

The *Mysterious* World of Grantor Trusts

Who uses them, and why?

2021 Tax Update Webinar

December 10, 2021

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The Mysterious World of Grantor Trusts

Webinar Agenda

- Overview of Trusts
- Revocable versus Irrevocable Trusts
- Unique Features of Grantor Trusts
- Tax Reporting for Grantor Trusts
- What's New
- Resources

Overview of Trusts



Overview of Trusts



Common motivations for estate and trust planning:

- accumulation/inheritance of wealth
- avoidance of probate
- perpetual care for vulnerable

Overview of Trusts

Transfer of Assets

Will

Probate, public record
Transfers only at death

Trust

No probate, no public record
Can control date of transfer, terms

What is a trust?

At its core, a trust is a mechanism to exercise control over the benefit of assets. It is a fiduciary arrangement that allows a trustee to hold and manage assets until those assets are legally transferred to the intended recipient.



Duties of a Trustee - Fiduciary Standard of Conduct

The primary responsibilities of the trustee are investment, administration and distribution of trust assets. The trustee may engage agents to assist with this process (such as accountants).

The trustee must consent to the position. Once accepted, the trustee cannot resign without the consent of all the beneficiaries or the court.

Duties of a Trustee - Fiduciary Standard of Conduct

The trustee is required to administer the trust in compliance with the terms of the trust document. In matters where the trust document is silent, the trust is governed by the local Trust Code of the jurisdiction where the trust has situs. Within the Trust Code are standards of conduct, some of which include the following:

- Duty of loyalty - administer the trust solely in the interest of the beneficiaries
- Duty of prudence - held to an objective standard of care in managing the trust property

Subsidiary duties

- Impartiality - no favoritism between classes of beneficiaries
- Keep trust property separate (no commingling with personal property)
- Duty to inform and account to beneficiaries
 - Comply with all recordkeeping requirements
 - File all necessary income and other tax returns
 - May include accountings

What to look for in a trust document

1. Declaration of intent
2. Statement of trust purpose (optional but useful)
3. Statement of revocability or irrevocability

What to look for in a trust document

4. Dispositive provisions -

- What happens to the property while it's held in trust
- What happens to the property when the trust terminates
- corpus (principal) and earnings may be allocated to different beneficiaries during the term of the trust and at termination

What to look for in a trust document

5. Administrative provisions

- Clarify terms to prevent unnecessary court involvement

6. Trustee provisions

- Clarify successor trustees, compensation, removal of trustee if needed

7. Governing and situs

- Clarify situs of trust, laws which will govern administration

Common Planning Considerations for Trust Documents

Will the trust assets be part of the grantor's estate?

- Is the goal to reduce the taxable estate?
- Will the trust assets be stepped-up to market value at death of grantor?

How will the income from the trust be taxed?

- Low threshold for maximum tax rates at the trust level provides an incentive for income to be taxed outside of the trust

Common Types of Trusts

Bypass and QTIP (tax/estate planning) (marital, credit shelter)

Living (avoid probate)

Charitable (tax/estate planning)

Dynasty (tax/estate planning)

Special Needs (provide for vulnerable)

Spendthrift (contingency plan)

Life insurance (tax/estate planning)

Medicaid Asset Protection (protect residence from nursing home/gov't, retain gain exclusion)

Totten - no document needed! (POD, ITF)

Revocable vs. Irrevocable Trusts

Quick Overview



Revocable Trust

Grantor has power to change/terminate trust at any time during lifetime

Assets belong to grantor (grantor retains control)

Grantor may also be Trustee

Incomplete gift - no gift return required

Death of grantor triggers irrevocability

Purposes: avoid probate, asset management if grantor becomes incapacitated

Estate Planning: assets are included in grantor's estate (with basis step-up)

Taxability: income taxed to grantor

Irrevocable Trust

Grantor relinquishes power to change/terminate trust

- Changes/termination requires consent of all parties

Assets held in trust, under management of trustee

Grantor may not be Trustee (spouse not recommended either)

Funding of trust constitutes a gift, with gift return implications

Purpose: transfer wealth, reduce taxes, protect assets from creditors

Estate Planning: assets are excluded from grantor's estate (no step-up)

Taxability: income taxation must be clarified by trust document terms

Unique Features of Grantor Trusts and their evolution



Evolution of Grantor Trusts

Grantor trusts evolved as a tax strategy.

For many years, the graduated tax rate schedules for trusts were comparable to the graduated tax rate schedules for individuals.

Wealthy taxpayers had an incentive to shift income-producing assets to their (less-wealthy) heirs so that the income would be taxed at lower tax rates. Assets could be transferred permanently *or* temporarily, allowing for control over the assets in addition to tax savings.

The IRS perceived this strategy to be an abuse of the tax rules.

Evolution of Grantor Trusts

For 2021, the maximum income tax rate (37%) applies to estates and nongrantor trusts with taxable income of only \$13,050, compared to \$523,600 for single individuals.

While the tax savings incentive has been addressed, grantor trusts are used to accomplish other objectives.

Unique Features of Grantor Trusts

Will the trust assets be part of the grantor's estate?

- governed by estate/gift (transfer) tax rules

How will the income from the trust be taxed?

- governed by income tax rules

The rules for income tax don't quite agree with the rules for transfer tax regarding the standards for determining whether a gratuitous transfer (gift) is complete. This mismatch creates the opportunity for significant tax planning. Trusts are written to be intentionally defective so as to trigger grantor tax status.

Unique Features of Grantor Trusts

Revocable (Living) trusts are

- disregarded for federal income tax purposes
- disregarded for federal estate tax purposes

Most other types of grantor trusts are irrevocable trusts that trigger grantor trust status so that they will be

- disregarded for federal income tax purposes
- recognized for federal estate tax purposes

Unique Features of Grantor Trusts

What determines if a trust is a grantor trust?

IRC §671

Grantor trust status is attained when the grantor retains certain **rights or control over trust assets.**

The grantor is treated as the owner of the trust.

Unique Features of Grantor Trusts

What determines if a trust is a grantor trust?

If the grantor is treated as the owner of any part of a trust, the grantor must include the trust's tax items of income, deductions and credits in his/her own personal taxable income.

Other specific triggers for grantor trust status are provided in IRC §673 through §679. Numerous exceptions are detailed in the IRC.

Other Provisions Triggering Grantor Trust Status

IRC §673

Grantor retains a **reversionary interest** in corpus or income and the value of the reversionary interest exceeds 5% of the value of the assets over which reversionary interest is held, based on date of transfer

Common Example:

- Parent receives life interest in residence during life, residence reverts to grantor at death of parent

Other Provisions Triggering Grantor Trust Status

IRC §674

Grantor has certain powers to affect the **beneficial enjoyment** of corpus or income, to the extent the beneficial enjoyment is subject to power of disposition without the approval or consent of an adverse party. There are several exceptions to this clause.

Common Example:

- “Sprinkling Powers” Grantor creates trust for benefit of grandchildren. Grantor, as trustee, has *discretionary* powers to distribute principal and/or income to grandchildren

Other Provisions Triggering Grantor Trust Status

IRC §675

Certain **administrative powers** provide benefit to grantor, rather than to beneficiaries

- Power to deal with trust property for less than adequate consideration
- Power to borrow without adequate interest or security
- Actual borrowing by the grantor (exception for loans for adequate consideration)
- Grantor has non-fiduciary prohibited powers:
 - Power to vote stock of corporation over which grantor and/or trust has significant voting control
 - Power to control investment of trust corpus to extent it involves stock of corporation over which grantor and/or trust has significant voting control
 - Power to reacquire corpus by substituting property of equal value

Other Provisions Triggering Grantor Trust Status

IRC §676

Grantor has power to **revoke** any part of the trust and reclaim the trust assets. Includes power to alter, amend, modify or terminate trust.

Other Provisions Triggering Grantor Trust Status

IRC §677

Income for the Benefit of the Grantor

- Income is actually or constructively distributed to the grantor/spouse
- Income is accumulated for future distribution to grantor/spouse
- Income is applied to pay premiums on life insurance policies on life of grantor/spouse

Other Provisions Triggering Grantor Trust Status

IRC §678

If a person other than the grantor is treated as the owner (generally, a beneficiary), that person is taxed on the income earned by the trust.

Generally, this provision is triggered if the person has the unilateral right to withdraw trust principal (corpus) or income without approval.

Common Types of Grantor Trusts

Living (revocable or irrevocable) These **may be** grantor trusts:

Charitable

Dynasty (assets remain in trust across generations)

Special Needs

Spendthrift

Life insurance

Medicaid Asset Protection

Tax Reporting for Grantor Trusts



Tax Reporting for Grantor Trusts

To get an EIN or not to get an EIN

That is the Question

As a disregarded entity for income tax purposes, a grantor trust is not required to obtain an EIN while the grantor/deemed owner is alive, unless the trust is required to file Form 1041.

If the trust holds qualified subchapter S stock, Form 1041 is required.

Tax Reporting for Grantor Trusts

To get an EIN or not to get an EIN

In Practice

Most financial institutions understand “revocable living trusts” and allow separate bank accounts to be opened for those trusts using the grantor’s SSN.

Some financial institutions implement a policy that if the trust is irrevocable, the trust must obtain its own EIN for purposes of opening a separate bank account in the name of the trust.

Tax Reporting for Grantor Trusts

To get an EIN or not to get an EIN

In Practice

While Form 1041 is optional for most grantor trusts, it is often used when an EIN is obtained. Disclosure on Form 1041 for grantor trusts follows a specific format, with 3 optional filing methods.

Page 1 contains only the trust's name, address and TIN. The activity reportable by the deemed owner is summarized on a separate statement.

When the beneficiary is considered the deemed owner, disclosure is similar, but is stated in a footnote rather than on Page 1.

Tax Reporting for Grantor Trusts

Department of the Treasury - Internal Revenue Service
Form 1041 U.S. Income Tax Return for Estates and Trusts **2020** OMB No. 1545-0092
 Go to www.irs.gov/Form1041 for instructions and the latest information.

For calendar year 2020 or fiscal year beginning **JUNE 26, 2020**, and ending **DECEMBER 31, 2020**

A Check all that apply:

Decedent's estate Name of estate or trust (if a grantor type trust, see the instructions.) **SUSAN GRANTOR 2020 IRREV TR FBO** C Employer identification number **12 3456789**

Simple trust **CHILDREN OF TRUSTEE** D Date entity created **06/26/2020**

Complex trust Name and title of fiduciary **JOHN W. TRUSTEE**

Qualified disability trust **TRUSTEE** E Nonexempt charitable and split-interest trusts, check applicable box(es). See instructions.

Grantor type trust Number, street, and room or suite no. (if a P.O. box, see the instructions.) **932 MAIN STREET** Described in sec. 4947(a)(1).

Bankruptcy estate-Ch. 7 City or town, state or province, country, and ZIP or foreign postal code **CHARLOTTESVILLE, VA 22902** Described in sec. 4947(a)(2).

Bankruptcy estate-Ch. 11 Pooled income fund

B Number of Schedules K-1 attached F Check applicable boxes: Initial return Final return Amended return Net operating loss carryback

GRANTOR LETTER
 JOHN W. TRUSTEE
 TRUSTEE
 932 MAIN STREET

Tax Year Ending: 12/31/20

Grantor Name & Address SUSAN GRANTOR 123 INHERITANCE ROAD CHARLOTTESVILLE, VA 22903 Social Security Number: 123-45-6789	Name of Trust SUSAN GRANTOR 2020 IRREV TR FBO CHILDREN OF TRUSTEE Employer ID Number: 12-3456789
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THE FOLLOWING INCOME, DEDUCTIONS AND CREDITS ARE TO BE REPORTED ON THE INCOME TAX RETURNS FOR THE ABOVE NAMED GRANTOR, IF REQUIRED.

G Check here if the estate or filing trust made a section 845 election Trust TIN

Income	1 Interest income	1
	2 a Total ordinary dividends	2a
	b Qualified dividends allocable to: (1) Beneficiaries (2) Estate or trust	
	3 Business income or (loss). Attach Schedule C (Form 1040)	3
	4 Capital gain or (loss). Attach Schedule D (Form 1041)	4
	5 Rents, royalties, partnerships, other estates and trusts, etc. Attach Schedule E (Form 1040)	5
	6 Farm income or (loss). Attach Schedule F (Form 1040)	6
	7 Ordinary gain or (loss). Attach Form 4797	7
	8 Other income. List type and amount	8
	9 Total income. Combine lines 1, 2a, and 3 through 8	9
	10 Interest. Check if Form 4952 is attached	10
	11 Taxes	11
	12 Fiduciary fees. If only a portion is deductible under section 67(e), see instructions	12

Handwritten notes on lines 5, 6, 7, 8, 9, 10, 11, 12:
 "UNDER THE TERMS OF THE TRUST INSTRUMENT, THIS IS A GRANTOR TRUST. IN ACCORDANCE WITH SECTIONS 671-679 IRC, 1986, ALL INCOME IS TAXABLE TO THE GRANTOR. STATEMENTS OF INCOME, DEDUCTIONS AND CREDITS ARE ATTACHED."

FEDERAL INFORMATION	
INCOME	
INTEREST INCOME.....	10.
(ENTER ON FORM 1040, SCHEDULE B, PART I, LINE 1)	
TOTAL ORDINARY DIVIDEND INCOME.....	17,471.
(ENTER ON FORM 1040 SCHEDULE B PART II LINE 5)	



Tax Reporting for Grantor Trusts

- Beneficiary is deemed owner of trust

GRANTOR LETTER
 UNITED BANK
 TRUSTEE
 1234 MAIN STREET
 CHARLOTTESVILLE, VA 22911

Department of the Treasury - Internal Revenue Service
1041 U.S. Income Tax Return for Estates and Trusts **2020** OMB No. 1545-0092
 Go to www.irs.gov/Form1041 for instructions and the latest information.

A Check all that apply:
 Decedent's estate
 Simple trust
 Complex trust
 Qualified disability trust
 ESBT (S portion only)
 Grantor type trust
 Bankruptcy estate-Ch. 7
 Bankruptcy estate-Ch. 11
 Pooled income fund

For calendar year 2020 or fiscal year beginning _____, 2020, and ending _____

Name of estate or trust (if a grantor type trust, see the instructions.)
TRUST F/B/O ANNETTE BENEFICIARY

C Employer identification number
12-3456789

D Date entity created
12/30/1982

Name and title of fiduciary
UNITED BANK TRUSTEE

E Nonexempt charitable and split-interest trusts, check applicable box(es). See instructions.
 Described in sec. 4947(a)(1)
 Described in sec. 4947(a)(2)
 Check here if not a private foundation

Number, street, and room or suite no. (if a P.O. box, see the instructions.)
1234 MAIN STREET

City or town, state or province, country, and ZIP or foreign postal code
CHARLOTTESVILLE, VA 22902

B Number of Schedules K-1 attached

F Check applicable boxes:
 Initial return
 Final return
 Amended return
 Net operating loss carryback

Change in trust's name
 Change in fiduciary
 Change in fiduciary's name
 Change in fiduciary's address

G Check here if the estate or filing trust made a section 845 election Trust TIII

Tax Year Ending: 12/31/20

Grantor Name & Address ANNETTE BENEFICIARY 96 INHERITANCE ST. CHARLOTTESVILLE, VA 22903 Social Security Number: 123-45-6789	Name of Trust TRUST F/B/O ANNETTE BENEFICIARY Employer ID Number: 12-3456789
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THE FOLLOWING INCOME, DEDUCTIONS AND CREDITS ARE TO BE REPORTED ON THE INCOME TAX RETURNS FOR THE ABOVE NAMED GRANTOR, IF REQUIRED.

FEDERAL INFORMATION	
INCOME	
INTEREST INCOME..... (ENTER ON FORM 1040, SCHEDULE B, PART I, LINE 1)	713.
INTEREST FROM U.S. OBLIGATIONS NOT INCLUDED ELSEWHERE..... (ENTER ON FORM 1040, SCHEDULE B, PART I, LINE 1)	22,444.
TOTAL ORDINARY DIVIDEND INCOME..... (ENTER ON FORM 1040, SCHEDULE B, PART II, LINE 5)	7,596.
QUALIFIED DIVIDEND INCOME INCLUDED ABOVE..... (USE FOR SCHEDULE D TAX CALCULATION)	7,596.

TRUST F/B/O ANNETTE BENEFICIARY

FORM 1041 FOOTNOTES
 STATEMENT 1

UNDER THE TERMS OF THE TRUST INSTRUMENT, THIS IS A GRANTOR TRUST. **THE BENEFICIARY IS TREATED AS THE OWNER OF THE TRUST.** IN ACCORDANCE WITH SECTION 678 IRC, 1986, ALL INCOME IS TAXABLE TO THE BENEFICIARY. BENEFICIARY INFORMATION IS SHOWN BELOW.

BENEFICIARY INFORMATION:
 ANNETTE BENEFICIARY
 96 INHERITANCE ST.
 CHARLOTTESVILLE, VA 22903
 SSN: 123-45-6789

Optional Method 1 (available if the trust is treated as owned by one person)

Trustee provides to all payors of income the following information:

- Grantor's name
 - to avoid confusion, also provide the Trust name
“Jane Gotbucks, Grantor of the Gotbucks Dynasty Trust dated 12/5/2020”
- Grantor's SSN
- Trustee's address

Trustee compiles all tax documents received and provides to grantor.

Grantor includes all income on personal tax return

Optional Method 2 (not recommended) - in lieu of Form 1041

Trustee compiles all income earned by Trust, and then files Forms 1099 for income reportable to deemed owner

- Required for all types of income received by trust, potentially resulting in multiple forms

In effect, the trust becomes the payor and the deemed owner becomes the payee

Unless the deemed owner is the trustee or co-trustee, trustee retains duty to provide tax information letter (summary)

Optional Method 3 (not recommended) - in lieu of Form 1041

Same as Option Method 2, for use when trust is treated as owned by two or more grantors. Trustee must issue Forms 1099 to each deemed owner for their proportionate share of each type of income.



Proposed Legislation which could impact grantor trusts

- Major changes to grantor trust tax rules
 - Require inclusion in grantor's estate of all assets held in grantor trust as of date of death, even if irrevocable (completed gift)
 - Sale transactions between grantor and trust would be subject to income tax as if between grantor and third party
 - Distributions from grantor trust to beneficiary other than grantor/grantor's spouse treated as taxable gift
 - If grantor chooses to "turn off" grantor trust power during lifetime, such action would constitute an additional gift to trust beneficiaries

What's New

Proposed Legislation which could impact grantor trusts

- Removed from current version, but stay tuned . . .

Recommended Resources and CPE

- PPC's 1041 Deskbook available in Thomson Reuters CheckPoint
- Trust Fundamentals: A Practical Primer for Tax Practitioners available in Wolters Kluwer CCH CPELink
- Estate & Trust Primer available as part of AICPA Tax Staff Essentials Level 3

Questions





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