

# IMPLICATIONS OF TERMINATION OF GRANTOR TRUST STATUS

Arielle M. Prangner\*

I. INTRODUCTION .....	444
II. GRANTOR TRUST TREATMENT .....	446
A. <i>Grantor Trust Rules</i> .....	446
1. <i>Section 672: Definitions and Rules</i> .....	446
2. <i>Section 673: Reversionary Interests</i> .....	447
3. <i>Section 674: Power to Control Beneficial Enjoyment</i> .....	448
a. <i>Power to Apply Income to Support Descendant</i> .....	449
b. <i>Power Affecting Beneficial Enjoyment Only After Occurrence of Event</i> .....	449
c. <i>Power Exercisable Only by Will</i> .....	449
d. <i>Power to Allocate Among Charitable Beneficiaries</i> .....	450
e. <i>Power to Distribute Corpus Subject to Reasonably Definite Standard or to Advance Principal</i> .....	450
f. <i>Power to Withhold Income Temporarily</i> .....	450
g. <i>Power to Withhold Income During Disability of Beneficiary</i> .....	451
h. <i>Power to Allocate Between Principal and Income</i> .....	451
4. <i>Additional Exceptions</i> .....	451
5. <i>Section 675: Administrative Powers</i> .....	452
6. <i>Section 676: Power to Revoke</i> .....	452
7. <i>Section 677: Income for Benefit of Grantor</i> .....	453
8. <i>Section 678: Persons Other than Grantor Treated as Substantial Owners</i> .....	453
9. <i>The Portion Rules</i> .....	454
B. <i>Common Types of Grantor Trusts</i> .....	455
1. <i>Revocable Trusts</i> .....	455
2. <i>Grantor Retained Interest Trusts</i> .....	456
3. <i>Spousal Lifetime Access Trusts</i> .....	457
4. <i>Irrevocable Life Insurance Trusts</i> .....	457
5. <i>Intentionally Defective Grantor Trusts</i> .....	458
C. <i>Termination of Grantor Trust Status</i> .....	459
III. TAX IMPLICATIONS OF TERMINATION OF GRANTOR TRUST STATUS .....	460
A. <i>Tax Reporting Requirements While Grantor Trust</i> .....	460

---

\* Attorney with Davis & Willms, PLLC in Houston, Texas. J.D., University of Texas School of Law, 2008, *with honors*; B.S., Special Education, Texas A&M University, 2005, *summa cum laude*.

1. Filing a Form 1041 .....	460
2. Optional Reporting Methods .....	461
a. One Grantor.....	461
b. More than One Grantor.....	462
B. Change in Reporting After Termination of Grantor Trust Status.....	463
1. EIN After Termination.....	463
2. Income Tax Reporting After Termination.....	464
3. Code Section 645 Election.....	465
C. Federal Income Tax Imposed at Trust Level.....	467
1. Tax Rates .....	468
2. Net Investment Income Tax .....	468
a. Material Participation Test.....	469
D. State Income Tax Implications .....	471
IV. ASSETS REQUIRING SPECIAL CONSIDERATION .....	472
A. S Corporation Stock.....	472
1. Qualified Subchapter S Trusts .....	473
2. Electing Small Business Trusts.....	473
3. Allocation of Income from S Corporation in Year of Termination .....	474
B. Outstanding Promissory Notes Payable to Grantor .....	475
1. Termination as the Result of the Grantor's Death .....	476
2. Termination of Grantor Trust Status During Life of Grantor .....	479
C. Life Insurance .....	480
V. ACTIONS TO BE CONSIDERED BEFORE TERMINATION.....	481
A. Swaps of Assets with Differing Basis .....	481
B. Transfer of Life Insurance to Trust .....	483
C. Sale of Principal Residence .....	484
VI. CONCLUSION .....	485

## I. INTRODUCTION

A grantor trust is a trust under which the grantor or someone other than the grantor is treated as the “owner” of the trust assets for federal income tax purposes under Subpart E of Part I of Subchapter J of the Internal Revenue Code of 1986, as amended (the Code).<sup>1</sup> To the extent that a trust is treated as a grantor trust, the grantor trust rules override the general rules of trust taxation.<sup>2</sup> As a result, all items of income, deduction, expenses, and credits associated with the grantor trust portion of the trust are attributed to the grantor (or someone treated as the grantor) and are reported directly by the grantor (or person treated as the grantor) on his or her individual income tax

---

1. See I.R.C. § 671.

2. See *id.*

return.<sup>3</sup> Grantor trusts can serve as an effective method for transferring wealth from one generation to the next while minimizing transfer tax costs and have become a popular tool among estate planning practitioners.<sup>4</sup>

When grantor trust treatment is proposed, an oft-touted attribute is that grantor trust treatment can always be “turned off,” at which point the trust will be taxed under the general rules of trust taxation and the grantor will no longer bear the trust’s income tax liability.<sup>5</sup> Of course, things are seldom that easy.<sup>6</sup> Although in some cases the actual act of terminating grantor trust status may be simple, the implications of the change are vast.<sup>7</sup> It is essential for estate planners to have an understanding of those implications.<sup>8</sup>

This article is not intended to be comprehensive with respect to grantor trusts.<sup>9</sup> There are a multitude of articles and treatises that have been published for that purpose.<sup>10</sup> Instead, it is meant to serve as a resource to highlight issues that require consideration when termination of grantor trust status has occurred, is being contemplated, or is foreseeable, and hopefully can help an estate planner formulate a checklist of items to analyze and discuss with clients in connection with the termination.<sup>11</sup>

The article will briefly outline the grantor trust rules, common types of grantor trusts, and termination of grantor trust status.<sup>12</sup> Income tax issues that arise as a result of the termination will then be addressed.<sup>13</sup> In addition to general tax implications, particular assets that may present challenges or require additional planning will be highlighted.<sup>14</sup> Lastly, actions that may be considered before termination of grantor trust status will be presented.<sup>15</sup>

---

3. *Id.*

4. *See generally* Steve R. Akers, *Planning with Grantor Trusts—Structuring a Grantor Trust to Maximize the Benefits and Minimize the Risk*, 2009 ALI-ABA 687 (detailed information on structuring and use of grantor trusts).

5. *See id.* at 715.

6. *See* Zaritsky, *Taxation of Trusts, Grantors, and Beneficiaries*, 2021 TAX PLAN. FAM. WEALTH TRANS. ANALYSIS FORMS ¶ 3.02[1][a] at 50–51.

7. *See id.*

8. *See id.*

9. *See infra* note 10 and accompanying text.

10. *See generally* Akers, *supra* note 4 (comprehensive information on grantor trusts); Westfall & Mair, *Taxation of Trust Grantors*, 2020 EST. PLAN. L. & TAX. ¶ 17.02 (information about grantor trusts and related taxation).

11. *See infra* Parts III–V.

12. *See infra* Sections II.A–C.

13. *See infra* Sections III.A–D.

14. *See infra* Sections IV.A–C.

15. *See infra* Sections V.A–C.

## II. GRANTOR TRUST TREATMENT

### A. Grantor Trust Rules

Termination of grantor trust status cannot be addressed without an understanding of the grantor trust rules.<sup>16</sup> A practitioner advising a client about termination must be familiar with the various interests or powers (the “triggers”) that may cause grantor trust treatment in order to assess when the treatment no longer applies.<sup>17</sup>

The grantor trust rules are organized like a list of prohibited powers and interests.<sup>18</sup> The underlying inquiry of the grantor trust rules is whether the grantor has left so many strings attached to a trust, enjoys benefits of the trust, or has retained so much control over the trust that it is fair that the grantor be treated as the true owner of the trust property for income tax purposes.<sup>19</sup>

#### 1. Section 672: Definitions and Rules

Code Section 672 sets out the general definitions and rules for implementing the subsequent sections containing the grantor trust rules.<sup>20</sup> A frequently encountered concept in the grantor trust rules relates to powers exercisable by the grantor without the consent of an “adverse party.”<sup>21</sup> An adverse party is any person who has a substantial beneficial interest in the trust that would be adversely affected by the exercise or nonexercise of the power.<sup>22</sup> Conversely, a “nonadverse party” is any person who is not an adverse party.<sup>23</sup>

A “related or subordinate party” is any nonadverse party who is one of the following: the grantor’s spouse (if living with the grantor); father, mother, issue, brother, or sister; an employee of the grantor; a corporation or any employee of a corporation in which the stock holdings of the grantor and the trust are significant from the viewpoint of voting control; or a subordinate employee of a corporation in which the grantor is an executive.<sup>24</sup> The concept

16. See I.R.C. §§ 673–77.

17. See Jeffrey N. Pennell, *Income Tax Consequences on Death of Grantor or Otherwise Termination of Grantor*, 2015 ALI-CLE 31.

18. See I.R.C. §§ 672–77.

19. See Ellen K. Pittman, *Planning with Grantor Trusts*, 2004 ALI-ABA 513, at 522.

20. See I.R.C. § 672.

21. See, e.g., *id.* §§ 674(a) (general rule for power to control beneficial enjoyment), 675(1)–(2) (administrative powers to (1) deal for less than adequate and full consideration; and (2) power to borrow without adequate interest or security), & 677 (income for benefit of grantor).

22. *Id.* § 672(a).

23. *Id.* § 672(b).

24. *Id.* § 672(c).

of a related or subordinate party is integral to determining whether a trustee is independent.<sup>25</sup>

Code Section 672(d) makes clear that even if the exercise of a power is subject to a requirement that notice be given or if it takes effect only on the expiration of a certain period of time after the exercise, the person in question will still be considered to have the power for purposes of the grantor trust rules.<sup>26</sup>

The rule in Code Section 672(e) is frequently referred to as the “spousal attribution” or “spousal unity” rule and was added to the Code in 1986.<sup>27</sup> It provides 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.<sup>28</sup> The grantor will also be treated as holding a power or interest held by a person who becomes the spouse of the grantor after the creation of the power, but only with respect to the periods after the marriage.<sup>29</sup> Accordingly, for transfers made to a trust after March 1, 1986, when reading the grantor trust rules, every reference to the “grantor” can effectively be read “grantor or the grantor’s spouse.”<sup>30</sup> However, for purposes of the spousal attribution rule, an individual legally separated from his or her spouse under a decree of divorce of separate maintenance is not considered to be married.<sup>31</sup>

Lastly, in general, only a U.S. citizen, resident, or domestic corporation will be taxable as the owner of a trust under the grantor trust rules.<sup>32</sup>

## 2. Section 673: Reversionary Interests

If the grantor creates a trust but retains a reversionary right to the property when the trust terminates, the trust may be treated as a grantor trust under Code Section 673.<sup>33</sup> If the transfer to the trust was made after March 1, 1986, the grantor is treated as the owner of any portion of a trust in which the grantor has a reversionary interest in either the corpus or the income therefrom, if, as of the inception of that portion of the trust, the value of such interest exceeds five percent (5%) of the value of such portion.<sup>34</sup> For transfers made to the trust on or before March 1, 1986, the grantor was treated as the

---

25. Compare I.R.C. § 674(c) (prevents application of I.R.C. § 674(a) if the power is solely exercisable by a trustee or trustees, none of whom is the grantor, and not more than half of whom are related or subordinate parties who are subservient to the wishes of the grantor), with I.R.C. § 675(3) (provides a similar exception with respect to a loan to the grantor of trust funds).

26. See *id.* § 672(d).

27. See Act of Oct. 22, 1986, P.L. 99-514, § 1401, 100 Stat. 2085, I.R.C. § 672(e).

28. See I.R.C. § 672(e)(1)(A).

29. See *id.* § 672(e)(1)(B).

30. See *id.*

31. See *id.* § 672(e)(2).

32. See *id.* § 672(f).

33. See *id.* § 673(a).

34. See *id.*

owner of the trust unless the reversionary interest would not vest in present possession within a term of ten years or within the life of the income beneficiary.<sup>35</sup> As a result of the prior rule, many trusts created when it was in effect were structured to last for some period longer than ten years (e.g., ten years and one day or eleven years).<sup>36</sup>

In most cases, the event triggering the reversion will be something like the death of a person, such as the beneficiary of a trust.<sup>37</sup> In such events, the value of the reversion can be determined actuarially.<sup>38</sup> Code Section 2037 incorporates a similar five percent test, so presumably a reversion under Code Section 673 would be valued the same way, using the Code Section 7520 rate and actuarial tables.<sup>39</sup> However, in this low interest rate environment, there is no way for a grantor to retain any significant reversion without triggering grantor trust treatment.<sup>40</sup> Code Section 763(b) provides an additional safe harbor if the reversion occurs because of the death of a lineal descendant who holds all of the present interest in any portion of the trust before the descendant attains age twenty-one.<sup>41</sup> In such a scenario, however, the trust would likely be excepted from grantor trust treatment under the five percent rule anyway, based on the likelihood of the lineal descendant dying before attaining age twenty-one.<sup>42</sup>

### 3. Section 674: Power to Control Beneficial Enjoyment

The general rule of Code Section 674 is that that the grantor will be treated as owner of any portion of the 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 (acting without approval or consent of any adverse party).<sup>43</sup> A power of disposition includes any power that can affect the beneficial enjoyment of the trust property.<sup>44</sup> Nearly all trusts permit trustees to control beneficial enjoyment of trust property without the consent of the beneficiaries, but Code Section 674 outlines several broad exceptions that, while technically powers of

---

35. For the effective date of the change from the ten-year rule to the five percent test, see P.L. 99-514, § 1402(c), 100 Stat. 2085 (1986).

36. See 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/GW6N-WPBX>].

37. Jeffrey D. Scibetta, *Grantor Trusts Explained: Trusts You Can't Trust*, KNOX LAW (Oct. 2017), <https://www.kmgslaw.com/knox-law-institute/publications/grantor-trusts-explained-trusts-you-cant-trust> [<https://perma.cc/JC26-E4HN>].

38. See *id.*

39. See *id.*

40. See *id.*

41. See I.R.C. § 673(b).

42. See Scibetta, *supra* note 37.

43. See I.R.C. § 674(a).

44. See Treas. Reg. § 1.674(a)-1(a) (1960).

disposition, will not cause the trust to be treated as a grantor trust.<sup>45</sup> The excepted powers that will not trigger grantor trust treatment are outlined in the following sections.<sup>46</sup>

*a. Power to Apply Income to Support Descendant*

A power in the trustee or the grantor, acting in a fiduciary capacity, allows the use or apply trust income to discharge the grantor's legal obligation of support.<sup>47</sup> However, grantor trust treatment will apply to the extent the trust income is actually used to discharge the support obligation under Code Section 677(b), as discussed below.<sup>48</sup>

*b. Power Affecting Beneficial Enjoyment Only After Occurrence of Event*

A power to affect the beneficial enjoyment of the trust property that only arises after the occurrence of an event, but only to the extent the power is postponed for a period which, were it a reversionary interest, would be less than five percent of the value of the trust under Code Section 673.<sup>49</sup>

*c. Power Exercisable Only by Will*

A power exercisable only in a person's Will, unless the power is to appoint income that has been accumulated for such disposition by the grantor or may be so accumulated in the discretion of the grantor or a nonadverse party without the consent or approval of any adverse party.<sup>50</sup> Thus the grantor may retain a testamentary power of appointment over the trust principal (but not income) without causing grantor trust status.<sup>51</sup> However, if a trust instrument provides that the income is payable to another person for the life of the grantor, but the grantor retains a testamentary power of appointment over the remainder, and under the trust instrument and local law capital gains are added to the corpus, the grantor is treated as the owner of a portion of the trust and capital gains and losses are included in that portion.<sup>52</sup> In addition, if the grantor is able to appoint the trust principal to the grantor's creditors or to the grantor's estate, the power could be deemed to be a reversionary interest causing grantor trust treatment under Code Section 677(a) discussed below.<sup>53</sup>

---

45. See I.R.C. § 674(b).

46. See *infra* Sections II.A.3.a.-h.

47. See I.R.C. § 674(b)(1).

48. See *id.*

49. See *id.* § 674(b)(2).

50. See *id.* § 674(b)(3).

51. See *id.*

52. See Treas. Reg. § 1.674(b)-1(b)(3) (1960).

53. See *id.*

*d. Power to Allocate Among Charitable Beneficiaries*

A power to determine beneficial enjoyment of the corpus or the income if such corpus or income is irrevocably payable to a charitable beneficiary for a charitable purpose as described in Code Section 170(c) or in an employee stock ownership plan in a qualified gratuitous transfer.<sup>54</sup>

*e. Power to Distribute Corpus Subject to Reasonably Definite Standard or to Advance Principal*

A power to distribute corpus to or for a beneficiary or beneficiaries or to or for a class of beneficiaries (whether or not income beneficiaries) provided that the power is limited by a reasonably definite standard set out in the trust instrument (often referred to as an "ascertainable standard").<sup>55</sup> An ascertainable standard includes the power to distribute corpus for the education, support, maintenance, or health of the beneficiary; for the beneficiary's reasonable support and comfort; or to meet an emergency of the beneficiary.<sup>56</sup> Additionally, a power to make distributions to current income beneficiaries when such distributions are charged against those beneficiaries' proportionate shares of the trust principal.<sup>57</sup> If, however, the grantor or a nonadverse party has one of the powers listed above and any person has the power to add beneficiaries of the trust other than after-born or after-adopted children, then the trust will be treated as a grantor trust.<sup>58</sup>

*f. Power to Withhold Income Temporarily*

A power to distribute or apply income to or for any current income beneficiary or to accumulate income for the beneficiary, provided that any accumulated income must ultimately be payable to the beneficiary, to the beneficiary's estate, to the beneficiary's appointees subject to a power of appointment (provided the power of appointment does not exclude from the class of possible appointees any person other than the beneficiary, his estate, his creditors, or the creditors of his estate); or, on the termination of the trust, or with current principal distributions, to the current income beneficiaries in shares irrevocably specified in the trust instrument.<sup>59</sup> This exception does not apply if any person has a power to add beneficiaries to the trust other than after-born or after-adopted children.<sup>60</sup>

---

54. See I.R.C. § 674(b)(4).

55. See *id.* § 674(b)(5)(A).

56. See Treas. Reg. 1.674(b)-1(b)(5)(i) (1960).

57. See I.R.C. § 674(b)(5)(B).

58. See *id.* § 674(b)(5).

59. See *id.* § 674(b)(6).

60. See *id.*

*g. Power to Withhold Income During Disability of Beneficiary*

A power to withhold income from a beneficiary during the existence of any legal disability or until the beneficiary reaches the age of twenty-one.<sup>61</sup> This exception does not apply if any person has a power to add beneficiaries to the trust other than after-born or after-adopted children.<sup>62</sup> Note that if the income is accumulated under this Section, it is not necessary that the accumulated income ultimately paid to the beneficiary as with the exception under Code Section 674(b)(6).<sup>63</sup> The income may be added to corpus and eventually paid to other beneficiaries.<sup>64</sup>

*h. Power to Allocate Between Principal and Income*

A power to allocate receipts and disbursements as between corpus and income, even if expressed in broad language.<sup>65</sup>

*4. Additional Exceptions*

In addition to the exceptions listed above, the general rule of Code Section 674(a) will not apply if an “independent” trustee has the power to distribute, apportion, or accumulate income to or for a beneficiary or beneficiaries, or to, for, or within a class of beneficiaries, or to pay out corpus to or for a beneficiary or beneficiaries or to or for a class of beneficiaries (whether or not income beneficiaries).<sup>66</sup> The trustee is independent so long as it is not the grantor and if no more than half of the trustees are related or subordinate parties who are subservient to the wishes of the grantor.<sup>67</sup> Again, this exception does not apply if any person has a power to add beneficiaries to the trust other than after-born or after-adopted children.<sup>68</sup>

Another exception exists for trustees other than the grantor and the grantor’s spouse.<sup>69</sup> Grantor treatment will not apply if a trustee (without the approval or consent of any other person) holds the power to distribute, apportion, or accumulate income to or for a beneficiary; in addition, grantor treatment will not apply if the power is limited by an ascertainable standard.<sup>70</sup> As with most exceptions to the general rule of Code Section 674, this

---

61. *See id.* § 674(b)(7)(A), (B).

62. *See id.* § 674(b)(7).

63. *See id.*

64. *See* Treas. Reg. § 1.674(b)-1(b)(7) (1960).

65. *See* I.R.C. § 674(b)(8).

66. *See id.* § 674(c).

67. *See id.*

68. *See id.*

69. *See id.* § 674(d).

70. *See id.* § 674(d).

exception does not apply if any person has a power to add beneficiaries to the trust other than after-born or after-adopted children.<sup>71</sup>

### 5. Section 675: Administrative Powers

Under Code Section 675, a trust is treated as a grantor trust if certain administrative powers are present.<sup>72</sup> These prohibited powers include a power in the grantor or a nonadverse party (without the consent of an adverse party) to purchase, exchange, or otherwise deal with, dispose of, or exchange either income or principal for less than full and adequate consideration.<sup>73</sup> A power exercisable by the grantor or a nonadverse party, or both, that enables the grantor to borrow from the trust without adequate interest or security will also cause grantor trust treatment, unless a trustee other than the grantor may do so if authorized under a general lending power to make loans to any person without regard to interest or security.<sup>74</sup> Additionally, the actual borrowing, whether directly or indirectly, of any portion of the trust by the grantor that has not completely been repaid, including any interest, before the beginning of the taxable year will trigger grantor trust status, unless the loan is made for adequate interest and security and is made by an independent trustee.<sup>75</sup> Lastly, any of the following powers in the grantor or a nonadverse party (without the consent of the trustee) acting in a nonfiduciary capacity will trigger grantor trust status: the power to vote or direct voting in a corporation in which the aggregate holdings of voting stock by the grantor and the trust are “significant;” the power to control the investment of the trust funds by directing investments or vetoing proposed investments, to the extent that the trust holds securities in a corporation in which the aggregate holdings of voting stock by the grantor and the trust are “significant;” and the power to reacquire the trust corpus by substituting property of equivalent value.<sup>76</sup>

### 6. Section 676: Power to Revoke

If the grantor or any other nonadverse person retains the power to revest the title to the trust assets in the grantor, then Code Section 676 provides that the trust will be treated as a grantor trust.<sup>77</sup> Under the law of most states, a trust by default is irrevocable, but this is not universally the case.<sup>78</sup> For

---

71. *See id.*

72. *See id.* § 675.

73. *See id.* § 675(1).

74. *See id.* § 675(2).

75. *See id.* § 675(3).

76. *See id.* § 675(4)(A)–(C).

77. *See id.* § 676.

78. Legal Match, *Revocation and Modification of Irrevocable Trusts*, LEGAL MATCH, [www.legalmatch.com/law-library/article/revocation-and-modification-of-irrevocable-trusts.html](http://www.legalmatch.com/law-library/article/revocation-and-modification-of-irrevocable-trusts.html) (last visited Feb. 1, 2021) [<https://perma.cc/U3ZS-UANY>].

example, under Texas law a grantor may revoke the trust unless it is made irrevocable by the express terms of the instrument creating it.<sup>79</sup>

### 7. *Section 677: Income for Benefit of Grantor*

Code Section 677 imposes grantor trust treatment when the income of a trust, may be, or actually is, used either directly or indirectly for the benefit of the grantor or the grantor's spouse.<sup>80</sup> Also, grantor trust status results if income, without the consent of an adverse party or at the discretion of the grantor and nonadverse party, is distributed to the grantor or the grantor's spouse;<sup>81</sup> held or accumulated for future distribution to the grantor or the grantor's spouse;<sup>82</sup> or used to pay premiums on life insurance on the life of the grantor or the grantor's spouse.<sup>83</sup> Generally, if a trustee has the discretion to distribute or accumulate the trust income in order to discharge a legal obligation of the grantor or the grantor's spouse, then the grantor trust status will be imposed; however, Code Section 677(b) provides an exception to this rule by limiting application of grantor trust status to the amount that income is actually so applied or distributed.<sup>84</sup>

### 8. *Section 678: Persons Other than Grantor Treated as Substantial Owners*

Code Section 678 acts to confer grantor trust status on persons *other* than the grantor of the trust.<sup>85</sup> A trust will be deemed to be a grantor trust as to a person if the person has the power, exercisable solely by the person, to vest income in the trust corpus in the person alone.<sup>86</sup> Note that if such a power is held in conjunction with another person, even if that person is not an adverse party, grantor trust treatment will not be invoked.<sup>87</sup> A trust will also be deemed to be a grantor trust as to a person if the person has previously partially released or modified a power exercisable solely the person to vest the corpus or the income the person alone, and after the release or modification retains such control as would, within the principals of Code Sections 671-677, subject a grantor of a trust to treatment as the owner thereof.<sup>88</sup> A common source for exposure under Code Section 678 is when a beneficiary is given a *Crummey* withdrawal right over gifts to a trust to ensure that the beneficiary has a present interest in the gift in order to qualify for a

---

79. See TEX. PROP. CODE ANN. § 112.051(a).

80. See I.R.C § 677(a).

81. See *id.* § 677(a)(1).

82. See *id.* § 677(a)(2).

83. See *id.* § 677(a)(3).

84. See *id.* § 677(b).

85. See *id.* § 678(a).

86. See *id.* § 678(a)(1).

87. See *id.*

88. See *id.* § 678(a)(2).

federal gift tax annual exclusion under Code Section 2503(b), and the withdrawal right is not exercised and lapses.<sup>89</sup>

Treasury Regulation Section 1.678(a)-1(b) provides that Code Section 678(a)(1) imposes grantor trust status if a person has a power exercisable solely by the person to apply the income or corpus for the satisfaction of the person's legal obligations, other than an obligation to support a dependent.<sup>90</sup> This rule is similar to the one that would cause grantor trust status to the grantor under Code Section 677.<sup>91</sup> However, similar to the exception in Code Section 677(b), if a person is acting in the capacity of trustee or co-trustee, a power to apply the income of the trust to the support or maintenance of a person whom the holder of the power is obligated to support or maintain will give rise to grantor trust treatment only to the extent of amounts actually applied for those purposes.<sup>92</sup>

Notwithstanding the foregoing, a person will not be treated as the grantor under Code Section 678(a) if such person's power under Code Section 678(a) is a power of income and if the grantor of the trust is treated as the owner of the trust under Code Sections 671-677.<sup>93</sup>

Code Section 678(d) provides for another exception to the rules applicable under Code Section 678(a) if the power holder renounces or disclaims the tainted power within a "reasonable time" after the power holder becomes aware of its existence.<sup>94</sup> However, it should be noted that neither the statute nor the regulations define the term "reasonable time."<sup>95</sup>

### 9. The Portion Rules

Grantor trust treatment may not apply with respect to an entire trust.<sup>96</sup> Depending upon the specific trigger that causes the grantor trust treatment, the portion of the trust that is affected may vary.<sup>97</sup> Some triggers cause us to treat the entire trust as a grantor trust (e.g., the revocation power under Code Section 676), some cause the trust to only be a grantor trust as to fiduciary accounting income (e.g., if the grantor or nonadverse party has unrestricted

---

89. *See id.* §§ 678, 2503(b).

90. *See* Treas. Reg. § 1.678(a)-1(b) (1960).

91. *Compare* Treas. Reg. § 1.678(a)-1(b) (imposes grantor trust status on person with sole exercisable power to apply the income or corpus for the satisfaction of the person's legal obligations, other than an obligation to support a dependent), *with* I.R.C. § 677 (causes grantor trust status whose income may be distributed, held, or applied, without approval of adverse party).

92. *See* I.R.C. § 678(c).

93. *See id.*

94. *See id.* § 678(d).

95. *See id.* § 672.

96. *See* Jeanne L. Newlon, *Developments Involving Grantor Trusts*, VENABLE LLP (Jan. 29, 2021, 2:39 PM), [https://www.venable.com/-/media/files/publications/2010/08/developments-involving-grantor-trusts/files/developments-involving-grantor-trusts/fileattachment/newlongrantor\\_trusts.pdf](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/QF2F-2WHM>].

97. *See id.*

powers over income under Code Section 674(a) and no exceptions apply), some cause grantor trust treatment only as to principal, and some cause the trust to be a grantor trust as to a fraction of the income or corpus (e.g., if the grantor retains a right to a portion of the corpus or a reversion of a portion of the corpus).<sup>98</sup> Additionally, grantor trust status can be applied to both income and principal and to specific assets of the trust (e.g., if a grantor retains the right to substitute particular assets under Code Section 675(4)).<sup>99</sup> Treasury Regulation Section 1.671-3 discusses the so-called “portion rules.”<sup>100</sup> However, in many instances application of the portion rules is not straightforward. It is generally desirable for a trust to be a grantor trust as to the entirety of the trust, and this article will focus on trusts that are “wholly owned” grantor trusts.<sup>101</sup>

### *B. Common Types of Grantor Trusts*

Any trust can be a grantor trust if a power or interest that would cause grantor trust status applies to the trust.<sup>102</sup> However, there are several types of trusts that are consistently structured as grantor trusts.<sup>103</sup>

#### *1. Revocable Trusts*

The defining feature of revocable trusts, which are often used to avoid probate and for disability planning, is the grantor’s power to revoke the trust, and thus causes grantor trust treatment under Code Section 676(a).<sup>104</sup> Generally revocable trusts also provide that income of the trust may be payable to the grantor, which causes grantor trust treatment under Code Section 677.<sup>105</sup> It is important to note that a trust may be revocable by the trust instrument’s express terms.<sup>106</sup> For example, Texas law provides that a trust is revocable unless made irrevocable by the express terms of the trust instrument.<sup>107</sup> Revocable trusts are typically not used for transfer tax avoidance.<sup>108</sup> Because the trust is revocable, contributions to the trust are not

---

98. See I.R.C. §§ 676, 674(a). Note any reference to “ordinary income” in Subpart E of Subchapter J of the Code means “fiduciary accounting income.” Treas. Reg. § 1.671-2(b).

99. See I.R.C. § 675(4).

100. See Treas. Reg. § 1.671-3.

101. See *infra* Section II.B.

102. See Scibetta, *supra* note 37.

103. See *id.*

104. See I.R.C. § 676(a).

105. See *id.* § 677.

106. See Travis Peeler, *Types of Trusts*, LEGALMATCH (Jan.29, 2021, 2:00 PM), <https://www.legalmatch.com/law-library/article/types-of-trusts.html> [https://perma.cc/HSR7-ZKFB].

107. See TEX. PROP. CODE ANN. § 112.051(a).

108. See *The Benefits and Shortcomings of Revocable Trusts*, FIDUCIARY TR. INT’L (Jan 29, 2021, 2:00 PM), [https://www.fiduciarytrust.com/insights/commentary?commentaryPath=templatedata/gw-content/commentary/data/en-us/en-us-fici/trust-estate/benefits\\_and\\_shortcomings\\_of\\_revocable\\_trusts&co](https://www.fiduciarytrust.com/insights/commentary?commentaryPath=templatedata/gw-content/commentary/data/en-us/en-us-fici/trust-estate/benefits_and_shortcomings_of_revocable_trusts&co)

completed gifts for gift tax purposes, and at the grantor's death the assets are included in the grantor's gross estate for federal estate tax purposes.<sup>109</sup>

## 2. Grantor Retained Interest Trusts

Several trusts in the estate planner's toolkit involve irrevocable trusts in which the grantor retains some interest for a term of years, during which the trust is taxed as a grantor trust.<sup>110</sup> At the end of the term, unless another grantor trust trigger applies, the grantor trust terminates.<sup>111</sup>

Grantor retained annuity trusts ("GRATs"), grantor retained unitrusts ("GRUTs"), and grantor retained interest trusts ("GRITs") all operate similarly.<sup>112</sup> The grantor creates the trust and provides that for a specified term of years, an amount is paid to the grantor each year, either in the amount of a fixed sum (in the case of a GRAT), a fixed percentage of the trust corpus (in the case of a GRUT), or income of the trust (in the case of a GRIT).<sup>113</sup> The value of the initial gift to the trust for gift tax purposes is only the remainder interest.<sup>114</sup> If the grantor survives the term of the trust, any remaining assets in the trust pass to the remainder beneficiaries free of additional gift tax, and the grantor excludes it from their taxable estate.<sup>115</sup> Generally, GRATs, GRUTs, and GRITs are taxed as grantor trusts under Code Sections 673(a) or 677 for the specified term of years.<sup>116</sup> However, it is not uncommon for these trusts to contain an additional grantor trust trigger for the grantor to include to ensure their trust treatment after the term of years expires.<sup>117</sup>

When a qualified personal residence trust ("QPRT") is created, the grantor transfers a residence or portion of a residence into the trust, reserving the right to occupy the residence rent-free for a specified term of years.<sup>118</sup> Any income of the trust must be distributed to the grantor not less frequently

---

mmentaryType=TRUST%20&%20ESTATE%20PLANNING [https://perma.cc/MT76-HM4U].

109. *See id.*

110. *See* Newlon, *supra* note 96.

111. *See id.*

112. *See* Garrett Ham, *GRATs and GRUTs*, GARRETHAM.COM (Jan. 29, 2021, 2:57 PM), <https://www.garrettham.com/grats-gruts/> [https://perma.cc/6AKH-F9RG].

113. *See id.*

114. *See* I.R.C. § 2702(a)(2)(A)–(B). To qualify for this treatment, a GRAT must meet the requirements set out in Treasury Regulation Sections 25.2702-3(b) and (d) and a GRUT must meet the requirements set out in Treasury Regulation Sections 25.2702-3(c) and (d). *See* Treas. Reg. § 25.2702-3. Note, however, that for a GRIT, if the remainder beneficiary is a member of the grantor's family as defined in Treasury Regulation Section 25.2702-2(2), then the retained interest will be valued at zero because it is not a "qualified interest" and accordingly the value taxed for gift tax purposes will be the entire value of the amount contributed to the trust. *See* I.R.C. § 2702(a)(2)(A).

115. *See supra* note 114 and accompanying text.

116. *See* I.R.C. §§ 673(a), 677.

117. Julia Kagan, *Grantor Trust Rules*, INVESTOPEDIA (Jan. 29, 2021, 2:21 PM), <https://www.investopedia.com/terms/g/grantortrustrules.asp> [https://perma.cc/YWF2-3ZHF].

118. *See* Treas. Reg. § 25.2702-5(c)(3).

than annually.<sup>119</sup> At the time of the transfer to trust, only the value of the remainder interest is taxed for gift tax purposes (if the QPRT meets the requirements set out in Treasury Regulation Section 25.2702-5(c)).<sup>120</sup> At the expiration of the term, the property is transferred to the remainder beneficiaries without additional gift tax consequences, and the value is excluded from the grantor's taxable estate at death.<sup>121</sup> A QPRT will generally be taxed as a grantor trust under Code Sections 673(a) or 677 for the specified term of years.<sup>122</sup>

### 3. *Spousal Lifetime Access Trusts*

A spousal lifetime access trust ("SLAT") is a trust created by one spouse (the "donor spouse") for the benefit of the other spouse (the "beneficiary spouse").<sup>123</sup> The trust can also be structured to benefit persons other than the beneficiary spouse, such as children or other descendants.<sup>124</sup> The donor spouse uses his or her gift tax exemption to make a gift to the SLAT.<sup>125</sup> While the donor spouse gives up his or her right to the property transferred to the trust, the beneficiary spouse maintains access to the property, and accordingly, the donor spouse may indirectly benefit.<sup>126</sup> If structured correctly, the value of the SLAT is excluded from the done spouse's taxable estate at death.<sup>127</sup> SLATs are generally grantor trusts under Code Section 677.<sup>128</sup>

### 4. *Irrevocable Life Insurance Trusts*

An irrevocable life insurance trust ("ILIT") is an irrevocable trust created during the life of an insured to own insurance on the life of the insured.<sup>129</sup> If drafted and administered properly, the proceeds of the life insurance are not included in the insured's gross estate for federal estate tax purposes, thereby allowing the full amount of the policy proceeds to pass to

---

119. *See id.*

120. *See id.* § 25.2702-5(c)(3).

121. *See id.*

122. *See* I.R.C. §§ 673(a), 677.

123. *See* Joylyn Ankeney, Marcy Lantz, *Unprecedented Opportunities in Gift Planning*, TAX ADVISER (Jan. 29, 2021, 12:12 PM), <https://www.thetaxadviser.com/issues/2020/dec/opportunities-gift-planning.html> [https://perma.cc/S6L8-FKPV].

124. *See id.*

125. *See id.*

126. *See* *Wealth Strategy: Spousal Lifetime Access Trusts (SLATs)*, CALAMOS WEALTH MGMT. (Jan. 29, 2021, 12:19 PM), <https://wm.calamos.com/newsinsights/wealth-strategy-insights/spousal-lifetime-access-trusts-slats/> [https://perma.cc/XT7A-7G8V].

127. *See* I.R.C. § 677(b).

128. *See id.* § 677.

129. *See* C. Daniel Yates & Michael O. Chenoweth, *Estate Planning: The Use of Irrevocable Life Insurance Trusts*, 23 IND. L. REV. 517, 517 (1990).

the beneficiaries of the trust free of estate taxes.<sup>130</sup> ILITs are generally treated as grantor trusts under Code §677(a)(3).<sup>131</sup>

### 5. Intentionally Defective Grantor Trusts

An intentionally defective grantor trust (“IDGT”) would not otherwise be taxed as a grantor trust but for the intentional inclusion of a trigger that causes grantor trust status.<sup>132</sup> The goal of an IDGT is for the grantor to be treated as the owner of the trust for income tax purposes, but not treated as the owner for gift, estate, or generation-skipping transfer tax purposes.<sup>133</sup>

When the grantor pays income tax that would otherwise be owed by the trust, the grantor can essentially make additional tax-free gifts to the trust, thus decreasing the value of the grantor’s gross estate and increasing the amount available to the beneficiaries of the trust.<sup>134</sup> When the trust assets do not have to be used to cover income tax liability, they can appreciate faster than they would have if the tax was paid directly from the trust.<sup>135</sup>

Moreover, since the sale of property from a grantor to a grantor trust will not give rise to gain since the grantor and trust are treated as being the same person, additional estate planning opportunities are available.<sup>136</sup> For example, a grantor may sell assets to a grantor trust with no gift tax and no income tax consequence.<sup>137</sup> The transaction can be structured as an installment sale, so that income of the trust can be used to pay the trust’s obligation to the grantor.<sup>138</sup> Again, because the grantor and trust are treated as being the same person, any interest payments from the trust to the grantor are ignored for federal income tax purposes.<sup>139</sup> This type of sale can effectively shift wealth to the beneficiaries of the trust, since the amount includable in the grantor’s estate is a promissory note with a fixed value, while the trust receives assets that may appreciate in value.<sup>140</sup> For these reasons, IDGTs are popular implements and are frequently recommended to clients by estate planning practitioners.<sup>141</sup>

---

130. *See id.* at 519–20.

131. *See* I.R.C. § 677(a)(3).

132. *See* Nicole Hart, *What is an Intentionally Defective Grantor Trust (IDGT)?*, WEALTHSPIRE (Jan. 27, 2020), <https://www.wealthspire.com/guides-whitepapers/intentionally-defective-grantor-trusts-idgt/> [<https://perma.cc/63E7-4JTW>].

133. *See id.*

134. *See id.*

135. *See id.*

136. *See* Rev. Rul. 85-13, 1985-1 CB 184.

137. *See* Hart, *supra* note 132.

138. *See* Lou Vlahos, *Sale to IDGTs: The Death of the Grantor*, FARRELLFRITZ ATTY’S (Aug. 17, 2015), <https://www.taxlawforchb.com/2015/08/sale-to-idgts-the-death-of-the-grantor/> [<https://perma.cc/H7RB-EMSS>].

139. *See* Hart, *supra* note 132.

140. *See id.*

141. *See id.*

Another attribute of IDGTs is that the grantor trust trigger that is used to activate grantor trust status is generally one that can be “turned off” if the grantor so desires.<sup>142</sup> At some point it may become too burdensome for the grantor to continue paying the income tax liability for the trust or the grantor may desire to terminate the grantor trust status for some other reason.<sup>143</sup>

When the goal is to cause grantor trust status without estate tax inclusion, the following are a few commonly used grantor trust triggers: power to add charitable beneficiaries under Code Section 674(b)(4), power to reacquire assets under Code Section 675(4)(C), and power to lend trust assets to the grantor under Code Section 675(2).<sup>144</sup>

### *C. Termination of Grantor Trust Status*

In some cases, it may not be possible to convert a grantor trust to a nongrantor trust during the grantor’s lifetime.<sup>145</sup> When it is possible, termination of grantor trust status can happen in a variety of ways depending upon the trigger causing grantor trust status.<sup>146</sup> The change in status may be intentional or unintentional; it may be inevitable, or it may be planned.<sup>147</sup>

In some events, as in the case with a revocable trust, grantor trust treatment will cease because of the death of the grantor.<sup>148</sup> For other trusts, the change will occur upon the happening of an event such as the expiration of a term of years during which provisions of the trust resulted in grantor trust treatment (e.g., a GRAT or a QPRT).<sup>149</sup> In yet other instances, grantor trust status will terminate as the result of changing trustees such that the new trustee is an independent trustee who may have the grantor trust causing power without causing grantor trust status.<sup>150</sup> Turning off the grantor trust status will sometimes be as easy as a release of the power or beneficial interest that caused the grantor trust treatment (e.g., releasing a power to reacquire trust property under Code Section 675(4)(C)), or payment of an outstanding loan by the grantor before the start of the trust’s taxable year (thus avoiding grantor trust treatment under Code Section 675(3)).<sup>151</sup>

---

142. See Walter Q. Impert, *A Review of Grantor Trusts*, DORSEY & WHITNEY, L.L.P. (2014), [https://www.dorsey.com/~media/Files/NewsResources/Publications/2014/11/A-Review-of-Grantor-Trusts\\_2014Fall5\\_Walter\\_Impert](https://www.dorsey.com/~media/Files/NewsResources/Publications/2014/11/A-Review-of-Grantor-Trusts_2014Fall5_Walter_Impert) [perma.cc/S35K-KSQL].

143. See *id.* at 9.

144. See I.R.C. §§ 674(b)(4), 675(4)(C), 675(2).

145. See Impert, *supra* note 142, at 9.

146. See *id.*

147. See *id.*

148. See *id.*

149. See *id.* at 12–13.

150. See, e.g., I.R.C. § 674(c) (exception for certain powers of independent trustees).

151. See *id.* §§ 675(3) & 675(4)(C) (In instances where grantor trust status can be turned “off,” it can often be turned back “on” again. However, a discussion about the effect of this kind of “togglng” is outside the scope of this article).

In many circumstances, in order to determine how to terminate grantor trust status or whether grantor trust status has been terminated, it is necessary to be familiar with the trust instrument, the parties involved and their relationships to each other, and specific circumstances surrounding the trust, its assets, and its administration.<sup>152</sup>

### III. TAX IMPLICATIONS OF TERMINATION OF GRANTOR TRUST STATUS

#### *A. Tax Reporting Requirements While Grantor Trust*

During the time it is treated as a grantor trust, a trust may be reporting income to the IRS in one of several ways.<sup>153</sup> The current rules for income tax reporting requirements of grantor trusts can be found in Treasury Regulation Section 1.671-4.<sup>154</sup> In some cases, a grantor trust will not be required to file an IRS Form 1041, "U.S. Income Tax Return for Estates and Trusts."<sup>155</sup> A grantor trust may not even be required to obtain a taxpayer identification number ("EIN").<sup>156</sup> However, once the grantor trust status has terminated, its reporting method, and even its EIN, if any, may change.<sup>157</sup> The way it will change will depend on the manner in which the trust was reporting income before the termination, the type of trust, and how the grantor trust status terminated.<sup>158</sup>

#### *1. Filing a Form 1041*

The general method of income tax reporting for a trust is that the trustee files a Form 1041.<sup>159</sup> If the trust is treated as a grantor trust as to any portion of the trust, the items of income, deduction, or credit attributable to the portion of the trust that is treated as being owned by the grantor or another person are not reported on the Form 1041, but are shown on a separate statement to be attached to that form.<sup>160</sup> If a grantor trust uses this traditional reporting method and files a Form 1041, it will already have a tax identification number.<sup>161</sup>

---

152. See Impert, *supra* note 142, at 9.

153. See Treas. Reg. § 1.671-4 (2006).

154. See *id.*

155. See *id.* § 1.671-4(a).

156. See *id.* § 1.671-4(b)(2).

157. See *id.* § 1.671-4(h)(2).

158. See *id.*

159. See I.R.C. § 6012(a)(4).

160. See Treas. Reg. § 1.671-4(a).

161. See *id.*

## *2. Optional Reporting Methods*

However, the Treasury regulations provide for alternate reporting methods that may be used in the case of “[a] trust *all of which* is treated as owned by one or more grantors or other persons and that is *not* one of the following: (i) a common trust fund as defined in Code Section 584(a); (ii) a trust that has its situs or any of its assets located outside of the United States; (iii) a trust that is a qualified subchapter S trust; (iv) a trust all of which is treated as owned by one grantor or other person whose taxable year is a fiscal year; (v) a trust all of which is treated as owned by one grantor or one other person who is not a United States person; or (vi) a trust all of which is treated as owned by two or more grantors or other persons, one of whom is not a United States person.<sup>162</sup> A trust treated as being owned by one grantor or other person who is an exempt recipient for information reporting purposes is also prohibited from utilizing the reporting methods in the Treasury regulation.<sup>163</sup> However, under certain circumstances a trust treated as owned by two or more grantors or other persons, one or more of whom are exempt recipients may use the reporting method.<sup>164</sup> If one of the optional methods of reporting is used, the trust is not required to file a Form 1041.<sup>165</sup>

The optional reporting methods that are available depend on whether the trust is treated as owned by only one person or by more than one person.<sup>166</sup> For these purposes, a married couple who files jointly under Code Section 6013 is considered to be owned by one grantor.<sup>167</sup>

### *a. One Grantor*

A trust treated as owned by *one* grantor or one other person can use one of two optional methods for reporting under Treasury Regulation Section 1.671-4(b)(2).<sup>168</sup>

The first method is referred to as “Optional Method 1” in the instructions to Form 1041.<sup>169</sup> Under Optional Method 1, the trustee may furnish the name and EIN of the *grantor* or other person treated as owner of the trust and the address of the *trust* to each payor of income during the taxable year.<sup>170</sup> If the grantor or other person treated as the owner of the trust is not the trustee or a co-trustee of the trust, the trustee must also give the

---

162. *See id.* § 1.671-4(b)(6).

163. *See id.* § 1.671-4(b)(7)(i).

164. *See id.* § 1.671-4(b)(7)(ii).

165. *See id.*

166. *See id.* § 1.671-4(b)(7)(ii).

167. *See id.* § 1.671-4(b)(8).

168. *See id.* § 1.671-4(b)(2).

169. *See Instructions for Form 1041 and Schedules A, B, G, J, and K-1*, DEP’T TREASURY I.R.S., <https://www.irs.gov/pub/irs-pdf/i1041.pdf> [<https://perma.cc/2VVS-YEPS>].

170. *See* Treas. Reg. § 1.671-4(b)(2)(i)(A).

grantor or other person a statement showing all items of income, deduction, and credit of the trust for the taxable year; identifying the payor of each item of income; providing the information necessary to take the items into account in computing that person's taxable income; and informing the grantor or other person treated as the owner that the items of income, deduction, and credit and other information shown on the statement must be included in computing the taxable income and credits of that person on his or her income tax return.<sup>171</sup> The trustee does not need to file anything with the IRS.<sup>172</sup> If Optional Method 1 is utilized, the trust does not have to obtain a tax identification number.<sup>173</sup>

The second reporting method available for a trust treated as being owned by *one* grantor or one other person is referred to as "Optional Method 2" in the Instructions to IRS Form 1041.<sup>174</sup> Under Optional Method 2, the trustee may furnish the *trust's* name, EIN, and address to all payors of income during the year.<sup>175</sup> The trustee must then file with the IRS the appropriate Forms 1099 reporting the income or gross proceeds paid to the trust during the taxable year, and showing the trust as the payor and the grantor or other person as the owner of trust as the payee.<sup>176</sup> Unless the grantor or the person treated as a grantor is the trustee or a co-trustee of the trust, the trustee must also furnish to the grantor or person treated as the grantor a statement showing all items of income, deduction, and credit of the trust for the taxable year; providing the information necessary to take the items into account in computing that person's taxable income; and informing the grantor or other person treated as the owner that the items of income, deduction, and credit and other information shown on the statement must be included in computing the taxable income and credits of that person on his or her income tax return.<sup>177</sup> If a grantor trust was reporting under Optional Method 2, it will already have an EIN.<sup>178</sup>

#### *b. More than One Grantor*

With respect to a trust all of which is treated as owned by *two or more* grantors or other persons, an alternate reporting method referred to in the Instructions to IRS Form 1041 as "Optional Method 3" is available.<sup>179</sup>

Similar to Optional Method 2, the trustee of the trust furnishes the *trust's* name, EIN, and address to all of the payors of the trust during the taxable

171. See *id.* § 1.671-4(b)(2)(ii)(A).

172. See *id.* § 1.671-4(b)(2)(ii)(b).

173. See *id.*

174. See *Instructions for Form 1041 and Schedules A, B, G, J, and K-1*, *supra* note 171.

175. See Treas. Reg. § 1.671-4(b)(2)(i)(B).

176. See *id.* § 1.671-4(b)(2)(iii)(A).

177. See *id.* § 1.671-4(b)(2)(iii)(B).

178. See *id.*

179. See *Instructions for Form 1041 and Schedules A, B, G, J, and K-1*, *supra* note 171.

year.<sup>180</sup> The trustee must then file with the IRS the appropriate Forms 1099 reporting the items of income paid to the trust attributable to the portion of the trust treated as owned by each grantor or other person, and showing the trust as the payor and each grantor or other person as the owner of trust as the payee.<sup>181</sup> The trustee must then provide each grantor or person treated as the grantor a statement showing all items of income, deduction, and credit of the trust for the taxable year attributable to the portion of the trust treated as owned by that person; providing the information necessary to take the items into account in computing that person's taxable income; and informing the grantor or other person treated as the owner that the items of income, deduction, and credit and other information shown on the statement must be included in computing the taxable income and credits of that person on his or her income tax return.<sup>182</sup> If the grantor trust was reporting under Optional Method 3, it will already have an EIN.<sup>183</sup>

## *B. Change in Reporting After Termination of Grantor Trust Status*

### *1. EIN After Termination*

If a grantor trust was utilizing the Optional Method 1 reporting method and an EIN was never obtained for the trust, then when grantor trust status is terminated, the trustee will be required to obtain an EIN.<sup>184</sup> A trustee may obtain an EIN by completing and filing an IRS Form SS-4, "Application for Employer Identification Number."<sup>185</sup>

If a trust already has an EIN and the grantor trust status terminates by any reason other than the death of the grantor or person treated as a grantor as to all of the trust, then after the termination of the grantor trust status, the same EIN can continue to be used by the trust.<sup>186</sup>

However, if a trust was wholly a grantor trust with respect to one grantor or person treated as a grantor (the "decedent") and the grantor trust status terminates because of the decedent's death, different rules apply.<sup>187</sup> If the trust continues after the death of the decedent, a new EIN must be obtained for the trust, regardless of whether the trust had previously been assigned an EIN.<sup>188</sup>

---

180. See Treas. Reg. § 1.671-4(b)(3)(i).

181. See *id.* § 1.671-4(b)(3)(ii)(A).

182. See *id.* § 1.671-4(b)(3)(ii)(B).

183. See *id.*

184. See *id.* § 301.6109-1(a)(2)(i)(B) (2013).

185. See *EIN Assistant*, I.R.S., <https://sa1.www4.irs.gov/modiein/individual/index.jsp> [perma.cc/9G66-6S2Q].

186. See Treas. Reg. § 301.6109-1 (2013).

187. See *id.* § 301.6109-1(a)(3)(i).

188. See *id.*

On the other hand, if only a portion of a trust was treated as being owned by the decedent, then after the decedent's death, the trust can continue to report under the EIN previously used by the trust as long as the portion of the trust treated as being owned by the decedent remains part of the original trust and the other portions continue to be treated as being owned by the other grantors.<sup>189</sup> An example of this would be a dual-grantor revocable trust for which an EIN had already been obtained.<sup>190</sup> At the death of one of the grantors, as long as the trust does not terminate, and as long as the other grantor continues to be treated as owner of one-half of the trust under the grantor trust rules, the same EIN can be used for the trust after the decedent's death.<sup>191</sup>

## 2. Income Tax Reporting After Termination

In the event of the death of the grantor or person treated as the grantor (the "decedent"), the Treasury regulations clarify that the trust or portion of the trust treated as being owned by the decedent can continue reporting in accordance with Treasury Regulation Section 1.671-4 for the taxable year that ends with the decedent's death, but may not do so for subsequent years.<sup>192</sup> Although the Treasury Regulations are silent as to termination of grantor trust status because of any reason other than the grantor's death, presumably the same rules apply in those circumstances.<sup>193</sup>

In the event that the trust was reported by filing a Form 1041 with an attached statement indicating the trust income allocable to the decedent, the Form 1041 due for the taxable year ending with the decedent's year of death will be due the fifteenth day of the of the fourth month following the close of the twelve-month period that began with the first day of the decedent's taxable year.<sup>194</sup> If the trust was deemed to be entirely owned by the decedent, then the return must also indicate that it is the final return to be filed under the EIN assigned during the decedent's lifetime.<sup>195</sup>

If the trust was reported using Optional Method 1, the trustee will need to furnish a new Form W-9 or an acceptable substitute containing the name, EIN, and address of the trust to all payors of income following the death of the decedent.<sup>196</sup> If the trust was reported using Optional Method 2, then the trustee must indicate on each Form 1096, "Annual Summary and Transmittal

---

189. *See id.* § 301.6019-1(a)(3)(i)(B).

190. *See id.*

191. *See id.*

192. *See id.* § 1.671-4(h)(2).

193. *See id.* § 1.671-4 (1963).

194. *See id.* §§ 1.671-4(h)(3)(i), 1.6702-1(a)(2)(i).

195. *See id.* § 1.671-4(h)(3)(i).

196. *See id.* § 301.6109-1(a)(3)(ii).

of U.S. Information Returns,” that it files for the last year in which that reporting method is used, that it is the final return of the trust.<sup>197</sup>

If before the decedent’s death the trust had been treated as owned entirely by two or more grantors and had been filing pursuant to Optional Method 3, the trust cannot report using that method if any portion of the trust has a short taxable year due to the decedent’s death and the portion deemed to have been owned by the decedent did not terminate at the decedent’s death.<sup>198</sup> Continuing with the example above with respect to a dual-grantor revocable trust, if the decedent died on any day other than the last day of the taxable year of the trust, the portion of the trust taxed to the decedent will have a short taxable year.<sup>199</sup> Accordingly, even though the trust’s pre-death EIN can continue to be used, for that year the trust cannot report using Optional Method 3, and would instead have to file a Form 1041.<sup>200</sup>

After termination of grantor trust status, the trustee must start filing a Form 1041 to report the items of income, deductions, and credits applicable to the period after the termination.<sup>201</sup> Notwithstanding the foregoing, if the trust in question is a certain kind of revocable trust and if grantor trust status terminates because of the death of the decedent, the trust has another option.<sup>202</sup>

### 3. Code Section 645 Election

With respect to a “qualified revocable trust,” at the death of the grantor, the trustee and the appointed executor, if any, may elect to treat the trust as part of the decedent’s estate (and not as a separate trust) for income tax purposes.<sup>203</sup> A “qualified revocable trust” is defined as a trust that, during the life of the grantor, was treated as a grantor trust because of the grantor’s right of revocation under Code Section 676.<sup>204</sup> The election must be made on the estate’s first timely filed income tax return (including extensions), and once the election is made, is irrevocable.<sup>205</sup> If an executor has been appointed, the executor and trustee of the trust make the election by signing and filing IRS Form 8855, “Election to Treat a Qualified Revocable Trust as Part of an Estate.”<sup>206</sup> If there is no executor, the trustee of the trust files the election form.<sup>207</sup>

---

197. *See id.* § 1.671-4(h)(3)(ii).

198. *See id.* § 1.671-4(h)(3)(iii).

199. *See id.*

200. *See id.* § 1.671-4(h)(3).

201. *See id.* § 1.671-4(i).

202. *See id.*

203. *See* I.R.C. § 645(a).

204. *See id.* § 645(b).

205. *See id.* § 645(c).

206. *See* Treas. Reg. § 1.645-1 (1963).

207. *See id.* § 1.645-1(c)(2).

Even if the so-called “645 election” is made, the trust must still obtain a new EIN at the death of the decedent.<sup>208</sup>

If it is anticipated that a 645 election will be made, the executor of the decedent’s estate and the trustee of the trust may treat the trust as an “electing trust” (one which has made a 645 election) from the decedent’s date of death until the due date for the section 645 election.<sup>209</sup> In that event, the trustee is not required to file a Form 1041 for the trust for the short taxable year beginning with the decedent’s date of death and ending December 31st of that year.<sup>210</sup> However, if the trust is treated as an electing trust from the decedent’s date of death until the due date for the 645 election but a 645 election is ultimately *not* made for the trust, the trust will be subject to penalties and interest for failing to timely file a Form 1041 and pay the tax due thereon.<sup>211</sup> If a Form 1041 is filed for the short taxable year after the decedent’s death and a 654 election is ultimately made, the trust’s Form 1041 must be amended.<sup>212</sup>

If there is an executor of the decedent’s estate, the effect of the 645 election is that during the election period the trust is treated as part of the related estate for all purposes of Subtitle A of the Code.<sup>213</sup> A single Form 1041 is filed annually under the name and EIN of the estate for the combined electing trust and the related estate and a separate Form 1041 does not need to be filed for the trust.<sup>214</sup> If there is no executor of the estate, then during the election period the trustee treats the trust as an estate for all purposes of Subtitle A of the Code and a Form 1041 is filed for the trust using its EIN and treating the trust as an estate.<sup>215</sup>

The election applies from the date of the decedent’s death until the earlier of the day on which both the electing trust and related estate, if any, have distributed all of their assets, or the day before the applicable date.<sup>216</sup> If no Form 706 “United States Estate (and Generation Skipping Transfer) Tax Return” is due, the applicable date is the day before two years after the date of the decedent’s death.<sup>217</sup> If a Form 706 is required to be filed, the applicable date is the later of the day that is two years after the date of the decedent’s death, or the day that is six months after the date of the final determination of the liability for estate tax.<sup>218</sup> Generally, the date of final determination of liability is the date that is six months after the date the closing letter is

---

208. *See id.* §§ 1.645-1(d)(1), 301.6109-1(a)(3)(i).

209. *See id.* § 1.645-1(d)(2)(i).

210. *See id.*

211. *See id.*

212. *See id.* § 1.645-1(d)(2)(ii).

213. *See id.* § 1.645-1(e)(2)(i).

214. *See id.* § 1.645-1(e)(2)(ii).

215. *See id.* § 1.645-1(e)(3).

216. *See id.* § 1.645-1(f)(1).

217. *See* I.R.C. § 645(b)(2)(A); Treas. Reg. § 1.645-1(f)(2)(i).

218. *See* Treas. Reg. § 1.645-1(f)(2)(ii).

issued.<sup>219</sup> Therefore, the 645 election will terminate one day less than twelve months after issuance of the closing letter.<sup>220</sup>

There can be several benefits to making a 645 election, including simplifying the number of income tax returns, the availability to report using a fiscal year, avoiding the requirement of making estimated tax payments for two years after the decedent's death, and the ability to hold S corporation stock for the duration of the administration of the estate, without meeting special trust rules.<sup>221</sup> On the other hand, if a 645 election is not made, the estate and trust each get a separate run up the tax bracket ladder and maintain the benefit of separate exemptions (\$600 for the estate, and either \$100 or \$300 for the trust).<sup>222</sup>

### *C. Federal Income Tax Imposed at Trust Level*

After the termination of grantor trust status, the general rules of income taxation of trusts will apply to the trust. The general principal of those rules is that the taxable income of a trust or estate is computed in the same manner as in the case of an individual, except as set forth in Part I of Subchapter J of the Code.<sup>223</sup> Subpart A of Part I of Subchapter J contains general rules for taxation of trusts and estates, Subpart B provides specific rules relating to trusts that distribute current income only, Subpart C deals with trusts and estates that may accumulate income or distribute corpus, Subpart D provides the rules for excess distributions by trusts, of course Subpart E governs the rules for grantor trusts, and Subpart F deals with miscellaneous provisions relating to limitations on charitable deductions, income of a trust or estate in the case of divorce, and taxable years to which the provisions of Subchapter J are applicable.<sup>224</sup> These rules have vast implications, and the subject of income taxation of trusts and estates is dense enough to fill a semester-long law school course.<sup>225</sup> Accordingly, a detailed discussion of income taxation of trusts and estates is outside the scope of this article.<sup>226</sup>

Broadly, once grantor trust status has terminated, the trust will be subject to what is often referred to as “conduit” taxation.<sup>227</sup> This means that a trust will be taxed only to the extent it receives and retains taxable income

---

219. *See id.* § 1.645-1(f)(2)(ii)(A) (*but see id.* §§ 1.645-1(f)(2)(ii)(B)–(E) regarding circumstances when the date of final determination of liability may be later).

220. *See id.* § 1.645-1(f)(2)(ii)(A).

221. *See id.* § 1.645-1(e)(3)(i).

222. *See I.R.C.* §§ 1(e), 642(b).

223. *See id.* § 641(b).

224. *See* Treas. Reg. § 1.641(a)-0(a).

225. *See id.*

226. *See* Mickey Davis & Melissa Willms, *Income Taxation of Trusts and Estates*, The Center for American and International Law 55th Annual Short Course on Estate Planning (Jan. 30, 2020).

227. *See* Allison Pedrazzi, *Guess What? The Laws HAVE Changed—Avoiding a Conduit Trust Catastrophe After the SECURE Act*, JD SUPRA (May 4, 2020), <https://www.jdsupra.com/legalnews/guess-what-the-laws-have-changed-59537/> [https://perma.cc/25GY-TRD8].

in the taxable year.<sup>228</sup> If the trust makes a distribution to a beneficiary, or is required to make a distribution to a beneficiary, then the trust is allowed a deduction to the extent of the distribution.<sup>229</sup> Any distributions from the trust are treated as being made first from income (even if what was distributed was corpus).<sup>230</sup> The income is allocated to the beneficiary and taxed to the beneficiary, retaining the same character that it had in the trust.<sup>231</sup> Accordingly, to the extent that distributions are required to be made or are actually made to beneficiary, the income will flow through the trust to the beneficiary.<sup>232</sup>

### 1. Tax Rates

Once grantor trust status is terminated, if taxable income of the trust is taxed at the trust level (and does not flow through to beneficiaries of the trust), income tax is imposed based on the income tax brackets for trusts.<sup>233</sup> Trusts share most of the same income tax brackets as individuals.<sup>234</sup> Although trust income tax brackets don't include a 12%, 22%, or 32% tax rate, they have the same highest tax bracket of 37% as individuals.<sup>235</sup> The most notable difference between the brackets for individuals and those for trusts is that the brackets are much more compressed for trusts.<sup>236</sup> For example, in 2020, trusts reach the highest bracket at \$12,950 of income, while single individuals reach the highest bracket at \$518,000, and married persons filing jointly reach the highest bracket at \$622,050.<sup>237</sup> Accordingly, trust income may be taxed at a much higher rate than it would have if the trust were still a grantor trust.<sup>238</sup>

### 2. Net Investment Income Tax

Internal Revenue Code Section 1411 imposes a net investment income tax of 3.8% on the unearned income of individuals, estates, and trusts commonly referred to as the "Net Investment Income Tax" or "Medicare

---

228. *See id.*

229. *See* Jeffrey Levine, *Restructuring Conduit Trust Beneficiaries of Retirement Accounts to Avoid the SECURE Act's 10-Year Rule*, KITCES (Mar. 4, 2020), <https://www.kitces.com/blog/secure-act-see-through-conduit-trust-stretch-ira-10-year-non-eligible-designated-beneficiary/#:~:text=Conduit%20Trusts%20force%20the%20almost,no%20longer%20protected%20by%20it> [<https://perma.cc/FR89-EFNN>].

230. *See id.*

231. *See id.*

232. *See id.*

233. *See* Rev. Proc. 2019-44, 2019-47 I.R.B 1093.

234. *See* I.R.C. § 1(j)(2) (In the last quarter of each year, the IRS issues a Revenue Procedure that provides the inflation-adjusted numbers for a variety of items, including income tax brackets. For 2020, the updated numbers can be found in Revenue Procedure 2019-44). *See* Rev. Proc. 2019-44.

235. *See* I.R.C. § 1(j)(2)(E).

236. *See id.*

237. *See id.*

238. *See id.*

Tax.”<sup>239</sup> For individuals, the tax is equal to 3.8% of the lesser of (i) the individual’s net investment income for the year, or (ii) the individual’s modified adjusted gross income for that taxable year in excess of a threshold amount (\$200,000 for single individuals and \$250,000 for married individuals filing jointly).<sup>240</sup> For estates and trusts, the tax is equal to 3.8% times the lesser of (i) the estate’s or trust’s undistributed net investment income, or (ii) the estate’s or trust’s adjusted gross income (as defined in Code Section 67(e)) for that taxable year in excess of the dollar amount at which the highest income tax bracket begins (\$12,950 for 2020).<sup>241</sup> Note that the threshold for trusts and estates is based on the highest income tax bracket for each, and accordingly the threshold is indexed each year.<sup>242</sup> In contrast, there is no indexing for individuals.<sup>243</sup>

The net investment income tax is not imposed on grantor trusts.<sup>244</sup> Instead, each item of income or deduction is treated as if it had been received by or paid directly by the grantor (or person treated as the grantor) for purposes of calculating the individual net investment income of the grantor (or person treated as the grantor).<sup>245</sup>

Again, a detailed discussion of the net investment income tax is outside of the scope of this article.<sup>246</sup> However, it is important to note that when grantor trust status is terminated, one test for determining whether income is subject to the net investment income tax will change.

#### *a. Material Participation Test*

Net investment income consists of three categories of income, each using the term “trade or business” as that term is defined in Code Section 162.<sup>247</sup> A trade or business to which the tax will apply includes one that is a passive activity within the meaning of Code Section 469.<sup>248</sup> Accordingly, it is imperative to determine what constitutes a passive activity in order to determine when the net investment income tax will be applied.<sup>249</sup> Activity is passive within the meaning of Code Section 469 if the taxpayer does not materially participate in the trade or business.<sup>250</sup> In order for a taxpayer to

---

239. *See id.* § 1411.

240. *See id.* § 1411(a)(1).

241. *See id.* § 1411(a)(2).

242. *See id.*

243. *See id.* § 1411(a)(1).

244. *See id.* § 1411(c).

245. *See* Treas. Reg. § 1.1411-3(b)(1)(v) (1963).

246. Davis & Willms, *supra* note 226.

247. *See* I.R.C. § 1411(c)(1)(A); Treas. Reg. § 1.1411-1(d)(12).

248. *See* I.R.C. § 1411(c)(2); Treas. Reg. § 1.1411-5.

249. *See* I.R.C. § 1411(c)(2).

250. *See id.* § 469(c)(1).

materially participate in an activity, the taxpayer's involvement in the operations of the activity must be regular, continuous and substantial.<sup>251</sup>

Treasury regulations list seven ways in which an individual can materially participate, but no regulations exist addressing material participation of a trust.<sup>252</sup> During the period in which a trust is treated as a grantor trust, the participation of the grantor or person treated as the grantor are evaluated to determine whether the material participation test is met.<sup>253</sup> However, when grantor trust status is terminated, how the test will be applied is unclear.<sup>254</sup>

The IRS has taken the position that for purposes of a nongrantor trust, the trustee's actions are the only appropriate measure of whether the material participation test is met.<sup>255</sup> In *Mattie K. Carter Trust v. United States*, which was a case of first impression on the issue, the Court concluded that material participation is determined by reference to all persons who conduct business on behalf of a trust, whether employees or fiduciaries.<sup>256</sup> The IRS has rejected the Court's position in *Mattie K. Carter Trust* and has continued to advance the argument that the IRS will look solely to the activities of the trustee.<sup>257</sup> In the most recent case to address the material participation issue with respect to a trust, *Frank Aragona Trust v. Commissioner*, the Tax Court held that under the narrow circumstances of that case, activities of a trustee who is also an employee of a trust can be used to assess whether a trust materially participates in an activity.<sup>258</sup>

With no treasury regulations under Code Sections 1411 or 469 to address the issue of material participation for trusts, it is difficult for practitioners to give guidance to clients regarding how to determine material participation by nongrantor trusts and whether such trade or business income may be non-passive, thereby avoiding imposition of the net investment income tax.<sup>259</sup> However, if a trust derives income from a trade or business, it is important to evaluate whether the grantor's participation renders the

---

251. See *id.* § 469(h)(1).

252. See Treas. Reg. § 1.469 (2021).

253. See JOINT COMM. ON TAX'N, 115TH CON., GENERAL EXPLANATION OF PUBLIC LAW 115-97 242, n.33 (Comm. Print 2018).

254. See *id.*

255. See I.R.S. Tech. Adv. Mem. 200733023 (Aug. 17, 2007); I.R.S. Priv. Ltr. Rul. 201029014 (Aug. 23, 2010); and I.R.S. Tech. Adv. Mem. 201317010 (Apr. 26, 2013); See also e.g., *Mattie K. Carter Trust v. United States*, 256 F. Supp. 2d 536 (N.D. Tex. 2003) (IRS has rejected the Court's position and only looks at activities of the trustee).

256. See *Mattie K. Carter Trust*, 256 F. Supp. 2d at 536.

257. See I.R.S. Tech. Adv. Mem. 200733023 (Aug. 17, 2007); I.R.S. Priv. Ltr. Rul. 201029014 (Aug. 23, 2010); and I.R.S. Tech. Adv. Mem. 201317010 (Apr. 26, 2013).

258. *Frank Aragona Trust v. Commissioner*, 142 TC 165 (2014).

259. See Michael T. Donovan & Timothy G. Stewart, *Material Participation by Trusts: Questions Remain after Frank Aragona Trust*, LEWISRICE (Oct. 3, 2014), <https://www.lewisrice.com/publications/material-participation-by-trusts-questions-remain-after-frank-aragona-trust/>.

income non-passive, and whether that may change once the grantor trust treatment ceases.<sup>260</sup>

#### *D. State Income Tax Implications*

As a practitioner in Texas where no state income tax is imposed on trusts, it is sometimes easy to forget that trusts may be subject to state income tax in addition to federal income tax.<sup>261</sup> However, when evaluating the consequences of terminating grantor trust status, any potential state income tax implications should be considered as well.<sup>262</sup> Generally, states may tax all income of their residents but only source income of non-residents.<sup>263</sup> The basis upon which a trust will be considered a resident varies from state to state.<sup>264</sup> In some states, residency of a trust is based on the domicile of a grantor at the time when an irrevocable trust is created (e.g., New York).<sup>265</sup> Other states determine residency by reference to the domicile of the trustee (e.g., Arizona), or the principal place of administration (e.g., Colorado), the place where the beneficiaries reside (e.g., Tennessee), or some combination of factors (e.g., California).<sup>266</sup>

If a trust is a grantor trust for federal income tax purposes, it is usually ignored as a separate taxpayer for state tax purposes as well, and accordingly most states look to the state of residence of the grantor (or person treated as the grantor) to determine residency for state income tax purposes.<sup>267</sup> As a result, the residency of the trust may be determined differently when grantor trust status terminates.<sup>268</sup> Therefore, if the trust has a nexus with any other state at the time that termination of grantor trust status is being contemplated,

260. *See id.*

261. Gregory A. Bergmann & Eric L. Johnson, *Selected Issues Concerning the State Income Taxation of Nonresident Trusts and Estates*, TAXADVISER (Sept. 1, 2011), <https://www.thetaxadviser.com/issues/2011/sep/salt-sep2011.html> [<https://perma.cc/A2YW-LBXT>].

262. *See id.*

263. *See id.*

264. *See id.*

265. *See id.*

266. A helpful table containing a summary of tax rules and rates for trusts in each state can be found in the current ACTEC State Survey. *See* Richard W. Nenko, *Bases of State Income Taxation of Nongrantor Trusts for 2018*, ACTEC, [https://www.actec.org/assets/1/6/Nenko\\_state\\_nongrantor\\_tax\\_survey](https://www.actec.org/assets/1/6/Nenko_state_nongrantor_tax_survey) (updated through August 14, 2019) [<https://perma.cc/9D3M-42FL>].

267. *See* Ed Morrow, *State Residency and Source Income Factors for State Income Taxation of Irrevocable Non-Grantor Trusts*, ACTEC, [https://www.actec.org/assets/1/6/Morrow\\_State\\_Residency\\_and\\_Source\\_Income\\_Factors\\_for\\_Taxation\\_of\\_Irrevocable\\_Non-Grantor\\_Trusts.pdf](https://www.actec.org/assets/1/6/Morrow_State_Residency_and_Source_Income_Factors_for_Taxation_of_Irrevocable_Non-Grantor_Trusts.pdf) [<https://perma.cc/9RV8-2WVZ>]. This is a companion chart to *Incomplete Gift, Non-Grantor Trusts - Not Just for State Income Tax Avoidance and Spousal Lifetime Access Non-Grantor Trusts*, CLE/article/webinars, compiled by Ed Morrow, J.D., LL.M. (tax), CFP (2019); *see, e.g.*, Cal. Rev. & Tax. Code §§ 17742–44 (trust residency factors: fiduciary, beneficiary, testator).

268. *See* Ed Morrow, Geoff Germane & David Bowen, *Ed Morrow, Geoff Germane and David Bowen on the Art of Using Trusts to Avoid Utah Income Tax*, LIEMBERG INFO. SERVS., INC. (Apr. 17, 2017), [http://leimbergservices.com/all/LISIMorrowGermaneBowen4\\_17\\_2017.pdf](http://leimbergservices.com/all/LISIMorrowGermaneBowen4_17_2017.pdf) [<https://perma.cc/CHP2-9ATB>].

it would be wise to examine the law of each such state to determine whether the termination will result in income taxation in that state.<sup>269</sup>

#### IV. ASSETS REQUIRING SPECIAL CONSIDERATION

In addition to the general income tax implications of termination of grantor trust status, if the trust owns certain assets, different rules may be triggered with respect to the assets themselves or because of the existence of the assets.<sup>270</sup>

##### A. S Corporation Stock

If a trust owns stock in a small business corporation that has elected to be taxed under Subchapter S of the Internal Revenue Code, terminating grantor trust status may have drastic results.<sup>271</sup> In order to elect S corporation status, the business must qualify as an eligible small business.<sup>272</sup> To qualify as such, a corporation may not have more than 100 shareholders, all of whom must be individuals (or estates or certain eligible trusts), and none of whom are nonresident aliens.<sup>273</sup> If stock is transferred to a trust that is not an eligible shareholder, the S election of the corporation will be terminated.<sup>274</sup>

Under Code Section 1361(c)(2)(A)(i), a grantor trust is a permissible shareholder of S corporation stock, without the need for any special elections, if the grantor is a permitted S corporation shareholder.<sup>275</sup> A grantor trust may hold stock for up to two years after the death of the grantor.<sup>276</sup> However, if grantor trust treatment ceases for any reason other than the death of a grantor, the same grace period does not apply.<sup>277</sup>

After the two year period if grantor trust status terminates at the grantor's death, or immediately after the termination in any other event, a trust will not be an eligible shareholder unless it is a Qualified Subchapter S Trust ("QSST") or an Electing Small Business Trust ("ESBT").<sup>278</sup> An

269. *See id.*

270. *See Scibetta, supra* note 37.

271. *See id.*

272. *See* I.R.C. § 1361(b).

273. *See id.*

274. *See id.* § 1362(d)(2)(A).

275. *See id.*

276. *See id.* § 1361(c)(2)(A)(ii).

277. *See id.* § 1361(d)(3)(A)(i)-(iv).

278. *See id.* § 1361(b)(1)(B); Treas. Reg. § 1.1361-1(e)(1) (However, a decedent's estate qualifies as an S corporation shareholder for the entire period of administration and counts as only one shareholder for the purposes of ensuring that the corporation has no more than 100 shareholders). I.R.C. § 645; Treas. Reg. § 1.645-1(f)(2). If the trustee of a qualified revocable trust and the appointed executor (if any) of the decedent's estate have made a 645 election in order to treat the revocable trust as part of the estate for income tax purposes, it becomes eligible to hold the S corporation stock as an estate, and can do so for as long as the election can be in place. I.R.C. § 645; Treas. Reg. § 1.645-1(f)(2).

election for a trust to be treated as a QSST or an ESBT must be made within two months and fifteen days after the expiration of the two-year grace period or the cessation of grantor trust treatment, as applicable, although late election relief is available.<sup>279</sup>

### *1. Qualified Subchapter S Trusts*

A Qualified Subchapter S Trust (a “QSST”) is a trust with a single income beneficiary.<sup>280</sup> No distributions of trust corpus may be made to anyone other than that beneficiary.<sup>281</sup> The income interest of the beneficiary must terminate on the earlier of the beneficiary’s death or the termination of the trust, and upon the termination of the trust during the beneficiary’s lifetime, all of the trust assets must pass to the beneficiary.<sup>282</sup> Additionally, all of the fiduciary accounting income of the trust must be distributed to the beneficiary.<sup>283</sup> The current income beneficiary of the trust must make the election for the trust to be treated as a QSST and agree to be taxed on the income of the S corporation.<sup>284</sup> The election is made by filing a statement providing the information outlined in Treasury Regulation Section 1.1361-1(j)(6).<sup>285</sup> In most cases, when a trust owns stock in an S corporation and the income beneficiary makes an election to have the trust treated as a QSST, because the beneficiary is treated as the owner of the stock for income tax purposes, all income from the S corporation which is attributable to the QSST will be taxed to the beneficiary.<sup>286</sup>

### *2. Electing Small Business Trusts*

An Electing Small Business Trust (“ESBT”) may have more than one beneficiary, but all beneficiaries must be eligible individuals, estates, or certain charities.<sup>287</sup> No interest in the trust may be acquired by purchase.<sup>288</sup> The trustee of the trust must make the election for the trust to be treated as an ESBT by submitting a letter to the IRS center where the corporation files its income tax return and providing the information outlined in Treasury Regulation Section 1.1361-1(m)(2).<sup>289</sup> If the election is made, the trust is treated as the taxpayer and, with respect to the S corporation, is taxed at the

---

279. See I.R.C. § 1361(c)(2) & (d)(2); see also Rev. Proc. 2013-30, 2013-36 IRB 173.

280. See I.R.C. § 1361(d)(3)(A).

281. See *id.*

282. See *id.*

283. See *id.* § 1361(d)(3)(B).

284. See *id.* § 1361(d)(2).

285. See Treas. Reg. § 1.1361-1(j)(6).

286. See *id.* § 1.1361-1(j)(7).

287. See I.R.C. § 1361(e)(1)(A).

288. See *id.* § 1361(e)(1)(A)(ii).

289. See *id.*

highest marginal federal income tax rate, regardless of whether its income is distributed.<sup>290</sup>

### 3. Allocation of Income from S Corporation in Year of Termination

Another issue that arises in connection with stock in an S corporation is how items of income and expense will be allocated between the grantor and the nongrantor trust in the taxable year that grantor trust status is terminated.<sup>291</sup> If there is a change of ownership in S corporation stock, items of income and expense for the entire year of the ownership change are divided by the number of days in the S corporations' taxable year to calculate a per diem amount allocable to the shareholders on each day.<sup>292</sup> This may be an issue if the grantor is seeking to terminate grantor trust status because he or she does not want to bear the income tax liability of a realization event with respect to the S corporation.<sup>293</sup> If the grantor trust status is terminated before the realization event but in the same taxable year as the realization event, the total pre-change income and post-change income is spread evenly over the total days in the taxable year.<sup>294</sup> In that event, the grantor would be taxed on a portion of the income attributable to the realization event, even though the termination occurred before that date.<sup>295</sup>

In the event of a complete termination of a shareholder's interest, an election is available under Code Section 1377(a)(2) which results in the calculation of a shareholder's share of income and expense as if the year consisted of two tax years: one before the termination and the other after the termination.<sup>296</sup> This closing of the books causes the income and expense for a period to be allocated only to shareholders owning shares during that period.<sup>297</sup> The shareholder whose interest is terminated, all shareholders to whom such shareholder has transferred shares during the taxable year, and the corporation must agree to the election.<sup>298</sup> The election must be made by attaching a statement to the S corporation's timely filed original or amended income tax return for the taxable year during which a shareholder's entire

---

290. *See id.* § 641(c).

291. *See* Treas. Reg. § 1.1377-1(a)(1).

292. *See id.* § 1.1377-1(a)(1). *See also id.* § 1.706-1(c)(2)(ii) (The treatment of disposition of a partner's entire interest in a partnership, in which case allocation of income is made by an interim closing of the partnership's books unless the partners agree to allocate income on per diem or other reasonable basis).

293. *See id.* § 1.1377-1(a)(1).

294. Mark Marquez & Anthony Scutto, Elections Available to S Corporations with Significant Owner Changes, TAXADVISOR (Nov. 30, 2010), <https://www.thetaxadviser.com/issues/2010/dec/clinic-dec2010-story-09.html> [<https://perma.cc/N2LL-RU4E>]

295. *See* I.R.C. § 1377(a)(2).

296. *See id.*

297. *See id.*

298. *See id.*

interest is terminated containing the information set out in Treasury Regulation Section 1.1377-1(b)(5).<sup>299</sup>

A shareholder's entire interest is "terminated" if the shareholder's entire stock ownership in the S corporation ceases, including a sale, exchange, or other disposition of all of the stock held by the shareholder; a gift of all the shareholder's stock; a spousal transfer of all the shareholder's stock; a redemption of all the shareholder's stock, and the death of the shareholder.<sup>300</sup> The applicable Treasury regulations provide that when during the tax year of an S corporation, if a trust that is an eligible shareholder of the S corporation converts from one type of eligible trust (including a grantor trust, post-death grantor trust, QSST, or ESBT) to another type of eligible trust for the remainder of the year, the trust is not treated as terminating its entire interest in the S corporation for purposes of the election, unless the trust was a post-death grantor trust or testamentary trust receiving stock under a Will.<sup>301</sup> Accordingly, unless the grantor trust status terminates because of the death of the grantor, it appears the election under Code Section 1377(a)(2) will not be available.<sup>302</sup>

Therefore, if the grantor desires to terminate grantor trust status to avoid paying income tax that will become due as the result of a realization event, then the termination should occur in the taxable year of the S Corporation before the realization event, if possible.<sup>303</sup>

### *B. Outstanding Promissory Notes Payable to Grantor*

As noted previously, a popular estate planning technique is for a grantor to create an intentionally defective grantor trust and sell assets to the trust in return for an installment note.<sup>304</sup> If structured and administered correctly, the assets of the trust will not be includable in the grantor's gross estate for federal estate tax purposes.<sup>305</sup> The sale to the trust will not be treated as a gift since the grantor receives full consideration for the transfer, and therefore will not be subject to a gift tax.<sup>306</sup> For income tax purposes, the sale of property to the trust will not give rise to gain because the grantor and trust are treated as one person.<sup>307</sup> However, if the promissory note is still outstanding at the time that the grantor trust status terminates, several

---

299. See Treas. Reg. § 1.1377-1(b)(5)(i).

300. See *id.* at § 1.1377-1(b)(4).

301. See *id.* § 1.1377-1(a)(2)(iii).

302. See *id.*

303. See *id.*

304. See *Installment Sales to Intentionally Defective Grantor Trusts*, BLANK ROME LLP, <https://www.blankrome.com/siteFiles/PrivateClient-IDGTs.pdf> (last visited, Feb. 2, 2021) [<https://perma.cc/8GTA-7WTW>].

305. See *id.* at 1.

306. See *id.*

307. See *id.*

questions arise regarding tax treatment of the transaction, the note, and the asset purchased by the trust.<sup>308</sup>

### *1. Termination as the Result of the Grantor's Death*

In the event the trust ceases to be a grantor trust because of the grantor's death and any portion of the note is still outstanding, the income tax implications as to the grantor and the trust are unclear.<sup>309</sup> No authority addresses the situation directly, and commentators have vigorously debated the topic.<sup>310</sup>

Three issues, which are interrelated, are in question in the event that a grantor dies and a debt is still owed to the grantor.<sup>311</sup> The first issue is whether death is a recognition event such that the grantor or the grantor's estate must recognize gain or loss.<sup>312</sup>

The second issue is whether the outstanding note constitutes a right to receive an item of income in respect of a decedent ("IRD") under Code Section 691.<sup>313</sup> Very broadly, IRD is comprised of items that would have been taxable income to the decedent if he or she had lived but are not properly includable in a pre-death income tax return of the decedent.<sup>314</sup> The most common example of IRD is an IRA.<sup>315</sup> Beneficiaries who receive payments that constitute IRD are taxed on those payments, which is an exception to the general rule that an inheritance is income-tax free.<sup>316</sup>

The third issue is the trust's basis in the asset sold to the trust by the grantor.<sup>317</sup> The general rule is that the basis of an asset is the cost of the

308. *See id.* at 2.

309. *See id.*

310. *See* Dunn & Handler, *Tax Consequences of Outstanding Trust Liabilities When Grantor Trust Status Terminates*, 95 J. TAX'N 49 (2001); Cantrell, *Gain Is Realized on Death of the Grantor With an Outstanding Installment Note*, *Trusts & Estates* (Feb. 2010); Manning & Hesch, *Deferred Payment Sales to Grantor Trusts, GRATs, and Net Gifts: Income and Transfer Tax Elements*, 24 TAX MGMT. EST., GIFTS, & TR. J. 3 (1999); Hatcher & Manigault, *Using Beneficiary Guarantees in Defective Grantor Trusts*, 92 J. TAX'N 152, 161-64 (2000); Blattmachr, Gans & Jacobson, *Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor's Death*, 97 J. TAX'N 149 (Sept. 2002); Blattmachr & Gans, *No Gain at Death*, *Trusts & Estates* (Feb. 2010).

311. *See* I.R.C. § 691; *see also* Leo J. Cushing & Luke C. Bean, *Revocable Grantor Trusts and IDGTs After the Death of the Trustor: Avoiding Gain Triggers, Navigating Basis Calculations*, STRAFFORD, 18 (Tuesday, Feb. 14, 2017, 12:00 PM) <http://media.straftfordpub.com/products/revocable-grantor-trusts-and-idgts-after-the-death-of-the-trustor-avoiding-gain-triggers-navigating-basis-calculations-2017-02-14/presentation.pdf>; Julia Kagan, *Income in Respect of a Decedent (IRD)*, INVESTOPEDIA, (Oct. 30, 2020), [https://www.investopedia.com/terms/i/income\\_respectof\\_decedent.asp](https://www.investopedia.com/terms/i/income_respectof_decedent.asp) [<https://perma.cc/P2ZU-WCFX>].

312. *See* Cushing & Bean, *supra* note 311.

313. *See id.* at 13; I.R.C. § 691.

314. *See* I.R.C. § 691(a)(1).

315. *See* Kagan, *supra* note 311.

316. *See* Treas. Reg. § 1.691(a)-1(b); I.R.C. § 102(a).

317. *See* *Topic No. 703 Basics of Assets*, I.R.S. (Jan. 25, 2021), <https://www.irs.gov/taxtopics/tc703> [<https://perma.cc/4KUL-FNWE>].

asset.<sup>318</sup> While the trust is a grantor trust, no sale is deemed to have occurred because the grantor and trust are treated as one person.<sup>319</sup> Accordingly, while the trust is a grantor trust, the asset retains the grantor's basis.<sup>320</sup> If property is "acquired from a decedent," however, a different rule applies.<sup>321</sup> If property is acquired from a decedent, in most instances the basis is the value of that property for federal estate tax purposes.<sup>322</sup> This rule is sometimes referred to as a "step-up" in basis, which is often the case, but the asset may also receive a "step-down" in basis.<sup>323</sup> Property acquired from a decedent includes property passing from the decedent by bequest, devise, or inheritance; property held in a revocable trust; property in which the decedent retained the right to control beneficial enjoyment; property subject to a general power of appointment by the decedent; and other property includable in the decedent's gross estate for federal estate tax purposes.<sup>324</sup> However, not all property acquired from a decedent is subject to the basis adjustment.<sup>325</sup> Property which constitutes IRD does not receive a new cost basis.<sup>326</sup> Another rule applies to property acquired by gift under Code Section 1015(a), which provides that the basis in the hands of the transferee is generally the same as it was in the hands of the transferor (called "carryover basis").<sup>327</sup> Code Section 1015(b) governs basis in the event of a transfer in trust (other than by a transfer in trust by a gift, bequest, or devise), in which case basis will be the same as it would be in the hands of the grantor, increased in the amount of gain or decreased in the amount of loss recognized to the grantor on such transfer under the law applicable to the year in which the transfer was made.<sup>328</sup>

As to the first issue, most practitioners believe that the death of the grantor is not a realization event, and accordingly, no gain or loss is realized at the grantor's death.<sup>329</sup> Similarly, most take the position that the note does not constitute IRD.<sup>330</sup> As to the question of basis, one argument is that the trustee of the trust has acquired the asset by bequest or devise, and accordingly Section 1014 will determine basis and the asset will receive a basis adjustment equal to its fair market value at the grantor's death.<sup>331</sup> The

---

318. *See id.*

319. *See* Rev. Rul. 85-13, 1985-1 CB 184.

320. *See id.* at 3.

321. *See* I.R.C. § 1014(a)(1).

322. *See id.*

323. *See id.* § 1014(b).

324. *See id.*

325. *See id.*

326. *See id.*

327. *See id.* § 1015(a).

328. *See id.* § 1015(b).

329. *See id.* § 1014(b).

330. *See id.*

331. *See id.* § 1015(a).

more popular view seems to be that the trust will take a carry-over basis equal to the grantor's adjusted basis under Code Section 1015(a).<sup>332</sup>

However, some argue that at the grantor's death, recognition is triggered, and a sale is treated as having occurred either immediately before the grantor's death or immediately after the grantor's death.<sup>333</sup> If the sale is treated as having occurred immediately before the grantor's death, the grantor would recognize gain on the excess of the note amount over the grantor's adjusted basis in the asset and would report it on the grantor's final 1040.<sup>334</sup> The note would not constitute IRD.<sup>335</sup> The trust's basis in the asset would be the grantor's adjusted basis plus any gain recognized (under Code Section 1015(b) governing transfers in trust other than by a gift, bequest, or devise).<sup>336</sup>

If the sale is treated as having occurred immediately after the grantor's death, the grantor's estate would recognize loss on the excess of the fair market value of the asset at the grantor's death over the note amount (or if the note amount exceeds the value at death, would recognize gain in the amount of the excess), and the loss or gain which would be reported on the first Form 1041 filed for the grantor's estate.<sup>337</sup> Because the transaction is not treated as having occurred until after the grantor's death, the note is IRD.<sup>338</sup> The trust's basis in the asset would be the amount of the outstanding balance of the note (under Code Section 1012 providing the general rule that the basis of an asset is the cost of the asset).<sup>339</sup>

Another theory is that the transaction is "part sale-part gift" occurring on the last day of the grantor's taxable year.<sup>340</sup> In that case, the grantor would realize gain on the excess of the note amount over the grantor's basis in the asset.<sup>341</sup> However, the gain would not be reportable on the grantor's Form 1040.<sup>342</sup> Instead, the theory is that the note constitutes IRD, and the estate of the grantor or the beneficiaries of the grantor's estate will be taxed when the subsequent note payments are collected.<sup>343</sup> The trust's basis in the asset would then be the greater of the balance of the note at the decedent's death

---

332. See Danielle T. Zaragoza & Sonja K. Johnson, *Morrison & Foerster LLP: Distribution of Liabilities from a Grantor Trust Likely Causes the Grantor to Recognize Gain*, LEXIS (Sept. 2, 2011), <https://www.lexisnexis.com/legalnewsroom/estate-elder/b/estate-elder-blog/posts/morrison-amp-foerster-llp-distribution-of-liabilities-from-a-grantor-trust-likely-causes-the-grantor-to-recognize-gain> [<https://perma.cc/NR64-7SGE>].

333. See *id.*

334. See *id.*

335. See *id.*

336. See *id.*

337. See *id.*

338. See *id.*

339. See *id.*

340. See *id.*

341. See *id.*

342. See *id.*

343. See *id.*

or the grantor's basis in the asset on the date of death (under Code Section 1015 and Treasury Regulation Section 1.1015-4 with respect to part sale-part gift transactions).<sup>344</sup>

Needless to say, each of these approaches yields vastly different income tax consequences, and since there is no clear authority on the issue it is difficult for practitioners to advise clients when the situation arises.<sup>345</sup>

## 2. *Termination of Grantor Trust Status During Life of Grantor*

Similarly, it does not appear there is any clear authority regarding the income tax treatment when the grantor trust status terminates during the grantor's life and the trust continues to owe a debt to the grantor.<sup>346</sup> Some practitioners posit that under those circumstances, the grantor will recognize gain to the extent that the debt owed to the grantor exceeds the grantor's basis in the asset, and the trust's basis in the asset will be equal to the amount of the then-outstanding debt.<sup>347</sup>

The release of a power that caused grantor trust status has been held to be a gain or loss recognition event to recapture partnership losses previously allowed to the grantor.<sup>348</sup> Accordingly there is precedent for the treatment of termination of grantor trust status as a realization event that triggers gain or loss.<sup>349</sup> Treasury Regulation Section 1.1001-2(a) provides generally that the amount realized from a sale or other disposition of property includes the amount of liabilities from which the transferor is discharged as a result of the sale or disposition.<sup>350</sup> Example 5 of Treasury Regulation Section 1.1001-2(c) applies this general rule of gain recognition in the context of a grantor trust.<sup>351</sup> In that example, the taxpayer transferred an asset encumbered by a liability to a grantor trust and subsequently, the grantor released the power that caused the trust to be treated as a grantor trust.<sup>352</sup> Example 5 sets out that at that time, the grantor is considered to have transferred ownership of the asset to the trust, and accordingly, gain must be recognized by the grantor to the extent that the liability exceeds the grantor's basis in the asset.<sup>353</sup> However, it is important to note that in Example 5 the debt is not owed to the grantor, but to a third party.<sup>354</sup>

---

344. *See id.*

345. *See id.*

346. *See id.*

347. *See, e.g.,* Dunn & Handler, *Tax Consequences of Outstanding Trust Liabilities When Grantor Trust Status Terminates*, 95 J. TAX'N 49 (2001).

348. *See Mandorin v. Comm'r*, 84 T.C. 667 (1985); Rev. Rul. 77-402, 1977-2 C.B. 222.

349. *See* Zaragoza & Johnson, *supra* note 332.

350. *See id.*

351. *See id.*

352. *See id.*

353. *See id.*

354. *See id.*

Similarly, in Technical Advice Memorandum 200011005, the grantor created a GRAT and the GRAT borrowed money from a third party to pay the annuity amounts.<sup>355</sup> The loans were still outstanding at the end of the GRAT term, at which time the GRAT terminated and property of the GRAT was distributed to beneficiary trusts, subject to the outstanding debt.<sup>356</sup> In that case, the IRS concluded that the transaction was not distinguishable from Example 5 of Treasury Regulation Section 1.1001-2(c), and thus, termination of the GRAT should be treated as a disposition by the grantor for income tax purposes and the grantor should realize gain on the disposition equal to the amount of the outstanding debt over the grantor's basis in the property.<sup>357</sup> Again, the liability in question was not to the grantor but to a third party.<sup>358</sup>

Although there is no dispositive authority specifying the tax result when grantor trust status is terminated during the grantor's life and there is an outstanding debt owed from the trust to the grantor, from the foregoing discussion it can be reasoned that at termination of the grantor trust status, the position of the IRS might be that gain would be recognized by the grantor to the extent that the debt owed to the grantor exceeds the grantor's basis in the asset.<sup>359</sup> If this is the case, then it follows that the trust's basis in the asset would be the amount of the outstanding debt at the time of the termination.<sup>360</sup>

Because of these potential tax consequences, it is typically recommended that grantor trust status not be terminated while the debt to the grantor remains outstanding if it can be avoided.<sup>361</sup>

### C. Life Insurance

If a grantor trust owns life insurance on the life of the grantor or the grantor's spouse, the existence of that asset in the trust may thwart attempts to terminate grantor trust status.<sup>362</sup>

If income of the trust is used to pay premiums on life insurance policies on the life of the grantor or the grantor's spouse, then it is clear that the income actually used for that purpose will be taxable to the grantor.<sup>363</sup> Although the Code and the Treasury regulations indicate that grantor trust status results if the income of a trust *may* be applied by the grantor or a nonadverse party to pay such life insurance premiums (without the approval or consent of any adverse party), there is conflicting guidance as to how that

---

355. *See id.*

356. *See id.*

357. *See* I.R.S. Tech. Adv. Mem. 200011005 (Mar. 17, 2020).

358. *See id.*

359. *See id.*

360. *See* I.R.C. § 1012 (providing the general rule that a taxpayer's basis in an asset is its cost).

361. *See* Dunn & Handler, *supra* note 347.

362. *See* I.R.C. § 677(a)(3); Treas. Reg. 1.677(a)-1(b)(2)(iii) (1996).

363. *See* I.R.C. § 677(a)(3); Treas. Reg. 1.677(a)-1(b)(2)(iii).

is applied.<sup>364</sup> One position is that if a trust does not actually own a life insurance policy on the grantor's life, the mere power to purchase an insurance policy and pay premiums is not sufficient to trigger grantor trust status.<sup>365</sup> When a trust already owns life insurance, some cases have held that the grantor will only be treated as owner to the extent that income is *actually used* to pay the premiums.<sup>366</sup> On the other end of the spectrum, the IRS has taken the position that the mere power to pay premiums would cause the entire trust to be a grantor trust.<sup>367</sup>

Accordingly, unless the life insurance held by the trust is a fully paid-up policy for which no further premiums will be required and the trust prohibits the trustee from paying premiums, it may be problematic for a life insurance policy to remain in the trust if the goal is that the grantor not be treated as owner for income tax purposes.

#### V. ACTIONS TO BE CONSIDERED BEFORE TERMINATION

If termination of grantor trust status is foreseeable or planned, an opportunity exists to take advantage of the benefits of grantor trust status before the change.<sup>368</sup> The following techniques are all available at any time that the trust is treated as a grantor trust, but it would be prudent to evaluate whether any of them are appropriate and would be beneficial if implemented before termination of grantor trust status, at which point the opportunity will be lost.<sup>369</sup>

##### A. Swaps of Assets with Differing Basis

Many grantor trusts are structured so that the assets of the trust are not includable in the grantor's gross estate at death. To the extent the assets are not included in the grantor's gross estate, the assets will not be eligible for the basis adjustment under Code Section 1014(a).<sup>370</sup> In many circumstances the grantor will have funded a grantor trust with rapidly appreciating assets to attempt to maximize the benefit of the estate planning strategies utilizing grantor trusts.<sup>371</sup> As a result, it is not uncommon for such trusts to hold low-basis assets.<sup>372</sup>

---

364. See I.R.C. § 677(a)(3); Treas. Reg. 1.677(a)-1(b)(2)(iii).

365. See *Corning v. Comm'r*, 104 F.2d 329 (6th Cir. 1939).

366. See *Weil v. Comm'r*, 3 T.C. 579 (1944), 1944 C.B. 29; *Iversen v. Comm'r*, 3 T.C. 756 (1944); I.R.S. Priv. Ltr. Rul. 6406221750A (June 22, 1964); Rev. Rul. 66-313, 1966-2 CB 245.

367. See I.R.S. Priv. Ltr. Rul. 8852003 (Dec. 30, 1988); I.R.S. Priv. Ltr. Rul. 8014078 (Jan. 10, 1980).

368. See I.R.S. Priv. Ltr. Rul. 8852003 (Dec. 30, 1988).

369. See discussion *infra* Sections V.A-C.

370. See I.R.C. § 1014(a).

371. See *id.*

372. See *id.*

If the low-basis asset is one that will likely not be sold before the grantor's death, and if the grantor has a power to reacquire assets under Code Section 675(4)(C), the grantor might exercise the power by transferring high-basis assets to the trust in exchange for the trust's low-basis asset of the same value.<sup>373</sup> If the grantor does not have the power to reacquire trust property, the same result could be accomplished by the grantor purchasing the low-basis assets from the trust.<sup>374</sup> If the low-basis assets are includable in the grantor's gross estate at his or her death, the assets will be subject to a basis adjustment, effectively wiping out any built-in capital gain.<sup>375</sup> One exception to the general rule of basis adjustment for property acquired from a decedent is that any property given to the decedent within one year of death that passes from the decedent back to the original donor (or to the spouse of the donor) as the result of the decedent's death does not receive a basis adjustment.<sup>376</sup> However, even if the grantor dies within a year of the exchange with the grantor trust, because the grantor is treated for income tax purposes as the owner of all of the assets at the time of the exchange, the one-year look-back of Code Section 1014(e) should not apply to limit the basis adjustment of the exchanged assets.<sup>377</sup>

If the fair market value of the low-basis asset cannot be easily determined, it is important to take appropriate steps to determine the fair market value of the asset, such as obtaining a formal appraisal, to ensure that the exchange is for assets of an equivalent value.<sup>378</sup> If the reacquired asset is valued at less than the value of the substituted assets, or if the amount paid by the grantor for the asset is less than the value of the asset, the grantor will have made a gift to the trust in the amount of the difference in value.<sup>379</sup>

The power to reacquire assets may also be exercised to preserve capital losses.<sup>380</sup> This may be helpful if the grantor does not have a long life expectancy.<sup>381</sup> If the grantor owns an asset with a basis in excess of its fair market value at the grantor's death, the basis adjustment will act to wipe out the built-in capital loss.<sup>382</sup> The asset could of course be sold before the grantor's death in order to generate the loss.<sup>383</sup> However, if the grantor does not have enough capital gain to offset the capital loss, net capital losses are not carried forward to the individual's estate after death, and as a result, they

---

373. *See id.* § 675(4)(C).

374. *See* Rev. Rul. 85-13, 1985-1 CB 184 (Remember such a sale will not result in gain to the trust because the trust and the grantor are treated as one person for income tax purposes).

375. *See* I.R.C. § 1014(e).

376. *See id.*

377. *See id.*

378. *See id.*

379. *See id.*

380. *See id.* § 675.

381. *See id.*

382. *See id.* § 1014.

383. *See id.*

are simply lost.<sup>384</sup> Instead, the grantor can reacquire assets from the trust in exchange for the asset with a basis in excess of its value.<sup>385</sup> The loss would then presumably be reserved in the trust.<sup>386</sup> An argument might be made that this type of loss-shifting is impermissible because Code Section 267 provides that no deduction is allowed for any loss on the sale or exchange of property between certain related persons, including between a grantor and a fiduciary of any trust created by that grantor.<sup>387</sup> However, Revenue Ruling 85-13 expressly provides that “a transaction cannot be recognized as a sale for federal income tax purposes if the same person is treated as owning the purported consideration both before and after the transaction.”<sup>388</sup> Because the grantor and the grantor trust are treated as the same person, there is no “sale or exchange” between them for purposes of Code Section 267, and accordingly, the loss-disallowance rule would not be triggered.<sup>389</sup>

### *B. Transfer of Life Insurance to Trust*

If an insured owns life insurance on his or her life, then at the insured’s death the proceeds of the life insurance are includable in his or her gross estate for federal estate tax purposes.<sup>390</sup> As a result, life insurance policies are an attractive asset to give away during lifetime.<sup>391</sup> However, if an insured dies within three years of the transfer of a life insurance policy, the proceeds of the life insurance policy will be includable in the insured’s gross estate for federal estate tax purposes despite the transfer.<sup>392</sup> However, the three-year rule will not apply to any bona fide sale for an adequate and full consideration in money or money’s worth.<sup>393</sup> Accordingly, if a grantor has the power to reacquire property and exchanges a life insurance policy for other assets of equivalent value owned by the trust, presumably, the three-year rule would not apply because the exchange would have been a sale for full and adequate consideration.<sup>394</sup>

However, when a life insurance policy is sold, another issue arises.<sup>395</sup> Generally, the proceeds of life insurance are not included in the recipient’s gross income for income tax purposes.<sup>396</sup> However, one exception to this general rule is applied when a life insurance contract is transferred for

---

384. Rev. Rul. 74-175, 1974-1 CB 52.

385. *See id.*

386. *See id.*

387. *See* I.R.C. § 267(b)(4).

388. *See id.*

389. *See id.*

390. *See id.* § 2042.

391. *See id.*

392. *See id.* § 2035(a).

393. *See id.* § 2035(d).

394. *See id.*

395. *See id.*

396. *See id.* § 101(a)(1).

valuable consideration.<sup>397</sup> Under this circumstance, when life insurance proceeds are received, the gross income exclusion is limited to an amount equal to the consideration paid for the policy and the premiums subsequently paid by the transferee.<sup>398</sup> Accordingly, if the sale of a life insurance policy resulted in a “transfer for value” under Code Section 101(a)(2), a large portion of the death benefit might be subject to income tax on the death of the insured.<sup>399</sup> However, this so-called “transfer for value” rule will not apply if the policy is transferred to the insured.<sup>400</sup> Accordingly, grantor trusts present a unique planning opportunity.<sup>401</sup> Because a grantor trust is not recognized as a separate taxpayer capable of entering into a sales transaction with a grantor for income tax purposes, the transfer for value rule will not apply when a policy is transferred from a grantor to a grantor trust.<sup>402</sup>

Accordingly, if a grantor owns a life insurance policy outright and there is a concern that the grantor may not survive for the requisite three years following the transfer of the policy, the grantor can exchange the policy for other assets of equivalent value owned by the grantor trust or can sell the policy to the trust, thereby removing the proceeds of the policy from his or her gross estate for estate tax purposes while preserving the income tax free nature of the proceeds once received by the trust.<sup>403</sup>

However, if the policy is not a paid-up policy (where no additional premiums will need to be paid), and trust income will need to be used to pay premiums on the policy, the grantor will be taxed on any trust income actually used to pay the premiums.<sup>404</sup> As discussed above, in some instances the IRS has taken the position that even the power to pay premiums will cause the entire trust to be a grantor trust.<sup>405</sup> Accordingly, the grantor must weigh the benefits of transferring the policy to the trust against the possibility of continued grantor trust treatment with respect to at least a portion of the trust.<sup>406</sup>

### *C. Sale of Principal Residence*

Code Section 121 excludes from gross income up to \$250,000 (for single persons) or \$500,000 (for married persons filing jointly) of gain on a sale or exchange of property if, for at least two years during the preceding five years, the taxpayer owned the property and used it as his or her principal

---

397. *See id.* § 101(a)(2).

398. *See id.*

399. *See id.* § 101(a)(2).

400. *See id.* § 101(a)(2)(B).

401. *See id.*

402. *See id.*

403. *See id.*

404. *See* Treas. Reg. § 1.644(a)-1(b)(2) (2006).

405. *See id.*

406. *See id.*

residence.<sup>407</sup> Nongrantor trusts are not eligible for the gain exclusion.<sup>408</sup> However, if a grantor trust owns property, then if the grantor (or person treated as the grantor) will be treated as owning the residence for purposes of satisfying the two-year ownership requirement of section 121, and the sale or exchange by the trust will be treated as if made by the grantor (or person treated as the grantor).<sup>409</sup>

Accordingly, if the trust owns property and is considering its sale, and if the grantor (or person treated as the grantor) has used it as his or her principal residence for at least two years during the preceding five years, the trustee should consider selling the property before termination of grantor trust status in order to be eligible for the gain exclusion.<sup>410</sup>

## VI. CONCLUSION

Although it is a common refrain that grantor trust status can simply be turned off, the implications of the termination of grantor trust treatment necessitate a deeper analysis than that would suggest.<sup>411</sup>

The consequences of the termination will differ depending upon the type of trust in question, the reason that grantor trust status terminated, how income was reported while the trust was treated as a grantor trust, and assets held by the trust when grantor trust treatment ceases.<sup>412</sup> When termination of grantor trust status has occurred, is foreseeable, or is being contemplated, it is necessary to determine the facts and circumstances at hand and to evaluate the implications of the termination and actions to be taken as a result.<sup>413</sup> If the change has not yet occurred, it is also prudent to assess whether any estate planning techniques available while the trust is treated as a grantor trust should be utilized before the termination.<sup>414</sup>

---

407. *See* I.R.C. § 121(a).

408. *See id.*

409. *See* Treas. Reg. 1.121-1(c)(3); Rev. Rul. 85-45, 1985-1 CB 183.

410. *See* Treas. Reg. 1.121-1(c)(3); Rev. Rul. 85-45, 1985-1 CB 183.

411. *See supra* Parts III-IV.

412. *See supra* Parts I-V.

413. *See supra* Parts I-V.

414. *See supra* Parts I-V.