

USING THE GRANTOR TRUST RULES
TO SHIFT TAX RESPONSIBILITY TO TRUST BENEFICIARIES
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Preface

A Modest Proposal to Facilitate
Explanation of the Grantor Trust Rules

The one word that should be avoided, at all costs, when trying to explain the grantor trust rules is, of course, the word “grantor.” The word is already ambiguous, meaning both a person who creates a trust, and a person who contributes property to the trust. To add a third meaning – the person who is responsible for paying taxes on trust income – only invites confusion. We can end up with such impenetrable constructions as “If, after a grantor creates a trust, there are additional grantors, who is the grantor?” Only a person inured to years of lawyerly obfuscation can hope to make sense of that.

There is an easy solution. The Internal Revenue Code consistently refers to the person responsible for paying taxes on trust income as the “Owner.” The person who creates a trust can also be referred to as the Trustmaker. One who contributes property to a trust can also be referred to as a Donor. Our previously impenetrable sentence now becomes: “If, after a Trustmaker creates a trust, there are additional Donors, who is the Owner? Clearer, no? It becomes even clearer if we move meaning from nouns to verbs: “If after a trust is created, several people contribute property to the trust, who is responsible for paying taxes on the income?”

While we’re at it, why don’t we stop referring to our trusts, or their beneficiaries, as defective? (Lawyer: “How dare you suggest I was negligent. That trust is intentionally

defective!”) One of the common names for a “defective” trust is GDOT, for Grantor Deemed Owner Trust, i.e. a trust in which the grantor is deemed to be the owner under the grantor trust rules. Using the same convention, a trust in which a beneficiary is the deemed owner under IRC section 678 becomes a BDOT, which sounds so much nicer than “Defective Beneficiary Trust.” As an alternative to the term “non-grantor trust”, a trust in which the trustee is treated as the owner for income purposes could be called a TDOT, to maintain consistency, though the Trustee of a non-grantor trust is, in fact, the legal owner of the trust assets, and therefore the Owner, not a Deemed Owner. Throughout the balance of this article, I will use this terminology. At least, I’ll try – old habits die hard.

What Are the Grantor Trust Rules?

As a general principal of tax law, the owner of the asset that creates income is responsible for paying the tax on that income. Because the trustee is the legal owner of trust assets, the trustee is responsible for paying the tax. To avoid double taxation after a distribution, the trustee is entitled to a deduction for the distribution, calculated using the DNI rules, and the tax liability flows to the beneficiary, in the same way partnership income flows to the individual partners.

However, the tax code has other principles, among them the idea of progressive taxation - that those who have more should pay at a higher rate. For much of the postwar era, until the mid-1960s, tax brackets were very progressive, with a top marginal rate of 91% and a bottom rate of 20%. Beginning in 1964, the top rate fell to 70%, and the bottom rate to 14%; however, there was still a considerable amount of progressivity. There was therefore a strong incentive for individuals in the top brackets to shift income to family members in lower brackets. One of many

strategies to effect this income shifting was to create a trust to hold a portion of the assets, relying on the usual rule that the trustee is responsible for paying the tax on trust assets. At the same time, the Trustmaker would retain powers that gave a significant level of control over trust assets, and might even retain a right to income.

To avoid this perceived abuse, Congress took a number of steps.¹ In 1954, Congress added subpart E (§§671-679) to Subchapter J of the Internal Revenue Code, the subchapter dealing with trust income taxation. Most of these sections provide that the Trustmaker who retains certain specified rights or powers over the trust will continue to be responsible for paying the tax on trust income, thereby eliminating the opportunity for income shifting. These include:

- Retaining a reversionary interest in trust principal (§ 673)
- Retaining power to control beneficial enjoyment (§ 674)
- Retaining certain administrative powers, such as the power to deal with trust assets for less than full consideration, the power to substitute assets of equal value, the power to borrow from the trust (§ 675)
- Retaining a power to revoke (§ 676)
- Retaining a right to income in the grantor or the grantor's spouse (§ 677).

It may be noted that many of these retained powers are similar to the powers that will cause estate tax inclusion under IRC §§ 2036 and 2038. However, as tax lawyers and accountants were quick to notice, the rules for estate inclusion and the rules making the Trustmaker the Owner for income tax purposes were not identical. It is therefore possible to create a trust which is outside

¹ Another, and later, approach was to compress the brackets for trust income, so that the top marginal rate is reached at a much lower level of income. It has been argued that this change, among others, has eliminated the need for the grantor trust rules. Mark L. Ascher, *The Grantor Trust Rules Should Be Repealed*, 96 *Iowa Law Review* 885 (2011)

the estate of the Trustmaker, but in which the Trustmaker or a Donor is deemed to be the Owner.

There are several advantages to this sort of trust:

- Given the compressed brackets, the Trustmaker will likely pay taxes at a lower rate than the Trustee.
- If the Trustmaker does not have access to trust funds, taxes will have to be paid out of other assets, thereby reducing the taxable estate, and effectively making a tax-free gift to the beneficiaries.
- Because the IRS generally ignores transactions between an individual and himself or herself, the Trustmaker can engage in any number of tax-free transactions with a GDOT. For example, an insurance policy owned by the Trustmaker can be purchased by a grantor ILIT without running afoul of the transfer for value rules.

It is said that all good things must end. Upon the death of the Trustmaker, the benefits of a trust in which the Trustmaker is the Deemed Owner stop. The trust is then taxed according to the normal principles of Subchapter J, including the compressed tax brackets. There is, however, another section of the grantor trust rules that can provide relief. IRC §678 provides that the trust beneficiary, rather than the Trustmaker or Donor, may, under some circumstances be treated as the Deemed Owner. It provides:

(a) General rule

A person other than the grantor shall be treated as the owner of any portion of a trust with respect to which:

- (1) such person has a power exercisable solely by himself to vest the corpus or the income therefrom in himself, or
- (2) such person has previously partially released or otherwise modified such a power and after the release or modification retains such control as would, within the principles of sections [671](#) to [677](#), inclusive, subject to grantor of a trust to treatment as the owner thereof.

As the title to § 678(a) suggests, there are exceptions² which I shall not discuss here. The power to vest described in §678(a) is essentially a general power of appointment. However, §671 makes clear that the beneficiary is the deemed owner of only that portion of income or principal to which the power applies.³ This means that a Trustmaker can be very selective as to which items of income will be taxable to a beneficiary. It may be that the Trustmaker only wants the beneficiary to be responsible for taxes on retirement plan income, or even income from a particular IRA. The Trustmaker could also provide for cascading powers to vest, both to ensure that all desired income is taxable to the beneficiary, and to establish a priority for which items of income will pass first.

Because trust terms generally control the determination of what is income and what is principal, the trust can provide that capital gains will be treated as income and taxed to the beneficiary, whether or not the gains are actually distributed. This is one of the key differences between the BDOT strategy, and other techniques for achieving tax efficiency by transferring the tax obligation to an individual. The distribution strategies require that the income actually be distributed in order to obtain the benefit; the BDOT strategy provides the tax benefit while permitting accumulation, and providing for continued creditor protection, asset management, and the other benefits for which the trust was created.

In the interest of creditor protection, it may be desirable to put another restriction on the power to vest. Because a creditor can reach any asset within the scope of a general power of

² The beneficiary is not treated as the Owner if the Trustmaker can also be treated as the owner (§678(b)); §678(a) is not applicable to a power that only lets the beneficiary satisfy an obligation of support (§678(c); and § 678(a) will not apply to a power that has been renounced or disclaimed within a reasonable time (§ 678(d)).

³ The Code itself does not provide much guidance on this point, but the regulations at Reg. 1.671-3(a) et seq. provide numerous illustrations and hypotheticals to clarify the meaning .

appointment, the Trustmaker may wish to limit the exercise of that power. So, for example, the power to vest might lapse after a certain period of time. It would then function essentially like a Crummey power. In order to assure that the beneficiary is the Owner of the income, it would probably be necessary to provide that the power to vest not lapse until December 31 of the tax year.

If flexibility is desired, a trust protector or some independent person could be given the power to suspend or modify the power to vest.

In conclusion, the BDOT is a tool that should be in the toolbox of anyone who does income tax planning for trusts, especially in light of the tax regimen imposed by the Affordable Care Act. But the window of opportunity may be closing. The 2015 Green Book would eliminate the gap between estate tax inclusion and income taxation to the Trustmaker: any trust for which income is taxed to the Trustmaker would be included in the Trustmaker's estate. In addition, as of January 2, 2014, questions involving § 678 are in "No Ruling" status. See Rev. Proc. 2014-3. This usually indicates that greater IRS scrutiny is anticipated, and that further regulation, or changes in the law or its interpretation may be expected.