WRMarketplace
An AALU Washington Report
Case Study Series

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TOPIC: Case Study Series: Grantor Trusts vs. Non-Grantor Trusts – Which and When?

MARKET TREND: While the popularity of grantor trusts has increased with the rise in income tax rates, non-grantor trusts still have a place in the estate planning process.

SYNOPSIS: Irrevocable trusts are frequently used to transfer family wealth to younger generations. Such trusts can be structured as either grantor or non-grantor trusts, where either the grantor pays the tax on trust income or the trust or its beneficiaries pay the tax. For clients able to bear the income tax burden, grantor trust status offers many benefits, including (1) constructive contributions to the trust through the payment of taxes on trust income, (2) indirect access to trust assets if the grantor's spouse is a trust beneficiary, and (3) flexibility for future estate planning approaches using installment sales and loans. Non-grantor trusts, on the other hand, relieve the grantor of the burden of the trust's income tax liability, and, if trust income is distributed to the beneficiaries, it may be taxed at lower rates, if the beneficiaries are in lower tax brackets. Careful planning is required to determine and establish the most appropriate tax status for an irrevocable trust.

TAKE AWAYS: Grantor trust status can enhance trust growth and provide flexibility needed for other income and wealth transfer planning. However, it should only be used when the client has the ability to pay the income tax liability *without relying on the trust for reimbursements. Non-grantor trust status may be appropriate where no further planning is anticipated or desired, if the client is unable or unwilling to bear the income tax liability, or if the beneficiaries are in lower income tax brackets. Both grantor and non-grantor trusts require careful navigation of the grantor trust rules to achieve the desired results.*

PRIOR REPORTS: 16-15; 13-18.

Irrevocable trusts are an efficient tool for passing family assets to the next generation while simultaneously providing asset protection, avoiding fractionalization of asset ownership, and providing continued unified asset management. Structuring the irrevocable trust will require the client to determine whether the trust should be a "**grantor trust**" or a "**non-grantor trust**" for income tax purposes. This case study compares the income tax treatment of grantor and non-grantor trusts and some of the factors that should be considered when selecting between them.

SOME BACKGROUND: GRANTOR VS. NON-GRANTOR TRUSTS

It is important to understand that the classification of a trust as non-grantor or grantor for federal income tax purposes does not change the fact that income tax applies to the trust's income. The main difference in the classifications is who must report and pay that income tax liability:

- *Non-Grantor Trusts*. If a trust is classified as a non-grantor trust, the trust must report and pay federal income tax on the trust income (or potentially the trust beneficiaries, if income is distributed to them).[1] Under applicable federal income tax brackets for non-grantor trusts, the trust will reach the maximum federal income tax rate of 39.6% if it has income of $12,400 or more in 2016. The trust also will be subject to the 3.8% federal net investment income ("**NII**") tax, making the trust's top effective federal income tax rate 43.4%. Further, the trust will bear state income tax liability, if any, according to applicable state tax laws.

- *Grantor Trusts*. If the trust is classified as a grantor trust, the trust grantor(s), not the trust, report and pay the taxes on the trust's income, as determined using the grantor's individual federal income tax brackets and rates. Under the federal income tax brackets, the top 39.6% bracket applies at a higher level of taxable income for individuals than for non-grantor trusts (e.g., $466,950 for married, joint filers). Inclusion of the trust's income with the grantor's income, however, may make the grantor reach the top brackets more quickly. The grantor also will be subject to federal NII tax and state income tax (if applicable) on the reported income.

Grantor trust status results when the trust provides certain rights or powers, as set forth in IRC §§ 671-679 (the so-called "grantor trust rules"). Clients may desire some of these rights and powers in their irrevocable trusts to ensure flexibility to adapt to future circumstances. For example, clients worried about a future change in their economic circumstances may want the ability to borrow from the trust without having to provide adequate security or interest or may want to ensure security for a spouse by naming him or her as a trust beneficiary (e.g., in case the grantor becomes incapacitated). These rights, among others, can trigger grantor trust status.[2]

As the trust's tax status determines who reports and pays the income tax liability, it is important for clients to analyze and understand the potential impact to them and their trusts when selecting between a grantor or non-grantor trust.

CASE STUDY

Client Background – Meet Anne and Sam. Anne and Sam have been married for 30 years, have three children and four grandchildren, and their accumulated wealth is invested in marketable securities. Anne and Sam also are the sole members of Y Co., a limited liability company that owns and manages several office buildings in Seattle, Washington, which they believe will increase in value in the future. While they currently are residents of Washington, they expect to move to Southern California in the near future. It is anticipated that their children will continue to live in Washington.

Concerns. Anne and Sam want to give $10 million in securities to their descendants but are concerned about: (1) fractionalizing the ownership of the securities, (2) maintaining centralized asset management, and (3) the possibility of divorce or other creditor issues for their children. Accordingly, instead of outright gifts, Anne and Sam decided to give the $10 million in securities to an irrevocable trust benefiting their descendants. They also plan to give or sell membership interests in Y Co. to the trust in the future. Anne and Sam plan to create the trust in Washington and have it governed by Washington law, but they are considering whether the trust should be a grantor or non-grantor trust for income tax purposes.

Income Tax Issues. A key issue in Anne and Sam's decision regarding the tax status of the irrevocable trust is whether they personally will be able to bear the tax burden on the trust's income. They estimate that the trust assets will generate 5% income annually.

As noted above, if the trust is created as a non-grantor trust, it must pay federal income and NII tax on the trust income, at a top effective rate of 43.4%. Washington State, however, does not have a state income tax.

If, alternatively, Anne and Sam create a grantor trust and then move to California (as anticipated), Anne and Sam will pay the taxes on the trust's income at their normal federal and state income tax brackets and rates. Although the trust grows without tax reductions, Anne and Sam will now be subject to California state income tax at a top rate of 13.3%.[3] Accordingly, the top combined income tax rate on Anne and Sam's income, including income they must report from the grantor trust, could reach 56.7% (top rates of 39.6% for federal income tax, 3.8% for federal NII tax, and 13.3% for California income tax).

Assume that Anne and Sam create the trust in Washington and then move to California. The trust makes no distributions for 10 years and has a 5% annual return on its reinvested income. The chart below illustrates the value of the trust at the end of the 10-year period, comparing grantor versus non-grantor trust status.

	Non-Grantor Trust	Grantor Trust
Initial Trust Value	$10,000,000	$10,000,000
Income Tax Paid by Trust (10 Years)	$2,468,273	$0
Income Tax Paid by Grantors for Trust (10 Years)	$0	$3,127,766
Trust Value After 10 Years	$13,218,993	$16,288,946
Increase in Trust Value	$3,218,993	$6,288,946

As shown, if Anne and Sam use a grantor trust, the potential income tax liability attributable to the trust's income could be $650,000 more than incurred by the non-grantor trust, due largely to Anne and Sam's exposure to California income tax rates.[4] If Anne and Sam wish to create a grantor trust, they will need to review whether and how they can address this ongoing liability. However, if they use a non-grantor trust, it will result in $3 million less in trust value after the 10-year period, due to the trust's payment of the income tax liabilities.

Additional Considerations for Grantor and Non-Grantor Trusts. Anne and Sam also should consider the following when deciding on the trust's tax status:

- *Grantor Trusts:*
    - Anne and Sam's payment of the trust's income taxes allows them to make constructive additions to the trust, without additional gift tax.
    - A grantor and his or her grantor trust can engage in various transactions without triggering gain or income recognition, such as installment sales, loans, and life insurance split dollar arrangements. These transactions are disregarded for income tax purposes according to longstanding and appropriate tax principles.
    - If only one spouse creates the trust, the other can be a trust beneficiary, providing the family with access to trust income and principal, if needed.
    - Anne and Sam can have indirect access to trust assets if they have the power to borrow from the trust. Interest payments to the trust will be disregarded for income tax purposes according to longstanding and appropriate tax principles.
    - If a substitution power is used to establish grantor trust status, the power can be used to manage the basis of trust assets.[5]
    - The trust can give an independent trustee the discretion to reimburse Anne and Sam for trust income taxes. Anne and Sam, however, should be able to afford to pay these taxes without relying on reimbursement.[6]
    - Anne and Sam can include provisions in the trust that will allow the termination of grantor trust status if the tax burden to them becomes unsustainable.[7]

- *Non-Grantor Trusts:*
    - Anne and Sam will not bear the burden of paying taxes on trust income, which could result in lower overall taxes when they move to California.
    - If the trust distributes all income to the beneficiaries, that income will be taxed at the beneficiaries' income tax rates, which likely will be lower than the rates applicable to the trust or to Anne and Sam.
    - A spouse, however, cannot be a beneficiary of the trust if non-grantor status is desired, and the trust document must be carefully designed to avoid any other rights or powers that may trigger grantor trust status.

Making the Decision. Anne and Sam should review and balance the following factors with their advisors to achieve the best solution for them:

Points for Grantor Trust: (1) Anne and Sam want to optimize the trust's opportunities for growth, (2) they currently have sufficient other assets to cover the trust's income tax liability, (3) grantor trust status leaves the door open for future estate planning, including an installment sale of their interest in Y Co. to the trust without triggering capital gain on the sale or tax on note interest payments, (4) Anne and Sam can include provisions in the trust that will allow tax reimbursement (in the discretion of an independent trustee) or the termination of grantor trust status if Anne and Sam can no longer afford to pay the tax on trust income.

Points for Non-Grantor Trust: (1) Given Anne and Sam's planned relocation to California while their children remain in Washington, non-grantor trust treatment may result in lower overall income taxes, (2) the trust can provide for mandatory distributions of income to Anne and Sam's children, which could cause the income to be taxed at lower income tax rates and also provide the children with a source of income, and (3) while Anne and Sam can bear the trust's income taxes today, that could change in the future.

TAKE AWAYS

- Grantor trust status can enhance trust growth and provide flexibility needed for other income and wealth transfer planning. However, it should only be used when the client has the ability to pay the income tax liability without relying on the trust for reimbursements.

- Non-grantor trust status may be appropriate where no further planning is anticipated or desired, if the client is unable or unwilling to bear the income tax liability, or if the beneficiaries are in lower income tax brackets.

- Both grantor and non-grantor trusts require careful navigation of the grantor trust rules to achieve the desired results.

NOTES

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[1] See *WRMarketplace No. 15-36* for a discussion of the taxation of non-grantor trusts.

[2] See IRC §§ 671-679. The rights and powers most frequently used in irrevocable trusts to intentionally obtain grantor trust status include:

- The authority given to the grantor, exercisable in a nonfiduciary capacity and without the approval or consent of any person in a fiduciary capacity, to reacquire trust assets by substituting other property of equivalent value (a "substitution power"). IRC § 675(4).
- The authority given to the grantor in a non-fiduciary capacity to borrow the income or principal of the trust without adequate interest or security (a "borrowing power"). IRC § 675(2).
- The authority given to the trustee, without the approval or consent of an adverse party, to distribute trust income to the grantor's spouse (for example, where the grantor's spouse is one of the discretionary beneficiaries to whom the trustee may distribute income during the grantor's life). IRC § 677(a).

Grantor trusts typically employ several rights or powers to achieve grantor trust status. Trusts that are intended to have non-grantor trust status, on the other hand, must be carefully drafted to eliminate all of the powers and rights that can trigger grantor trust status.

[3] It is anticipated that Anne and Sam will fall into this tax bracket when they move to California.

[4] As the trust's income and deductions must be reported on Anne and Sam's personal tax returns as part of the calculation of their personal tax liability, Anne and Sam's specific exposure will depend on numerous factors, including the amount of their personal investment income and wages, available personal/itemized deductions, etc.

[5] *See AALU WRMarketplace No.* 2016-15.

[6] A trust tax reimbursement clause can trigger inclusion in the grantor's estate if it is not completely discretionary or if there is an understanding between the grantor and the person holding the power regarding the reimbursement.

[7] Note, however, that care must be taken in navigating the grantor trust rules to allow grantor trust treatment to be turned off if or when appropriate – that means being able to snip all of the strings that trigger grantor trust treatment. Termination of grantor trust status also should not require discretionary actions of the trustee, as this may violate the trustee's fiduciary duties to the trust beneficiaries.

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