Unraveling Trusts: Grantor Trusts and The Reciprocal Trust Doctrine

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I. IN GENERAL

A. All trusts have:

1. Grantor
2. Trustee
3. Beneficiary

B. Grantor Trusts are trusts in which the grantor retains enough control (as determined by the IRS) over the trust for the grantor to still be treated as the owner of the trust for federal income tax purposes.

C. Reciprocal Trusts are trusts that are created around the same time and with similar terms: the grantor of trust A is the beneficiary of trust B, and vice versa – the law operates to make the grantor of trust A also the beneficiary of trust A.

II. GRANTOR TRUSTS

A. General Rule:

1. IRC Section 671 provides, in part, that if the grantor is treated as the owner of any portion of a trust, then there shall be included in computing the taxable income and credits of the grantor those items of income, deductions, and credits against tax of the trust which are attributable to that portion of the trust.

   i. A transfer between a grantor and a grantor trust is ignored for federal income tax purposes.

2. Section 674(a) provides that the grantor shall be treated as the owner of any portion of a trust in respect of which the beneficial enjoyment of the corpus or the income therefrom is subject to a power of disposition, exercisable by the grantor or a nonadverse party, or both, without the approval or consent of any adverse party.

3. "Adverse Party" and "Nonadverse Party" definitions.

   i. Section 672(a) provides that the term "adverse party" means any person having a substantial beneficial interest in the trust which would be adversely affected by the exercise or non-exercise of the power which he possesses respecting the trust.

   ii. Section 672(b) provides that the term "nonadverse party" means any person who is not an adverse party.

   iii. Section 1.672(a)-1(a) of the Income Tax Regulations provides that a trustee is not an adverse party merely because of his interest as trustee.

iv. Section 1.672(a)-1(a) of the Income Tax Regulations provides that a beneficial interest is a substantial interest if its value in relation to the total value of the property subject to the power is not insignificant.

v. A contingent beneficial interest is not automatically insignificant because it is contingent.[1] When the relevant contingency is the death of another individual, courts have looked at the relative ages of the current and future beneficiaries to determine the likelihood that the contingent interest would vest in determining if the contingent interest is insignificant.[2]

vi. For example, in Joseloff v. Comm'r,[3] a contingent remainder interest would only vest if the holder of such interest survived both of her daughters and their issue. The holder of the contingent interest was 44 years old and her daughters were 13 and 11. The court determined that the contingent remainder was too remote to have any substantial value.

B. Most common powers that cause a trust to be a grantor trust:

1. Loans to grantor without adequate interest or security under IRC Section 675(2)

2. Power to add charitable beneficiary under Section 674(b)(5) flush

3. Power to reacquire trust corpus by substituting other property of an equivalent value under Section 675(4)(C) ("Swap power")

i. Near death swap to take advantage of Section 1014 step-up or step-down

ii. Control cash flow

iii. Avoid 3-year rule – grantor owns insurance policy outright, not expected to live for 3 years, swap policy into grantor trust

a. ILITs are commonly grantor trusts to avoid transfer for value rules

[1] *See* Treas. Reg. Sec. 1.672(a)-1(d) which describes a contingent remainder beneficiary as being an adverse party in the example in the regulation.

[2] Chase Nat'l Bank v. Comm'r, 225 F.2d 621 (8th Cir. 1955); Comm'r v. Katz, 139 F.2d 107, 31 AFTR 1008 (7th Cir. 1943); Comm'r v. Caspersen, 119 F2d 94, 27 AFTR 48 (3rd Cir. 1941); Loeb v. Comm'r, 113 F2d 664, 25 AFTR 443 (2nd Cir. 1940); Fulham v. Comm'r, 110 F2d 916; 24 AFTR 812 (1st Cir. 1940); Holt v. United States, 669 F.Supp 751, 60 AFTR 2d 87-5544 (W.D.V.A. 1987); Joseloff v. Comm'r, 8 T.C. 213 (1947); Savage v. Comm'r, 4 T.C. 286 (1944); Crossett v. United States, 30 F Supp 802, 24 AFTR 322 (Ct. Cl. 1940).

[3] 8 T.C. 213 (1947).

C. <u>Others powers that cause a trust to be taxed as a Grantor trust</u>:

1. Section 675 administrative powers

   i. IRC Section 675(1): Power to purchase, exchange, or otherwise dispose of or deal with trust corpus or income for less than full and adequate consideration

   ii. Section 675(2): Power to borrow without adequate interest or security – mentioned above

   iii. Section 675(3): Borrowing of the trust funds

      a. If not repaid by beginning of taxable year, then trust is treated as a grantor trust for that year

   iv. General powers of administration under Section 675(4) – exercisable in a non-fiduciary capacity by any person without approval or consent of any person in a fiduciary capacity

      a. Power to vote or direct the vote of certain stock

      b. Power to control investment of trust funds

      c. Swap power

2. Section 676 power to revoke, exercisable by a grantor or a non-adverse party

3. Section 677 income for benefit of grantor or wife – if income can, at the direction of grantor or a non-adverse party, be:

   i. Distributed to grantor or spouse

   ii. Held or accumulated for future distribution to grantor or spouse

   iii. Used to purchase life insurance on grantor or spouse

4. Persons other than grantor treated as substantial owner (Section 678)

   i. If person has power exercisable solely by himself to vest the corpus or income in himself

   ii. Useful if beneficiary is in substantially lower income tax bracket than grantor

D. **Exceptions to the General Rule**

1. Result: not a Grantor trust

2. Exceptions in Section 674(b)

   i. Section 674(b)(1) – power to apply income to support of a dependent

   ii. Section 674(b)(2) – power affecting beneficial enjoyment only after occurrence of event

   iii. Section 674(b)(3) – power exercisable only by will

   iv. Section 674(b)(4) – power to allocate among charitable beneficiaries

   v. Section 674(b)(5)(B) – power to distribute corpus to or for an current income beneficiary

      a. Exception resulting in grantor trust treatment: if any person has a power to add to the beneficiaries or class of beneficiaries

   vi. Section 674(b)(6) – power to withhold income temporarily

   vii. Section 674(b)(7) – power to withhold income during disability of a beneficiary

   viii. Section 674(b)(8) – power to allocate between corpus and income

   ix. Section 674(b)(5)(A) provides that Section 674(a) shall not apply to "[a] power to distribute <u>corpus</u> . . . to or for a beneficiary or beneficiaries or to or for a class of beneficiaries . . . provided that the power is limited by a <u>reasonably definite standard</u> which is set forth in the trust instrument".

      a. Sidebar: the reasonably definite standard

         1. Broader than the ascertainable standard of health, education, maintenance, and support

         2. Section 1.674(a)-1(b)(5)(i) of the Income Tax Regulations provides the following with respect to defining a reasonably definite standard and determining if a power is subject to a reasonably definite standard:

            i. ". . . A clearly measureable standard under which the holder of a power is legally accountable is deemed a reasonably definite standard for this

> purpose. For instance, a power to distribute corpus for the education, support, maintenance, or health of the beneficiary; for his reasonable support and comfort; or to enable him to maintain his accustomed standard of living; or to meet an emergency, would be limited by a reasonably definite standard. However, a power to distribute corpus for the pleasure, desire, or happiness of a beneficiary is not limited by a reasonably definite standard."

E. <u>Other exceptions causing no grantor trust treatment:</u>

1. Section 674(c) – powers of independent trustee to distribute income or corpus

   i. Does not include power to add to class of beneficiaries

2. Section 674(d) provides that Section 674(a) "shall not apply to a power solely exercisable (without the approval or consent of any other person) by a trustee or trustees, none of which is the grantor or spouse living with the grantor, to distribute, apportion, or accumulate <u>income</u> to or for a beneficiary or beneficiaries, . . . if such power is limited by a <u>reasonably definite *external* standard</u> which is set forth in the trust instrument".

   i. Section 1.674(d)-1 of the Income Tax Regulations refers to Treas. Reg. Section 1.674(a)-1(b)(5)(i) for purposes of determining what constitutes a reasonably definite external standard for purposes of Section 674(d).

F. <u>Toggling of grantor trust status:</u>

1. You can turn grantor trust status off and on, but Notice 2007-73 says that this toggling is a "transaction of interest" that requires disclosure to the IRS

2. Can toggle by releasing a power, or by taking affirmative action (i.e. adding spouse to class of beneficiaries)

G. <u>Exceptions to the Exceptions to the General Rule:</u>

1. Result: Grantor trust

2. Reasonably definite standard exception: Section 1.674(a)-1(b)(5)(i) "The entire context of a provision of a trust instrument granting a power must be considered in determining whether the power is limited by a reasonably definite standard. For example, if a trust instrument provides that the determination of the trustee shall be <u>conclusive</u> with respect to the exercise or non-exercise of a power, the power is <u>not</u> limited by a reasonably definite standard. . . ."

H. Uses of Grantor Trusts:

1. Way to gift your limit per year, but, by giving that amount to a grantor trust (the beneficiary of which is a child), the grantor can also pay tax on the gift (thereby having the effect of increasing the amount of the gift).

2. One example: GRATs – Grantor Retained Annuity Trust

   i. Authority: Statutorily governed under IRC Section 2702 and Treas. Reg. Section 25.2702-3

   ii. Process: A donor sets up a GRAT by making a gift into a trust. The trust is set up as an annuity whereby the grantor (and no one else) receives an annual payment from the trust for a fixed period of time. At the end of the term, any remaining value in the trust is passed on to a beneficiary of the trust. The annuity is a "qualified interest" under IRC Section 2702(b). In general, a "qualified interest" is any interest which consists of the right to receive fixed amounts payable not less frequently than annually, or any interest which consists of the right to receive amounts which are payable not less frequently than annually and are a fixed percentage of the fair market value of the property in the trust (determined annually).

      a. Does not have to be same annuity amount every year, but yearly payment may not exceed 120% of the amount payable in prior year.

      b. Cannot prepay

      c. Cannot make additions once funded (but you can swap)

   iii. The present value of this gift for gift tax purposes is usually zero because the gift value is equal to the initial contribution, plus a reasonable rate of interest (120% of federal mid-term rate, i.e. the Section 7520 rate), minus the scheduled annuity payments. However, you can make use of some gift tax exemption, or pay gift tax on the amount transferred if you give more to the GRAT.

   iv. Benefit: Because of its status as a grantor trust, the grantor remains responsible for any income taxes generated by the assets of the trust. Therefore, the assets held in the GRAT itself are not eroded by income and capital gains tax making it easier to outperform the Section 7520 hurdle.

v. <u>Bets/Risks:</u>

a. If a grantor dies before the trust period ends, the assets in the GRAT are included in the grantor's estate by operation of IRC Sections 2036 or 2039, eliminating any potential gift tax benefit; this is the GRAT's main weakness.

1. Can purchase term life insurance to offset some risk and help pay any estate taxes

b. GRAT will produce enough income to pay annuity.

1. A note, other debt instrument, option, or similar financial arrangement may <u>not</u> be used, directly or indirectly, to pay the annuity amount. Treas. Reg. Section 25.2702-3(b)(1)(i)

2. Also consider funding with enough cash to pay first year of annuity

c. <u>Rate of return:</u>

1. The Section 7520 rate essentially provides a "hurdle" which is necessary for the trust assets to overcome in order for the GRAT to be effective.

2. If the actual rate of return exceeds the Section 7520 rate, the remainder passes to the beneficiaries free of estate or gift tax.

3. If the actual rate of return does not exceed the Section 7520 rate, then the GRAT unwinds and the grantor is in the same position as if he had never set up the GRAT, less transaction costs.

vi. <u>When to consider:</u>

a. Assets that are expected to highly appreciate

1. Race horses

2. Stock in a company expected to go public

b. Minimize transfer taxes

3. Another Example: Sales to IDGTs – Intentionally Defective Grantor Trusts

i. Authority:

a. Creature of case law

b. Purposefully drafted to invoke grantor trust rules (i.e. grantor = owner of trust assets)

1. Called "defective" because it used to not be desirable to invoke grantor trust treatment because grantor would be hit with income tax bill for income he did not receive

2. Called "intentional" because trust includes one or more powers to invoke grantor trust treatment

c. Trust is irrevocable

d. Tool used to freeze assets for estate tax (not income tax) purposes

ii. Benefits: assets in an IDGT can grow unreduced by income taxes (i.e. the payment of taxes by the grantor is a tax-free gift to the beneficiaries) and corpus is not included in gross estate

a. The main benefit of the IDGT is that, if drafted properly, the trust assets can pass to the beneficiaries free from the estate tax at the grantor's death, as well as free from generation-skipping transfer taxes.

iii. Process: Sale to IDGT

a. Typically, the grantor funds the trust as an initial gift with sufficient cash for a down payment (usually 10%) to be made back to the grantor as part of the purchase price for certain highly appreciable assets, with the grantor taking a promissory note for the balance secured by the assets sold to the trust. The note can provide for payments of interest only, on at least an annual basis. The payments generally are made for a specified term of years, with a balloon payment of principal at the end of the specified term, and a right to prepay the balance at any time without penalty.

b. Because grantor and IDGT are treated as one person under federal income tax rules, any interest payments on a promissory note from the IDGT to the Grantor are not subject to income tax

c. Note will pay enough interest to classify it as not below-market, but assets are expected to appreciate at a faster rate

d. After note paid off, good idea to terminate IDGT

iv. Bets/Risks:

a. Not statutorily authorized (just a creature of case law) – some uncertainty exists in tax treatment if grantor dies before note is paid

b. Recharacterization of sale as an annuity not meeting requirements of Section 2702 or a retailed life interest under Section 2036

c. Arms-length sale

1. The grantor should not be the trustee of the IDGT, be in a position to make decisions regarding the trust's participation in the transaction or make decisions regarding payments of interest or principal on the note. The interest rate on the promissory note should not be tied in any manner to the income produced from the assets sold to the IDGT or any other trust assets.

2. Security for sale of assets or personal guarantee of debt to bolster sale treatment.

3. FMV sale - IDGT the risk is the initial valuation and the gift tax consequences

d. Rate of return: must be at least AFR for the applicable period of the note

I. IDGT v. GRAT

1. GST:

i. GRATs not favorable for GST tax planning because GST exemption not allocated until grantor's interest in GRAT terminates (not when GRAT is funded)

ii. Can allocate GST exemption to IDGT at time of funding, and all post-funding appreciation can grow under the initial allocation

2. When complete:

i. GRAT is completed gift at time of funding

a. Take a stand on valuation at time of funding and on gift tax return (recommended even if zero-out GRAT)

ii. IDGT has annual payments until note paid, arguably can be audited until note is satisfied and valuation or sale challenged by IRS

3. Valuation:

i. GRAT needs an appraisal of initial amount contributed – can be tricky/time consuming if valuing FLP units or other hard to value assets

ii. IDGT valuation is typically a valuation of cash

a. Can disclose a zero-value gift on gift tax return to start the statute, but not necessary if appraisal shows a FMV purchase price for the assets

4. If grantor dies during term – clarity of tax treatment

i. GRAT – estate tax inclusion of all remaining trust property – this is clear

ii. IDGT – estate tax inclusion of balance of promissory note (but asset appreciation is untaxed) – but this is unclear

a. Commentators disagree as to whether the deemed sale takes place immediately before or immediately after the grantor's death.

1. If the sale is deemed to have occurred immediately before the grantor's death, gain may be realized to the extent the note balance exceeds the seller's basis in the assets sold. The assets deemed sold would receive a new income tax basis equal to the balance due on the note.

2. On the other hand, If the transfer is deemed to have occurred immediately after death, the assets would have to be considered owned by the grantor at death and therefore the amount due on the note would be entitled to a step-up in basis under Section 1014(a).

b. It also is possible that there are no income tax consequences if the grantor dies while the note remains outstanding. Because the sale is ignored for income tax purposes, the grantor's death may only cause the note to be included in his or her gross estate, without triggering any income tax consequences. However, the lack of clarity on this issue underscores the necessity of extinguishing the note prior to the grantor's death. Remember – you can pre-pay.

5. Rates of return:

   i. GRAT requires 120% of mid-term rate

   ii. IDGT is AFR of the term (short, mid, or long, so could be less than 120% of mid-term)

6. Future of grantor trusts

   i. The use of GRATs and sales of IDGTs is useful mainly to taxable estates – in 2015, a married couple will have a $10,860,000 unified credit, and the per year gift exclusion is $14,000 – as long as the combined federal and state estate taxes exceeds a grantor's combined federal and state income taxes, then grantor trusts remain a useful estate freeze tool

   ii. Since 2012, Obama has proposed legislation that would eliminate the benefits of a sale to a grantor trust by deeming that the portion of the trust attributable to the property received by the trust in the transaction:

      a. Will be subject to estate tax (gross estate inclusion);

      b. Will be treated as a gift by the deemed owner to the extent distributions are made to beneficiaries during the grantor's life; and

      c. Will be subject to gift tax when grantor trust status turned off.

   iii. Proposal would apply to all transactions/sales to grantor trusts after the date enacted (no grandfathering)

   iv. Obama also has a proposal to eliminate many of the benefits of a GRAT by:

      a. Requiring that a GRAT must have a remainder value (i.e. eliminating the zeroed-out GRAT concept);

      b. Prohibiting a decrease in annuity amount over the GRAT term; and

      c. Increasing the minimum GRAT term for 2 years to 10 years.

   v. Proposal would apply on a prospective basis (i.e. current GRATs would be grandfathered)

III. RECIPROCAL TRUSTS

A. In general: The reciprocal trust doctrine is a judicially created doctrine that developed in response to the potential for gift and estate tax abuse when two transferors create trusts for each other. At its heart, the doctrine seeks to reveal collusive transfers to trusts that would otherwise avoid taxation under the literal language of the tax laws. The remedy for reciprocal trusts is to "uncross" the trusts and treat the taxpayer as the transferor of the trust for his or her benefit.

B. Benefit: take assets out of gross estate

C. Example:

1. The reciprocal trust doctrine would be applicable in the following situation: Individual A sets up a trust, funds it with $100 and names himself as a beneficiary during his lifetime. The trust's assets will be included in his estate at his death and subject to estate tax because A is both a grantor of the trust and a beneficiary of the trust. Alternatively, A could set up a trust, fund it with $100 and name B as the beneficiary during B's lifetime while at the same time B would set up a trust, fund it with $100 and name A as the beneficiary during A's lifetime. This leaves A in the same economic position has in the original scenario. If this structure in the second scenario were accepted, none of the assets in either trust would be included in A's estate for estate tax purposes because A would not be both a grantor and a beneficiary with respect to either trust. The IRS, however, would use the reciprocal trust doctrine to say that A is the grantor of the trust benefitting A, causing the trust to be included in A's estate just as in the original scenario.

D. Common Law and background

1. Grace

   i. Though federal case law regarding the reciprocal trust doctrine began as early as 1940, its development in the years since has been sparse, leaving little guidance on how to determine whether trusts fall outside of reciprocal trust treatment.

   ii. The standard set by the Supreme Court in Estate of Grace is an "interrelatedness" test that examines whether the mutual trust arrangement "leaves the [grantors] in approximately the same economic position as they would have been in had they created trusts naming themselves as . . . beneficiaries."

2. Post-Grace and Extension of Reciprocal Trust Doctrine to Trust Powers

   i. The Grace case involved reciprocal interests rather than powers. After Grace, the reciprocal trust doctrine continued to generate substantial controversy, including the question of whether transferors must have beneficial interests in the trust at issue for the doctrine to be applied. Subsequent cases have differed regarding whether the reciprocal trust doctrine also applies to powers that would cause estate inclusion under IRC Sections 2036(a)(2) or 2038.

3. Reciprocal Trust Doctrine Does Not Extend to Non-Transferors

i. There have been no cases or revenue rulings that stand for (or even address) the proposition that the reciprocal trust doctrine should apply to persons who were not the transferors of the property at issue.

a. There is, however, one Private Letter Ruling that does so extend the reciprocal trust doctrine; but, subsequent treatment of the PLR has not been positive and the IRS has seemed to back away from this position in subsequent PLRs

E. When does this come up?

1. Attributing gifts

2. Estate inclusion

3. End of 2012 - SLATs (Spousal Lifetime Access Trusts) and IDGTs

IV. RECIPROCAL TRUST DOCTRINE AND GRANTOR TRUSTS

A. Krause

1. Krause v. Comm'r[4] is in one of a series of cases that address both grantor trust status and the reciprocal trust doctrine.[5] In Krause, the trusts were interrelated. All of the trusts were created on the same day, had the same trustees, and contained identical provisions. The primary beneficiaries were the natural objects

[4] 57 T.C. 890 (1973), aff'd, 497 F. 2d 1109 (6th Cir. 1974), *cert. denied* 419 US 1108 (1975); See also PLR 8813039.

[5] See Estate of Newberry v. Comm'r, 17 T.C. 597 (1951), *rev'd* 201 F. 2d 874 (3d Cir. 1953) (husband and wife created reciprocal trusts, had power to change beneficiaries, power sufficient to warrant estate inclusion); Tobin v. Comm'r, 11 T.C. 928 (1948), *rev'd in part* 183 F. 2d 919 (5th Cir. 1950); Haldeman v. Comm'r, 6 T.C. 345 (1946) (husband and wife, separately created five family trusts, in each of which one or the other was the trustee and their minor daughter or the wife the primary or the secondary beneficiary, trustees had powers of management and control in excess of normal fiduciary authority; held each is taxable upon the income of the trusts controlled by him); Wieboldt v. Comm'r, 5 T.C. 946 (1945) (husband and wife each created a trust naming their children beneficiaries, gave spouse power to alter, amend, or terminate, and the right to direct a corporate trustee as to the sale, retention, or reinvestment of trust properties; trusts created within 13 days of each other, of practically the same value, and contained substantially the same terms and conditions; held, the respective petitioners are taxable on the income from the trust nominally created by the other).

of the grantor's bounty. However, each trust contained provisions permitting the trustees to pay the accumulated income and corpus to the grantor's spouse. It is therefore apparent that, though the grantors mutually desired to make provision for their children and grandchildren, they did not wish such provision to separate them irrevocably from financial security — thus, the "crossed" power to aid each other. As a result the grantors maintained the same economic position throughout the entire transaction.

2. The court applied the reciprocal trust doctrine "only so [the court could] determine whether in fact petitioners are taxable under the grantor trust provisions." Having applied the reciprocal trust doctrine to treat each grantor as the grantor of the trust created by his or her spouse, the court then turned to determining the grantor trust status of the trust.

3. The Krause court saw the reciprocal trust doctrine as a threshold to determine, or a necessary step to untangle the trust ownership in that case. Application of the doctrine allowed the court to determine that the trusts were grantor trusts by determining the "true" transferor of the trusts at issue, then applying the grantor trust rules.

B. Argument that IRS has **abandoned the reciprocal trust doctrine** for grantor trust purposes

1. Jonathan Blattmachr argues that Treas. Reg. Section 1.671-2(e)(1) shows that the IRS has abandoned the application of the reciprocal trust doctrine for grantor trust purposes.

   i. That regulation provides: "If a person creates or funds a trust on behalf of another person, both persons are treated as grantors of the trust . . . [a] person who funds a trust with an amount that is directly reimbursed to such person within a reasonable period of time and who makes no other transfers to the trust that constitute gratuitous transfers is not treated as an owner of any portion of the trust under" the grantor trust rules.

   ii. Under this regulation, the person who makes the reimbursement is the trust's owner for grantor trust purposes (Treas. Reg. Section 1.671-2(e)(6) ex. 3). Thus, unless the person who creates the trust receives a "direct reimbursement," the creator of the trust is treated as the grantor.

   iii. His argument is further discussed here: https://www.cfsarasota.org/Portals/0/Uploads/Documents/Plan/SuperChargedCreditShelterTrust.pdf.