusion can be avoided if

315. *Id.*

316. *Id.*

317. *Millstein v. Millstein*, 2018 WL3005347 *1, *2 (Ohio Ct. App. 2018).

318. *Id.*

319. Author's original example.

320. *See* Rev. Rul. 2004-64, 2004-2 C.B. 7.

321. *Id.*

322. *Id.*

323. I.R.C. § 2036(a)(1).

local law allows the trust instrument to—and the trust instrument does—provide otherwise.³²⁴

The IRS further provided that it would not apply this adverse estate tax ruling to any trust created before October 4, 2004.³²⁵ If the trust instrument or local law gives the trustee the discretion to reimburse the grantor for taxes paid attributable to trust income, the IRS found that the provision would not cause the trust to be included in the grantor's estate, whether or not the discretion is exercised.³²⁶

However, the IRS also stated that a discretionary provision combined with other facts could cause estate tax inclusion.³²⁷ Other facts may include the following: (1) the grantor and the trustee's understanding or pre-existing arrangement as to the trustee's exercise of the discretionary provision; (2) the grantor's retention of the power to remove the trustee and name himself or herself as successor; and (3) a provision in local law subjecting the trust assets to the claims of the grantor's creditors.³²⁸ The burden of proof falls to the taxpayer to show that there was not an understanding or arrangement in place.³²⁹ Additionally, it makes sense that the party permitted to reimburse the grantor should not be related or subordinate to the grantor within the meaning of Section 672(c) of the Code.³³⁰

This ability for a trustee (or other designated party) to reimburse a grantor is used sparingly for the reasons stated above and to avoid a grantor being in a situation described in the Revenue Ruling.³³¹ There are situations, most often unforeseen circumstances, such as a large tax liability that would significantly deplete the grantor's balance sheet, where reimbursement may make sense.³³² If the grantor's balance sheet could not support the tax payment, then a grantor's only other choice may be to terminate grantor status, which could then foreclose additional planning opportunities in the future.³³³ Additionally, if the grantor has other liquidity to pay the income tax liability, then reimbursing the grantor adds assets back into the grantor's estate that may be subject to estate tax, which negates to some extent the purpose of creating a completed gift IDGT.³³⁴

So, while reimbursement clauses seem to be common, a trustee may nonetheless choose to exercise the power they grant carefully and

324. See Rev. Rul. 2004-64, 2004-2 C.B. 7.

325. See *id.*

326. See *id.*

327. See *id.*

328. *Id.*

329. I.R.C. § 7491(a)(2)(A).

330. *Id.* § 672(c).

331. See Rev. Rul. 2004-64, 2004-2 C.B. 7.

332. Newlon, *supra* note 285, at 38–40.

333. See *id.*

334. See Rev. Rul. 2004-64, 2004-2 C.B. 7.

cautiously.³³⁵ The drafting attorney must also take care in drafting the provisions to provide specific instructions to the trustee.³³⁶ Many attorneys opt to leave tax reimbursement provisions out of a trust agreement and instead rely on state law.³³⁷ Alternatively, the grantor may expressly waive the right to reimbursement if state law provides a mechanism for reimbursement.³³⁸

C. Other Considerations

1. Specialty Assets

a. Qualified Small Business Stock

Qualified small business stock (QSBS) is governed by Section 1202 of the Code, which provides that shareholders of C corporations that meet certain qualifications may exclude a significant portion, or even all, of the capital gains realized upon the sale or exchange of those shares if the requirements in the section are satisfied.³³⁹ The term “qualified small business stock” means any stock in a domestic C corporation when, at its issuance, it is acquired by the taxpayer as original issue (directly or through an underwriter) in exchange for money or other property (not including stock), or as compensation for services provided to such corporation (other than services performed as an underwriter of such stock).³⁴⁰ The corporation must be an active business.³⁴¹ Additionally, the aggregate gross receipts of the corporation before issuance must not exceed \$50 million and the aggregate gross assets of such corporation immediately after the issuance (determined by taking into account amounts received in the issuance) must not exceed \$50 million.³⁴²

For QSBS acquired before February 18, 2009, and held for over five years, the maximum capital gains exclusion is 50%.³⁴³ For QSBS acquired

335. See Jennifer E. Smith & Kristen A. Curatolo, *Grantor Trust Reimbursement Statutes*, TR. & EST. MAG. 25, 25 (Feb. 2021), <https://www.kirkland.com/-/media/professionals/c/curatolo-kristen/grantor-trust-reimbursement-statutes.pdf> [<https://perma.cc/7K27-ZVU2>].

336. See Kim Kamin, *Where Are All The Grantor Trust Reimbursement Statutes?*, WEALTHMANAGEMENT.COM (Jan. 17, 2018), <https://www.wealthmanagement.com/estate-planning/where-are-all-grantor-trust-reimbursement-statutes> [<https://perma.cc/3WZP-JVVV>].

337. See DEL. CODE ANN. tit. 12, § 3344; N.Y. EST. POWERS & TRUSTS LAW § 10-6.6(s)(1) (2015); N.H. REV. STAT. ANN. § 564-B:8-816(c) (2019); COLO. REV. STAT. § 15-5-818 (2019); CONN. GEN. STAT. § 45a-499fff (2020); FLA. STAT. § 736.08145 (2022) (Connecticut, Florida, New Hampshire, and New York have specific tax reimbursement statutes); Smith & Curatolo, *supra* note 335, at 27.

338. See Smith & Curatolo, *supra* note 335, at 29.

339. I.R.C. § 1202.

340. *Id.* § 1202(c)(1). C corporation stock must be originally issued after the date of the enactment of the Revenue Reconciliation Act. Revenue Reconciliation Act of 1993, Pub. L. 103-66, 107 Stat. 416.

341. I.R.C. § 1202(c)(2).

342. *Id.* § 1202(d)(1)(A)–(B).

343. *Id.* § 1202(a)(1).

from February 18, 2009 to September 27, 2010, and held for over five years, the maximum capital gains exclusion is 75%.³⁴⁴ Gains are tax-free for QSBS acquired after September 27, 2010 and held for over five years.³⁴⁵ Stocks held over a year but less than five years are subject to long term capital gains taxes, and stocks held less than a year are subject to short term capital gains taxes.³⁴⁶ There is a maximum gain cap whereby a QSBS shareholder can exclude any gain up to the greater of ten times the adjusted cost basis or \$10,000,000.³⁴⁷

Many taxpayers who may qualify for this benefit under Section 1202 may elect to engage in estate planning using QSBS.³⁴⁸ The exclusion applies to the taxpayer, and when taxpayers are married the Code provides that, in the case of any joint return, the amount of gain taken into account under Section 1202(a) shall be allocated equally between the spouses for purposes of applying this subsection to subsequent taxable years.³⁴⁹ This prevents married couples, whether in a community property state or non-community property state, from availing themselves of more than one QSBS exclusion.³⁵⁰

Though a deep discussion on the many nuances of QSBS is beyond the scope of this Article, some taxpayers choose to “stack” their exclusions by making gifts, as arguably permitted by Section 1202(h)(2)(A) of the Code, to non-grantor trusts—often by separate gifts into separate trusts—one for the benefit of each of their children.³⁵¹ At first, this approach appears appealing, as the ability to exclude in the typical case and notwithstanding any changes to Section 1202 by Congress, \$10 million worth of gain from tax (as may be possible where a trust owns QSBS issued or gifted to the trust since September 28, 2010), when multiplied by two or three (or more), is highly attractive.³⁵² An IDGT holding proceeds from the sale of QSBS starts at a significant deficit (because of the taxes paid by the grantor versus no taxes paid by either the grantor or an non-grantor trust) compared to a non-grantor trust holding those same proceeds.³⁵³ However, after a number of years

344. *Id.* § 1202(a)(3).

345. *Id.* § 1202(a)(4).

346. *Id.*

347. *Id.* § 1202(b)(1).

348. Scott W. Dolson, *Maximizing the Section 1202 Gain Exclusion Amount*, FROST BROWN TODD (Oct. 7, 2021), <https://frostbrowntodd.com/maximizing-the-section-1202-gain-exclusion-amount/> [<https://perma.cc/9FBD-AAMS>].

349. I.R.C. § 1202(a), (b)(3).

350. *See id.* § 1202. Other practitioners may argue that in certain circumstances, spouses may each avail themselves of a separate QSBS exclusion for their respective and individual ownership in the C-corporation. *See Dolson, supra* note 348.

351. I.R.C. § 1202(h)(2)(A); Maureen Reynolds & Alyssa Zebrowsky, *Irrevocable trusts: What beneficiaries need to know to optimize their resources*, J.P. MORGAN PRIVATE BANK (Oct. 6, 2021), <https://privatebank.jpmorgan.com/gl/en/insights/planning/irrevocable-trusts-what-beneficiaries-need-to-know-to-optimize-their-resources> [<https://perma.cc/NGX7-CEGY>].

352. I.R.C. § 1202(h)(2); *see Dolson, supra* note 348.

353. *See Scott W. Dolson, Transfer Planning With Qualified Small Business Stock*, FROST BROWN TODD (May 21, 2021), <https://frostbrowntodd.com/transfer-planning-with-qualified-small-business-stock/> [<https://perma.cc/Q37G-EPVF>].

(depending on the trust's total returns) the family may fare better financially had the IDGT—rather than the non-grantor trusts—held the QSBS.³⁵⁴ Because of the tax deferral, the lure of stacking QSBS exclusions through the use of non-grantor trusts endures despite the demonstrable long-term benefit of having trusts structured as grantor trusts from the outset.³⁵⁵

In some cases, a grantor may elect to create a hybrid known as spousal lifetime access non-grantor trust, sometimes referred to as a “SLANT” or “SALTy SLAT.”³⁵⁶ This trust is structured as a non-grantor trust with the design that it qualifies as a separate taxpayer for purposes of the Section 1202 exclusion.³⁵⁷ Though a non-grantor trust, the trust can name a spouse as a beneficiary, which generally would cause the trust to be taxed as a grantor trust under Section 677, but the trust agreement can be drafted around Subpart E so that when adverse parties are given certain powers, the trust is a non-grantor trust for income tax purposes.³⁵⁸ For example, any distributions to the spouse must be approved by the adverse party.³⁵⁹ Generally, this provides that another trust beneficiary must approve any distributions made to the spouse, and in some cases, drafters will require that all distributions to any beneficiary must be so approved by the adverse party.³⁶⁰ The beneficiary spouse cannot serve as an adverse party for purposes of approving a distribution.³⁶¹

b. Qualified Opportunity Zones

The qualified opportunity zone (QOZ) incentive program found in Section 1400Z-2 of the Code allows a taxpayer to defer capital gains tax, and potentially to reduce tax, if those capital gains proceeds are rolled over into a qualifying investment in a QOZ and certain other conditions are met.³⁶² A qualifying investment is made through a corporation, partnership, or other business in a low-income community in the U.S., including Washington,

354. See Andrew Seiken, *Maximize Next Generation Assets With Intentionally Defective Grantor Trusts*, BYN MELLON WEALTH MGMT., <https://www.bnymellonwealth.com/articles/strategy/maximize-next-generation-assets-with-intentionally-defective-grantor-trusts.jsp> (last visited Sept. 13, 2022) [<https://perma.cc/RKH5-YGQF>].

355. *Id.*; Dolson, *supra* note 348.

356. See discussion *supra* Section III.C.

357. Ed Morrow, *Using Spousal Lifetime Access Non-Grantor Trusts (SLANTs) After the 2017 Tax Reform*, LEIMBERG'S INCOME TAX PLAN. EMAIL NEWSL. (Apr. 23, 2018), leimbergservices.com/all/LISI-MorrowPDF_23_2018.pdf [<https://perma.cc/YR4U-GGL3>].

358. *Id.*; I.R.C. § 677.

359. See Morrow, *supra* note 357.

360. I.R.C. § 677; see Morrow, *supra* note 357.

361. See I.R.C. § 677.

362. See *id.* §§ 1400Z-1 to -2 (Section was contained in the TCJA); Kelly M. Perez & Christine Quigley, *Qualified Opportunity Zones (QOZ): Maximizing Impact for Clients and Community*, AM. BAR ASS'N (Feb. 6, 2019).

D.C., and U.S. territories.³⁶³ The QOZ tax incentives are designed to attract investment to the nation's most economically distressed communities by offering powerful tax planning opportunities for taxpayers who inject capital into these areas.³⁶⁴

In a nutshell, the new QOZ provisions under Section 1400Z-2 may provide taxpayers with (1) temporary deferral of capital gain recognition, (2) a possible step-up in the income tax basis of their investment, and (3) possible permanent exclusion of capital gains from the growth of the QOZ investment if the holding period is at least ten years.³⁶⁵

Planning with an asset subject to holding periods often requires thorough review and attention.³⁶⁶ When planning with QOZ assets (referred to herein as qualified opportunity fund or QOF), certain transfers (such as *inter vivos* gifts or testamentary transfers) made by a taxpayer may constitute "inclusion events" and require some or all of the taxpayer's previously deferred gain to be immediately subject to income tax.³⁶⁷ An inclusion event either reduces the taxpayer's QOF investment, or results in the taxpayer receiving property from the QOF as a distribution for federal income tax purposes.³⁶⁸ These inclusion events are narrowly defined.³⁶⁹

During lifetime, if a taxpayer makes a gift of a QOF investment to a non-charitable or charitable donee before the tax deferral period ends, the deferral period terminates at the time of the gift.³⁷⁰ This inclusion event triggers income tax, so it is not advantageous from a tax standpoint to make gifts of a QOF investment in this manner.³⁷¹ The taxpayer must then include the deferred gain when filing the taxpayer's income tax return, reporting the

363. I.R.C. §§ 1400Z-1(c), 45D(e) (defining the term "low-income community" as having a poverty rate of at least 20% or is determined by certain levels of median family incomes).

364. *Opportunity Zones*, IRS (Nov. 10, 2021), www.irs.gov/credits-deductions/businesses/opportunity-zones [<https://perma.cc/J3XC-35SN>].

365. I.R.C. §§ 1400Z-2(a)–(c). In 2022, the capital gains tax rate is 20%, and taxpayers may also be subject to an additional 3.8% net investment income tax (NIIT) under Section 1411. *Id.* § 1411. Certain states levy their own separate state income tax and may have their own rules and regulations that may affect rolling over capital gains into a QOF.

366. See Julia Kagan, *Holding Periods*, INVESTOPEDIA, <https://www.investopedia.com/terms/h/holdingperiod.asp> [<https://perma.cc/FE2E-9TPQ>].

367. Treas. Reg. §§ 1.1400Z-2(b)-1(c), 1.1400Z-2(a)-1(b)(14)(iv).

368. *Id.*

369. *Id.*

370. Upon the taxpayer's death the deceased taxpayer's QOF investment transfers to the taxpayer's beneficiaries with the tax incentives and holding period intact. This is not considered an inclusion event. Transfers on death may occur through the taxpayer's last will and testament or revocable trust, through a state's intestacy statute, or to a joint owner of an account such as an account held as joint tenants with rights of survivorship. However, the gain required to be recognized on the initial investment in the QOF will be treated as income with respect to the decedent (IRD) under Section 691 and will not be eligible for a stepped-up income tax basis on death. The long-term benefit of non-recognition of gain on investments held longer than ten years still applies; the IRD applies only to the original deferred gain. *Id.* § 1.1400Z-2(b)-1(c)(3)–(4).

371. *Id.*

gain on U.S. Form 8949 (Sales and Other Dispositions of Capital Assets).³⁷² There is an exception, however, if the taxpayer transfers a QOF investment to a grantor trust, which is deemed owned by the taxpayer.³⁷³

As stated above, grantor trusts are eligible to hold QOFs, and transfers by gift to grantor trusts are not considered inclusion events for tax purposes.³⁷⁴ When a taxpayer makes a gift of a QOF to a grantor trust, the taxpayer's holding period will be tacked to the grantor trust.³⁷⁵ Taxpayers may create a variety of different types of grantor trusts to hold QOF investments, such as revocable trusts, dynasty IDGTs for the next generation, SLATs, and GRATs.³⁷⁶ It may also make sense to have any continuing trust (such as follow-on trusts for GRATs) be taxed as grantor trusts so the trust may continue to hold the QOF without triggering gain.³⁷⁷ It is possible to transfer QOF investments to a charitable lead trust for clients who are charitably inclined yet are prevented from making a direct transfer to a charity without triggering an inclusion event for tax purposes.³⁷⁸

If a grantor trust that holds a QOF ceases to be classified as a grantor trust (other than on account of the grantor's death), the trust will recognize the deferred gain.³⁷⁹ For example, if the grantor elected to terminate grantor trust status by relinquishing the required powers under Subpart E, this would result in the recognition of the deferred gain because the trust itself would then own the QOF on behalf of the beneficiaries.³⁸⁰ If the grantor dies, however, then the transfer of the QOF investment held in the grantor trust may pass to the trust's beneficiaries without triggering recognition of the deferred gain at the grantor's death.³⁸¹

2. Assignment of Income Doctrine

The assignment of income doctrine provides that a taxpayer cannot escape taxation by anticipatory assignments where the right to such income has vested.³⁸² A grantor is subject to the assignment of income doctrine regardless of whether the terms of a trust comport with the requirements of Sections 671 through 679 for avoiding grantor trust status, if the doctrine

372. *Id.*

373. *Id.* § 1.1400Z-2(b)-1(c)(5).

374. *Id.*

375. *Id.*

376. *See supra* Section II.

377. *See supra* Section II.

378. *See supra* Section II.B.

379. Treas. Reg. § 1.1400Z-2(b)-1(c)(5)(ii).

380. *Id.*

381. *Id.* § 1.1400Z-2(b)-1(c)(4).

382. The Supreme Court would not recognize for income tax purposes an "arrangement by which the fruits are attributed to a different tree from that on which they grew." *Lucas v. Earl*, 281 U.S. 111 (1930); *see also Harrison v. Schaffner*, 312 U.S. 579, 582 (1941).

would apply “whether or not the assignment is to a trust.”³⁸³ Using a very general example, a grantor will be taxed on future employment income that the grantor assigns to an irrevocable trust to which the grantor trust rules do not apply.³⁸⁴ This is an important consideration for those who established trusts in which they then attempt to assign rights to their future services to shift their own income to the trusts.³⁸⁵ Courts have systematically held that the grantors remain taxable on compensation income under the grantor trust rules to the extent applicable, or under the assignment of income doctrine when the grantor trust rules do not apply.³⁸⁶

V. CONCLUSION

IDGTs are one of the most valuable tools to implement the strategy of transferring wealth to the next generation in both an income tax and a transfer tax-efficient manner.³⁸⁷ But like any wealth planning strategy they are best used with a complete and comprehensive understanding of not only Subchapter E and other relevant Code sections—such as Sections 2036 through 2038—but also the grantor’s overall financial condition and intent in the creation and future utility of a grantor trust.³⁸⁸

* * * * *

AUTHOR NOTES: *Case study:* Assumptions for a balanced portfolio, as used in the “case study” are assumed to have the following asset allocation: 75% developed world equity, 10% diversified hedge funds, 15% municipal bonds. Expected nominal return: 6.37%; expected volatility: 11.88%; yield: 2.06%; expected appreciation: 4.32%; geometric appreciation: 3.66% and turnover: 37.72%.

References to expected returns are not predictions of future performance. Actual results may be expected to vary from assumptions, which are made for discussion purposes only.

The author would like to thank J.P. Morgan Private Bank Advice Lab for its assistance with diagrams contained herein.

383. Treas. Reg. § 1.671-1(c); *Helvering v. Horst*, 311 U.S. 112, 119 (1940).

384. Treas. Reg. § 1.671-1(c).

385. *See id.*

386. *Pfluger v. Comm’r*, 840 F.2d 1379, 1333–35 (7th Cir. 1988).

387. *See supra* Section II.C.

388. *See supra* Section II.C.

Exhibit A³⁸⁹

Grantor status provides advantages over a non-grantor trust

Texas

Consider this example:

James, an unmarried 50-year-old with a net worth of \$25 million, has one child, Margery. In 2021, James does one of the following three things regarding wealth transfer:

- **Scenario 1:** Nothing. At his death, everything would pass to a trust for the benefit of his issue
- **Scenario 2:** Gives \$5 million to an NGT for the benefit of his issue, with the assets he retains also ultimately passing to a trust for the benefit of his issue
- **Scenario 3:** Gives \$5 million to an IGT for the benefit of his issue, with the assets he retains also ultimately passing to a trust for the benefit of his issue

CASE STUDY AT A GLANCE

YEAR		NO TRUST SCENARIO	NON-GRANTOR TRUST SCENARIO		GRANTOR TRUST SCENARIO	
			PERSONAL ASSETS	TRUST	TRUST	GRANTOR
0	Initial value	\$25,000,000	\$20,000,000	\$5,000,000	\$5,000,000	\$20,000,000
	Net amount invested	25,000,000	20,000,000	5,000,000	5,000,000	20,000,000
1-30	After-tax income consumed by beneficiaries	—	—	—	—	—
30	Value of assets at death of grantor	86,258,393	69,006,714	19,335,176*	26,475,690*	61,866,200
	Estate tax	(32,503,357)	(27,602,686)	—	—	(24,746,480)
	Embedded tax liability on unrealized gain	—	—	—	—	—
	Net assets to family	53,755,036	41,404,028	19,335,176	26,475,690	37,119,720
	Total value available to family in year 30**	53,755,036	60,739,204		63,595,410	
	Real value, adjusted for annual inflation of 2.25%	27,575,262	31,158,001		32,623,178	
	Value added vs. non-grantor trust				2,856,206	
	Value added vs. no trust					9,840,375

* Assets held in trust do not receive a step-up in basis at the grantor's death.

** A break-even never occurs within the grantor's expected lifetime; the grantor trust scenario is always more favorable. For illustrative purposes only.

Assume James dies in 2051. Also assume that the gift tax exclusion at both the time of gift and time of James's death is \$5 million; that the trustee during those 30 years makes no distributions; that the estate tax rate in 2051 is a flat 40%; that the 2021 income tax brackets and rates prevail for all 30 years; and that the trust assets are invested in a balanced portfolio. (See last page for assumptions for a balanced portfolio).

How much would go to James's progeny? At his death, there would be available to his issue, after estate taxes:¹

- **Scenario 1 (do nothing):** \$53.76 million
- **Scenario 2 (non-grantor trust):** \$60.74 million
- **Scenario 3 (grantor trust):** \$63.60 million

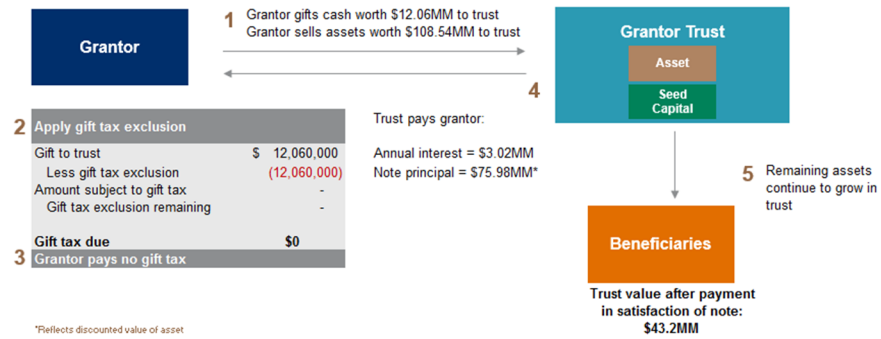
James's IGT (Scenario 3) would provide his issue 18.3%, and his NGT (Scenario 2) would provide about 13% more wealth than if he'd done nothing (Scenario 1).

The "excess wealth" attributable to the trust's being an IGT rather than an NGT is therefore, over the 30 years of the analysis, 530 basis points (1,830 minus 1,300).

Put another way, the "tax alpha" attributable to the trust's being an IGT versus an NGT is 40.76% (530 divided by 1,300), or, on an annualized basis, 0.60%. (Here, "tax alpha" is the outperformance of the respective trusts attributable to their different tax statuses, net after taking into account income and estate taxes not only on an ongoing basis during James's lifetime, but also at his death.)

¹ This example illustrates solely on the estate tax consequences, reflecting the income tax consequences only implicitly.

Exhibit B³⁹⁰



390. Author's original diagram.