



WRMarketplace

An AALU Washington Report

The WRMarketplace is created exclusively for AALU members by experts at Greenberg Traurig and the AALU staff, led by **Jonathan M. Forster, Steven B. Lapidus, Martin Kalb, Richard A. Sirius, and Rebecca S. Manicone**. WR Marketplace #18-15 was written by **Jonathan M. Forster, Shareholder, and Jennifer M. Smith, Associate, Greenberg Traurig, LLP**.

The AALU WR Newswire and WR Marketplace are published by the AALU as part of the Essential Wisdom Series, the trusted source of actionable technical and marketplace knowledge for AALU members—the nation’s most advanced life insurance professionals.

Thursday, 10 May 2018

WRM #18-15

TOPIC: Flipping the Script: Nongrantor Trusts with Grantor Trust Benefits – Can It Be Done?

MARKET TREND: New tax rules mean new approaches and opportunities for irrevocable trust planning.

SYNOPSIS: Grantor trusts, which tax the trust’s income to the trust creator (“donor”), have long been a planning mainstay, as they can enhance growth in the trust and offer significant flexibility in transactional planning with the donor. As discussed in WRMarketplace No. 18-03, however, new limits on tax deductions, including for state and local taxes, may generate greater tax burdens for donors of grantor trusts, making them less efficient. Accordingly, there is a renewed interest in nongrantor trusts, which not only bear their own tax burden but also receive a separate set of deductions. Donors choosing nongrantor trusts, however, may still want the benefits and flexibility afforded by many common grantor trust provisions, such as the power to benefit the donor’s spouse, pay premiums on life insurance on the donor or donor’s spouse, or substitute trust assets with other assets of equivalent value.

TAKE-AWAYS: With careful planning, donors of nongrantor trusts can achieve benefits similar to those provided by typical grantor trust provisions without triggering grantor trust status. For example, the trust can require the prior consent of an adverse

party for distributions to the donor’s spouse or a fiduciary’s consent to a donor’s exercise of a nonfiduciary substitution power. Implementation of these provisions involves far more “moving parts,” however, so proper trust administration is critical to preserving nongrantor status.

As discussed in WRMarketplace No. 18-03, tax reform has altered the tax consequences and economics of irrevocable trust planning, creating renewed interest in nongrantor trusts. While grantor trusts offer significant planning flexibility (as transactions between the donor and the trust are disregarded for income tax purposes, a spouse can benefit from the trust, and the donor can hold a power to substitute trust assets for assets of equivalent value), whether a grantor or nongrantor trust makes sense will ultimately depend on numerous factors and projections unique to a donor’s circumstances. Donors opting for nongrantor trusts, however, may still be able to achieve much of the flexibility associated with desirable grantor trust features.

GRANTOR TRUSTS – FEATURES WE LIKE

The so-called “grantor trust rules” in Internal Revenue Code (“Code”) §§ 671-679 set out the rights and powers that result in grantor trust status. Several of these powers also can be beneficial for trust disposition, management, and/or administration:

Grantor Trust Feature	Potential Benefit
<p>Disregarded Transactions with Trust. Transactions between the donor and trust are disregarded for income tax purposes.</p>	<p>With disregarded transactions: (1) no taxes result from the donor’s sale of assets to the trust, (2) transfers of a life insurance policy on the donor’s life between the donor and trust are not “transfers for value,” and (3) interest paid by the trust to the donor on loans or installment sales is not taxable income to the donor.</p>
<p>Power to Pay Premiums. The power, without the consent of an adverse party¹ (“AP consent”) to use trust income to pay premiums on life insurance on the donor or donor’s spouse.²</p>	<p>Allows the trust to use its own income to “self-fund” premiums, possibly avoiding the need for annual “Crummey” gifts if the trust is funded with assets other than the policy.</p>
<p>Power to Benefit Donor’s Spouse. The power, without AP consent, to distribute or accumulate trust income for the donor spouse’s benefit.³</p>	<p>Permits creation of spousal lifetime access trusts, allowing the donor to make gifts without giving up complete access to the trust assets, if needed.</p>

Grantor Trust Feature	Potential Benefit
<p>Nonfiduciary Substitution Power. A power held by the donor or a nonadverse party⁴ to substitute trust assets with assets of equivalent value.⁵</p>	<p>Allows the donor to manage trust investment performance and facilitate basis management (e.g., can swap assets to lock-in gains or substitute high basis assets for low basis assets).</p>
<p>Power to Borrow without Adequate Interest or Security. The power of the donor to borrow from the trust, or a nonadverse party to loan to the donor from the trust, without adequate interest or security.⁶</p>	<p>Provides flexibility for the grantor to access trust assets if needed without meeting the typical requirements for taking out a commercial loan.⁷</p>

NONGRANTOR TRUSTS – THE ALTERNATIVES

While nongrantor trusts cannot incorporate every grantor trust feature “as is,” there are several alternatives that may help achieve some similar benefits in a nongrantor trust plan, including:

Grantor Trust Feature	Nongrantor Trust Alternative
<p>Disregarded Transactions with Trust</p>	<p>While transactions with the trust likely result in recognizable income/gain, the donor can consider a taxable installment sale to the trust, allowing for a basis step up in the asset sold while gaining deferral over the note term.⁸</p>
<p>Power to Pay Premiums</p>	<p>Trust income can be used to pay premiums with AP consent, or the trustee can use trust principal only to pay premiums.⁹</p>
<p>Power to Benefit Donor’s Spouse</p>	<p>A spouse can benefit from the trust with AP consent or as a permissible appointee of a lifetime limited power of appointment over the trust held by a person in a nonfiduciary capacity.</p>
<p>Nonfiduciary Substitution Power</p>	<p>A person can hold the power subject to the consent of a trust fiduciary (e.g., a trustee, trust protector, or other trust advisor treated as a fiduciary under the trust).¹⁰ The trust also can provide powers of appointment to</p>

Grantor Trust Feature	Nongrantor Trust Alternative
	beneficiaries to trigger estate inclusion for basis management purposes.
Power to Borrow without Adequate Interest or Security	The trustee can hold a general lending power to make loans to any person (including the donor) without regard to interest or security. ¹¹

BE CAREFUL OUT THERE

Generally, implementation of these planning alternatives will involve more detailed trust drafting and administrative complexity (e.g., obtaining AP consent for distributions to a spousal beneficiary), potentially leading to a number of traps for the unwary. Areas of caution include:¹²

Identifying an Adverse Party. Certain desirable grantor trust powers do not trigger grantor trust status if they require AP consent. For this purpose, an “adverse party” is a person who has a substantial (i.e., not insignificant) beneficial interest in the trust that would be adversely affected by the exercise or non-exercise of the power. There is no definitive guidance, however, on what represents a substantial beneficial interest (1%, 5%, 25%?) or the extent to which partial grantor trust status may result if a party is not considered adverse as to the entire trust (e.g., a beneficiary with a fixed or limited interest in the trust may only be adverse as to that portion).

- **Practice Point:** One option is to craft the trust by analogy to recent private letter rulings approving incomplete, nongrantor (“**ING**”) trusts, in which trust distributions required the consent of a distribution committee that included at least two trust beneficiaries.¹³ For even greater certainty, the trust could require the consent of all persons who may be adverse to the power, such as requiring all of a trust’s remainder beneficiaries to consent to a distribution to a spousal beneficiary.

Complying with Administrative Requirements. If, despite the terms of the trust, a trustee uses trust income to pay insurance premiums on the life of the donor or donor’s spouse, makes distributions to a donor’s spouse without obtaining AP consent, or makes loans to the donor without adequate interest or security, grantor trust status will be triggered. Further, grantor trust status can be triggered if the exercise of a general lending power is, in fact, intended or exclusively used to benefit only the donor. Accordingly, proper trust administration is critical to preserving nongrantor trust status.

Avoiding Crummey Powers. Even if a trust is a nongrantor trust with respect to the donor, Code §678 may treat a trust beneficiary who has a power to withdraw trust income or principal as the “grantor” of that portion of the trust for income tax purposes. That beneficiary would then be taxed on a pro rata portion of the trust’s income.¹⁴ Accordingly, to prevent the unintended taxation of trust beneficiaries, the donor may not want the trust to provide Crummey withdrawal powers.

- **Practice Point:** Irrevocable trusts often include Crummey withdrawal powers to qualify trust contributions for the annual gift tax exclusion. With the significantly higher federal gift tax exemption, however, donors may simply want to make gifts to the nongrantor trusts using that increased exemption. Such gifts would eliminate the need for, and administrative hassles associated with, Crummey powers (e.g., notifying trustees and beneficiaries of these powers upon each trust contribution).

CHANGING YOUR MIND - TOGGLING

Nongrantor trust agreements should incorporate the flexibility to adapt the trust's status to changing tax and economic circumstances, including the ability to "turn on" grantor trust status.¹⁵ To facilitate the conversion, the trust can appoint a trust protector who has the authority to grant a nonfiduciary power of substitution to the donor or to grant a power to a nonadverse party to make loans from the trust to the donor without adequate interest.¹⁶

TAKE-AWAYS

With careful planning, donors of nongrantor trusts can achieve many of the same benefits associated with typical grantor trust provisions without triggering grantor trust status. For example, the trust can require the consent of an adverse party to make distributions to the donor's spouse or the consent of a fiduciary to the donor's exercise of a nonfiduciary substitution power. As implementation of these provisions involves far more "moving parts," however, proper trust administration is critical to preserving nongrantor trust status.

NOTES

¹ For purposes of the grantor trust rules, an "adverse party" is a person who has a substantial beneficial interest (that is, an interest that is not insignificant) in the trust that would be adversely affected by the exercise or non-exercise of the power in question. A current beneficiary of the trust typically would be an adverse party. See Code §672(a).

² Code §677(a)(3).

³ Code §677(a)(1).

⁴ A "nonadverse party" means anyone who is not an adverse party (generally a third party who has no current or future beneficial interest in the trust) (Code § 672(b)).

⁵ Code §675(4). See Rev Rul. 2008-22 and Rev. Rul. 2011-28 for IRS guidance on including this power in an irrevocable trust without inadvertently triggering estate tax inclusion of the trust assets in the grantor's estate.

⁶ Code §675(2). Note that the power to lend to the grantor, or for the grantor to borrow, does not trigger grantor trust status if the loan is made as part of a general power to lend to any person without regard to interest or security

⁷ The loan should provide for adequate interest (i.e., at the applicable federal rate) to avoid potential gift and estate tax issues.

⁸ The transaction will be subject to, and must comply with, the installment sale and related party rules under Code §453.

⁹ The nongrantor trust will require careful drafting and administration to ensure premium payments cannot and do not come from trust income, whether currently held or accumulated and added to principal.

¹⁰ Consider that a person in a fiduciary capacity may have a desire to approve or use the substitution power to manage the manage basis of trust assets for income tax purposes.

¹¹ To avoid triggering grantor trust status, however, any trust loan to the grantor must be completely repaid (including any interest) before the beginning of the taxable year unless the loan provides for adequate interest and security.

¹² See LISI Income Tax Planning Newsletter #139 (April 23, 2018) (<http://www.leimbergservices.com>) for a detailed discussion of AP consent issues (and potential solutions) and trust administration requirements.

¹³ See *WRMarketplaces Nos. 16-36* and *17-05* for a more detailed discussion of ING trusts. The distribution committee cannot mirror exactly these PLRs if the irrevocable trust is intended to remove the trust assets from the donor's estate, as ING trusts are designed to create incomplete gifts to the trust and will generally result in estate tax inclusion of the trust assets in the donor's estate.

¹⁴ Note that this Code section is often intentionally used in the creation of a beneficiary defective irrevocable trust (a "BDIT"), which effectively results in the beneficiary being treated as the grantor of the entire trust. See *WRMarketplace No. 15-32* for a discussion of BDITs.

¹⁵ Turning on grantor trust status should not trigger gain or otherwise be a taxable event. See CCA 200923024.

¹⁶ If the trust already includes a general power for the trustee to lend without adequate interest or security, this power should be automatically released if the trust protector appoints a nonadverse party to make such loans to the grantor.