Don't Feel the Burn: Foot Faults and Planning Obstacles with Grantor Trusts

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The grantor trust likely is a staple of your estate planner's diet. The wealth transfer opportunities that grantor trusts can afford (because the grantor can bear the income tax liability for a completed gift trust) have been well discussed. Grantor trusts also have the appeal of being "easy" for clients: without fear of income tax consequences, clients *may* be able to lease from their grantor trusts, lend to and from their grantor trusts, substitute assets in and out of and sell assets to their grantor trusts, and be reimbursed for income tax liabilities associated with their grantor trusts.[1] It is an elegant structure that can be woven seemingly seamlessly into the fabric of your client's estate plan.

This article aims to view planning with grantor trusts from a different angle. It flags some of the foot faults that lay lurking with any grantor trust planning, foot faults that our complacency with this "easy" structure can sometimes distract us from seeing.

Part I of this article will discuss issues that arise with "multiple grantor" trusts. Part II will discuss trigger events resulting in a change of grantor trust status. Finally, Part III will end the article with a potpourri of regulatory, property tax and income tax related issues to consider when planning with grantor trusts.

I. Multiple-Grantor Trusts

When a trust does not have a single grantor, even if it is "wholly-grantor trust" as to these multiple grantors, complexities arise.

This Section first will discuss instances in which "multiple-grantor trusts" may arise – either intentionally or inadvertently. Next it will discuss complications that may result from a multiple-grantor trust.

A. How and Why Would This Happen?

The regulations define a "grantor" to include "any person to the extent such person either creates a trust, or directly or indirectly makes a gratuitous transfer of property to a trust." Treas. Reg. Section 1.671-2(e)(1). However, a person who establishes a trust without making a gratuitous transfer to the trust is not treated as the owner of any portion of the trust under the grantor trust rules. Any time multiple persons make gratuitous transfers to a trust, therefore, the trust may have multiple grantors, and then an analysis must be made under IRC Sections 671 through 679 of whether those persons are treated as owners of any portion of the trust (and of what portion). This subsection will explore a nonexclusive list of why this situation may arise more commonly than planners expect – and sometimes in inadvertent or surprising contexts.

[1] Depending on authority in the trust instrument and default law, and subject to the considerations described in further detail in this article.

1. Community Property Jurisdictions

Multiple-grantor trusts in fact are common for spouses in community property jurisdictions where joint revocable trusts are standard testamentary planning tools. As revocable trusts between two grantors who are spouses (in a community property jurisdiction), these trusts often do not invite all of the same complexities discussed in subsection B of this article, but their prevalence makes them worth noting.

2. Eager Family Members

Frequently clients call because a family member (perhaps a parent) hopes to contribute to the same trust that client created. Rather than incur the expense and aggravation of establishing their own trust, the family member (and client) assume(s) that they can as easily wire funds to the client's existing trust. The well-trained client calls before that wire occurs but sometimes we are not so lucky and we learn of these transfers too late, after they have happened.

3. Trust Decantings

Clients often will find that, over the years, their estate plans have become a proliferation of trusts and entities, with clients (and their estate planners) losing sight of what, if any, special purpose one trust may serve over another. Decanting or merging trusts can be a good solution to help simplify the estate planning structure (and to modify and improve on the terms of the existing trusts). There are a host of potential tax considerations to assess before a decanting, but among them is whether the decanting will create multiple grantors.

Treas. Reg. Section 1.671-2(e)(5) provides that if a trust makes a gratuitous transfer of property to another trust, then the grantor of the transferor trust generally will be treated as the grantor of the transferee trust unless a person with a general power of appointment over the transferor trust exercises that power in favor of the transferee trust (in which case that person exercising the general power of appointment will be treated as the grantor of the transferee trust).

If a trust decants to another trust (other than by exercise of a general power of appointment), and both trusts do not have the same grantor, then the decanting will result in a trust with multiple grantors. (Likewise, if a person exercises a general power of appointment in favor of a trust, and is not the grantor of that transferee trust, then the transferee trust also will have multiple grantors.)

4. Crummey Powers

Most planners are familiar with the technique of including so-called *Crummey* withdrawal powers in trust agreements.[2] These powers allow a grantor to maximize gift tax efficient transfers to the trust by qualifying the transfers for the annual exclusion from gift tax under IRC Section 2503(b); the withdrawal power, if properly drafted, causes the transfer to be respected as a "present interest" in the property, qualifying for the benefit of the annual exclusion under IRC Section 2503(b). Most traditionally these powers are used to protect transfers to a trust holding life insurance in order to help fund the

[2] The name derives from the case blessing the use of these withdrawal powers, *Crummey v. Commissioner,* 397 F.2d 82 (9th Cir. 1968).

premiums on the life insurance policies. However, their use in this context is not exclusive and they can appear in trusts holding non-life insurance investments as well.

These powers have the potential of creating another flavor of "multiple grantor" trust problems. IRC Section 678(a) states that a beneficiary will be deemed to be the owner of a trust if the beneficiary has a "power exercisable solely by himself to vest the corpus or the income therefrom in himself." A beneficiary's *Crummey* withdrawal power may be an IRC Section 678(a) power and cause the beneficiary to be a deemed grantor of a portion of the trust, at least for the period of time until the power lapses and potentially even after the power lapses. IRC Section 678(b) trumps the general rule of IRC Section 678(a) if the grantor of the trust is treated as the owner of the trust. Thus, a beneficiary *may not* be deemed the owner of any portion of a trust if the grantor (who made the gratuitous transfer to the trust) otherwise is treated as the owner under the rules of IRC Sections 673-677 and 679. This position is supported in several private letter rulings.[3] In the context of a trust that is non-grantor as to the grantor, these *Crummey* powers can create "deemed grantor trust" treatment under IRC Section 678(a) with respect to a portion of the trust so that a portion of the trust is treated as owned by the beneficiary under IRC Section 678 and the remaining portion is not treated as owned by the grantor (or by the beneficiary) (*i.e.,* remains a non-grantor trust). Some commentators worry that, notwithstanding the private letter rulings, these *Crummey* powers may create multiple grantors even if the trust is grantor trust as to the grantor, at least while the powers are outstanding and have not lapsed.

5. Deemed Gratuitous Transfers to Foreign Trusts

Planning with foreign trusts and foreign grantors implicates many other considerations, both specific to grantor trust treatment of the trust and otherwise.[4] This article does not purport to address these. However, one rule specific to foreign trusts merits discussion; it has the potential of triggering a "deemed gratuitous transfer" that can cause a trust to be treated as having multiple grantors. If a US person beneficiary makes a loan to a foreign trust, and the loan does not satisfy the requirements of a "qualified obligation" as defined in Treas. Reg. Section 1.679-4(d), then the US person beneficiary will be treated as having made a transfer to the foreign trust and may be treated as an owner of part of the foreign trust under IRC Section 679.[5] These rules can be implicated even while the foreign trust is revocable by its grantor and certainly after the trust is irrevocable (and likely otherwise will be a non-grantor trust). They can surprise planners less familiar with planning with foreigners and foreign trusts and create difficult results, including the income tax treatment of the trust and of underlying entities in which the trust is invested (potentially implicating some of our anti-avoidance rules that apply in the context of foreign corporations with US person owners).

B. Why Should We Care – Getting "Burnt" Planning with Multiple-Grantor Trusts?

Planning with wholly-grantor trusts (with only one grantor) can be so "easy" that planners may forget the complexities that can crop up once there are multiple grantors. This subsection highlights some of those complexities in order to arm planners with the foresight to anticipate and solve for them.

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[3] See, e.g., PLRs 200729005-200729016; 200606006.

[4] See, e.g., the special rules that apply in IRC Section 672(f) (determining when a nonresident alien of the US (or a foreign corporation) will be treated as owning a trust) and IRC Section 679 (determining when a foreign trust as defined in IRC Section 7701(a)(31)(B) will be treated as a grantor trust with respect to a US transferor as defined in Treas. Reg. Section 1.679-1(c)).

[5] Treas. Reg. Section 1.679-4(c). A "US person" has the meaning described in IRC Section 7701(a)(30) for these purposes. A "foreign trust" has the meaning described in IRC Section 7701(a)(31)(B) for these purposes.

1. Regarded Sales Transactions if Multiple Grantors Are Not Spouses

Rev. Rul. 85-13 addressed the federal income tax consequences of transactions between a grantor and a trust that is treated as wholly owned by that grantor pursuant to IRC Sections 671-679. It held that transactions between the grantor and the grantor trust are disregarded for federal income tax purposes. Sales (or substitutions) by a grantor to her grantor trust do not trigger gain or loss. Interest on loans between a grantor and her grantor trust is not income to the grantor (or deductible by the grantor trust). These consequences (or lack thereof!) are fundamental to many of the estate planning techniques that we use routinely, including of course installment sales to intentionally defective grantor trusts. The installment sale technique involves a grantor's sale of an asset to a completed gift grantor trust in exchange for a promissory note. The technique promises to transfer the appreciation on the transferred property in excess of the interest on the promissory note to the grantor trust, free from any gift tax. The fact that this sale can be done without triggering gain (or loss) for the grantor and that the interest on the promissory note will not create taxable income for the grantor helps to eliminate any income tax friction that otherwise might occur with the technique.

Once a trust has multiple grantors, *unless the grantors are spouses*, any sale transaction will be regarded (at least in part) and may trigger gain (or loss). Some portion of the sale may continue to be disregarded consistent with Rev. Rul. 85-13 because some portion will be attributed to the portion of the trust that remains "grantor" as to the selling party. (Later in this Section we will discuss how to determine the appropriate portion that will be treated as "grantor" as to each of the multiple grantors.) However, the portion of the trust that is grantor as to the non-selling party will be entering into a regarded transaction with the selling party. If the property is held at a gain, then the sale will result in gain recognition for the selling party. If the property is held at a loss, then the sale may result in loss realization for the selling party, but *only if* the sale does not implicate the "related party loss disallowance" rules found in IRC Section 267. These rules provide that losses from sales of property between related parties are not deductible for tax purposes. Related parties are defined in IRC Section 267(c) and include rules for determining when a trust is a "related party."

Now, if the multiple grantors are spouses, the sale will remain disregarded for purposes of realizing gain or loss. IRC Section 1041(a)(1) provides that no gain or loss is recognized on a transfer of property from a person to her spouse. When a person sells property to a trust that is grantor trust as to the spouse, the sale is treated as a sale to the person's spouse, and IRC Section 1041(a)(1) and Rev. Rul. 85-13, together, preserve the treatment of that sale as a disregarded sale. This result has been confirmed in private letter rulings.[6]

2. Interest and Rental Income Realized

Similarly, once a trust has multiple grantors, any interest income or rental income that arises from loans or leases between a party and the trust will result in taxable income with respect to the portion of the trust that is not "grantor" as to the lending or leasing party.

[6] See, e.g., PLR 201927003.

Importantly, IRC Section 1041(a)(1) does not help avoid this result when the grantors are spouses.[7] IRC Section 1041 only applies to property transfers and not to all potentially taxable transactions, including loans and leases. It is not settled if, in the case of interest income, the interest must be realized according to the spouse's tax method of accounting or according to the OID rules which may require interest income recognition regardless of the tax method of accounting employed by the spouse.[8]

3. Eligible S Corporation Shareholder

A grantor trust wholly owned by a single individual is an eligible S corporation shareholder.[9] A trust wholly grantor but as to multiple individuals is not. (The language of IRC Section 1361(c)(2)(A)(i) refers to a trust "all of which is treated … as owned by an individual who is a citizen or resident of the United States" (emphasis added).)

A husband and wife who file a joint return and each of whom is a citizen or resident of the United States will be treated as one individual for these purposes.[10]

If a grantor trust with multiple grantors (who are not spouses filing a joint return) owns shares in an S corporation, then it must qualify as an eligible S corporation shareholder in another way (i.e., generally either as an electing small business trust, or "ESBT," described in IRC Section 1361(c)(2)(A)(v) or as a qualified subchapter S trust, or "QSST," described in IRC Section 1361(d)(3)); it cannot qualify because of its "grantor trust status." Losing S corporation eligible shareholder treatment generally terminates the S corporation election for the entity and can have severe tax consequences that should be avoided with proper planning.

4. DREs Become Partnerships

In most cases, if a trust with multiple grantors owns an interest in a pass-through entity, the entity will be a partnership, rather than a disregarded entity (as would be the case if the trust has only a single grantor).

The exception to this rule is when the only grantors are spouses in a community property jurisdiction.[11]

Needless to say, it is critical to know if an entity interest is a disregarded entity or a partnership, not least of which for purposes of determining appropriate tax reporting for the entity. Accounting and tax consequences of dealing with a partnership rather than a disregarded entity need to be carefully evaluated and are beyond the scope of this article.

5. Drafting/Property Ambiguities

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[7] See, e.g., Cipriano v. Comm'r, T.C. Memo 2001-157, 81 T.C.M. (CCH) 1049 (2001); Gibbs v. Comm'r, T.C. Memo 1997-196, 73 T.C.M. (CCH) 2669 (1997).

[8] For a more complete discussion, see The Tax and Practical Aspects of the Installment Sale to a Spousal Grantor Trust, Culp, Hattenhauer and Mellen, ACTEC Law Journal, Vol. 44:63,

[9] IRC Section 1361(c)(2)(A)(i).

[10] Treas. Reg. Section 1.1361-1(e)(2); Treas. Reg. Section 1.1361-1(h)(3)(i)(A).

[11] Rev. Proc. 2002-69.

Outside of joint revocable trusts drafted and designed for multiple grantors, many planners' trust agreements are drafted contemplating only a single grantor. Once a trust has multiple grantors, a careful review of the trust agreement is necessary to understand the implications for the "uncontemplated" grantor. For example, substitution powers included in a trust to satisfy IRC Section 675(a)(4)(C), income tax reimbursement powers and prohibitions on who may serve as trustee often are drafted with only one grantor anticipated. (For example, these powers and prohibitions may reference the grantor by name or may extend only to a defined "Grantor," who has been defined as a single individual and not as any donor of property to the trust.)

In the case of the income tax reimbursement power, this distinction between the contemplated and uncontemplated grantor can have real economic consequence (unless the trust is governed by the laws of a state whose statute extends the reimbursement power as a default matter).

In the case of substitution powers, IRC Section 675(a)(4)(C) will trigger grantor trust treatment if "any person" acting in a "nonfiduciary capacity" and "without the approval or consent of any person in a fiduciary capacity" can reacquire the trust corpus by substituting other property of an equivalent value. This means that, usually, even if the substitution power is only given to our "contemplated" grantor over all of the trust property (including the property contributed by the "uncontemplated" grantor), it will be sufficient to trigger grantor trust treatment. However, our uncontemplated grantor has a meaningfully different bundle of property rights than the contemplated grantor, if she does not have the same substitution power over property. This distinction can create planning complexities down the road.

In the case of the prohibition on who can serve as trustee, this means that an important tax savings provision and guardrail may be missing if the "uncontemplated" grantor is permitted to serve as trustee. Hopefully the trust has additional belt and suspender provisions to prevent any estate tax inclusion or gift tax issues that otherwise could arise if a grantor to the trust ends up serving as trustee because of a prohibition that did not contemplate that additional grantor.

Similar issues can arise, particularly in the case of creditors, including future ex-spouses, when a trust that has been drafted with one grantor in mind has additional grantors. If a planner discovers that such a trust has inadvertently acquired additional grantors, then a careful and thorough review of the trust agreement provisions and any potential "fixes" should be undertaken.

6. Allocation and "Cream in the Coffee" Issues

When a trust has multiple grantors, you must determine the portion of the trust owned by each grantor. The regulations do not give a single method to make that determination. Instead, Treas. Reg. Section 1.671-3 describes three competing methods: by a fractional share; by a pecuniary amount; or by tracing specific property. Beyond describing these methods, caselaw, rulings and other IRS guidance are largely silent on how and which method to utilize. Given the important tax implications to each grantor, a careful assessment must be made as early as the multiple-grantor trust issue is identified in order to appropriately allocate items of income, expense and deduction between and among the grantors. No one approach may be intrinsically better or worse, and facts and practicalities must be considered. Separately, many planners will want to consider if there is any way to restore a trust with multiple grantors to a trust with a single grantor, or, stated differently, once the cream of an additional grantor has been poured in the coffee of the original grantor, can you "uncream the coffee." In many cases that may not be possible.

C. **Can the grantor trust report its income under the grantor's SSN? And if yes, should it?**

If a trust is treated as a grantor trust, the rules governing the taxation of the trust under Subchapter J of the Internal Revenue Code do not apply and all trust income, deductions, and credits are attributable to the grantor. However, a grantor trust, in general, must obtain a taxpayer identification number (EIN) and report its income by filing a Form 1041.[12] Grantor trusts, like nongrantor trusts, must file an income tax return within three-and-a-half months after the end of its taxable year if they meet any of the following requirements: (i) have taxable income of any amount, (ii) have gross income of $600 or more, or (iii) have one or more nonresident beneficiaries.[13]

Due to the attribution of the trust's income to the grantor, however, simplified reporting requirements apply. If there is only one grantor, the Form 1041 need only supply the entity information, and all items of income, deduction and credit attributable to the grantor may appear on a separate statement attached to the Form 1041.[14] There are two exception reporting methods that also may be available, including the first method described below that does not require any reporting under the grantor trust's separate EIN.[15]

Alternative Reporting Method No. 1

If the trust is treated as being owned by only one grantor, the trust can report its income using the grantor's TIN or SSN, provided the trustees furnish the following information to all payors of income and proceeds during the taxable year: [16] (i) the name and taxpayer identification number (TIN) of the deemed owner and the address of the trust, and, (ii) if the grantor is not a trustee, a statement fully disclosing all items of income, deduction, and credit of the trust, identifying the payor of each item of income, and providing the grantor with information that must be included in computing taxable income and credits.[17] A trustee who reports under this alternative is not required to file any returns with the IRS, even Forms 1099.[18] This method is only available for a trust treated as wholly owned as to one grantor or other owner and is the only method that allows for reporting under the grantor's SSN.

Alternative Reporting Method No. 2

The second alternative method requires that the name, EIN, and address of the trust be furnished to all payors during the taxable year. The trustee must then file one or more appropriate Forms 1099 with the IRS, showing 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 treated as the owner of the trust) as the payee.[19]

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[12] Treas. Reg. § 301.6109-1(a)(2)(i)(A).
[13] IRC § 6012(a)(4)-(5). A calendar year trust will be required to file its income tax return on or before April 15th for the prior tax year.
[14] Treas. Reg. § 1.671-4(a).
[15] Treas. Reg. § 301.6109-1(a)(2)(i)(B).
[16] Treas. Reg. § 1.671-4(b)(2).
[17] Treas. Reg. § 1.671-4(b)(2)(i)(A).
[18] Treas. Reg. § 1.671-4(b)(2)(i)(B).
[19] Treas, Reg. § 1.671-4(b)(2)(iii).

Given the flexibility in grantor trust reporting methods in the circumstance of one grantor, the question often arises as to whether a separate EIN is indeed desirable for a wholly owned grantor trust. Consider the following circumstances:

1. Revocable Trusts

A revocable trust that can be revoked or amended by the grantor typically reports income under the grantor's SSN. In many instances, the grantor is also serving as the trustee, so the information reporting requirement of Treas. Reg. 1.671-4(b)(2)(i)(A) is not applicable. However, a separate trust TIN is required upon the death of the grantor or if ever the grantor trust powers are released prior to the death of the grantor.

2. Irrevocable Trusts

The general rule is that irrevocable trusts should obtain a separate EIN upon creation. However, it is possible for a grantor trust that qualifies for the first alternative reporting method to only rely on the grantor's SSN while the trust is a wholly owned grantor trust as to one grantor.

a. *Account opening* – Even if an irrevocable trust may use the simplified reporting method under the grantor's SSN, a separate trust EIN may be required for account opening purposes, depending on the financial institution. Further, in the event that a grantor has created multiple irrevocable grantor trusts, the separation by individual EINs can also assist with ensuring that assets are deposited/debited to and from the intended trust.

b. *Separation for estate and gift tax* – While not a dispositive factor in and of itself as to whether irrevocable grantor trust assets would be included in a grantor's estate under IRC Section 2036 or other Code provision, tax reporting under a separate trust EIN may be desirable to create additional separation between the grantor and an irrevocable trust for completed gift purposes. Case law analyzing IRC Section 2036 typically focuses on the grantor's retained powers and control over the property transferred to the trust and look to whether a grantor's sale of property to an irrevocable grantor trust was truly bona fide.[20] Although the substance of the transaction is the crux of the analysis, respecting the formalities of the trust agreement and related transaction documents is reviewed in these cases. Identifying trust property under a separate tax identification number may not only assist with the overall optics of the transaction, but may also aid to prevent foot faults that may arise if all of the grantor's property and the trust's property is identified under the same number, such as inadvertently directing that property be distributed to a grantor from her irrevocable grantor trust account reported under her SSN, rather than from her revocable grantor trust account, also reported under her SSN.

c. *Toggling to nongrantor trust* - In all events, a separate trust EIN will be required for the year in which the trust ceases to be a grantor trust or ceases to be a wholly owned grantor trust.[21]

d. *EIN recordkeeping* – Recordkeeping is essential to avoid tax reporting complication. If an EIN was applied for upon the creation of the trust but never used due to the

[20] *See e.g., Estate of Powell v. Comm'r*, 148 T.C. 392 (2017); *Estate of Strangi v. Comm'r*, 417 F.3d 468 (5th Cir. 2005).
[21] IRS Notice 2010-19 provides clarification on reporting when trusts transition between grantor and nongrantor status.

utilization of the first alternative reporting method while the trust was a grantor trust as to one grantor, it is imperative that the same EIN be used to report trust income upon the termination of grantor trust status. Inserting the EIN, once obtained, on the trust agreement can assist with reporting confusion is many decades and/or tax preparers have come and gone since the trust's creation and the transition to nongrantor trust.

II. Issues with Toggle Events

This Section now returns to the comfort of a trust with a single grantor, but explores a different potential pain point – first, events that may trigger a change in trust status as grantor or non-grantor and, second, the grantor trust treatment of spousal limited access trusts (or "SLATs") after a divorce (or death of a spouse).

A. Can you inadvertently create a grantor trust?

Many trusts are grantor trusts due to the inclusion of affirmative grantor trust powers provided for in the trust agreement, such as a retained swap power under IRC Section 675(4)(C) or a power to add trust beneficiaries under IRC Section 674(a). However, there are occasions in which a nongrantor trust becomes a grantor trust (sometimes inadvertently) due to the actions and activities of the grantor or other trust contributor.

1. Borrowing from the trust

IRC Section 675(3) provides that if the grantor actually borrows trust property without adequate interest and adequate security and does not repay the loan and interest before the beginning of the following taxable year, the trust will be treated as a grantor trust. Section 675(3) will apply for any year of which a loan by the trust to a grantor-trustee is outstanding at the beginning of the year, even if repayment occurs prior to the end of the year in which the loan is made.[22] Indirect borrowing, like direct borrowing, by the grantor or the grantor's spouse will cause grantor trust status under this section.

2. Actual payment of income for benefit of grantor or grantor's spouse

Pursuant to IRC Section 677(a), the grantor shall be treated as the owner of any portion of a trust whose income is actually (i) distributed to the grantor or the grantor's spouse, (ii) held or accumulated for future distribution to the grantor or the grantor's spouse, or applied to the payment of premiums of insurance on the life of the grantor or the grantor's spouse, without the approval or consent of an adverse party.

3. Actual payment to beneficiary in discharge of support obligation

IRC Section 677(b) causes grantor trust status in the event that, in the discretion of the trustee, or the grantor acting as trustee or co-trustee, trust income is actually paid, distributed, or applied for

[22] Rev. Rul. 86-82. However, IRC § 675(3) does provide an exception if a loan provides adequate interest and adequate security and is made by a trustee other than the grantor or a "related or subordinate" trustee subservient to the grantor (as such terms are defined in IRC § 672(c)), and such loan will not cause the trust to be treated as a grantor trust.

the support or maintenance of a beneficiary (other than the grantor's spouse) whom the grantor is legally obligated to support. Similarly, IRC Section 678(c) applies the same principle to a person other than the grantor who, in their capacity as trustee or co-trustee, actually pays, distributes, or applies trust income for the support of maintenance of a beneficiary whom such person is legally obligated to support.

4. Contribution to foreign trust with US beneficiary

IRC Section 679 causes grantor trust status in the event that any US person directly or indirectly transfers property to a foreign trust in each year in which there is a US beneficiary of such trust. Under IRC Section 679(a)(4)(A), grantor trust status can be caused by non-US persons who later become US persons within five years after the transfer of property to such a trust.

5. Beneficiary contributions to trust

In the event that a beneficiary directly or indirectly contributes property to a trust, the beneficiary is deemed to be the grantor of that portion of the trust related to the property so contributed under IRC Section 678.[23] One common occurrence of this instance is when a beneficiary is given a *Crummey* withdrawal right over contributions to a trust by the grantor or other person.

B. SLATs and Death or Divorce of a Spouse

With available exemptions only increasing in near memory due to legislative changes and high inflation adjustments, the "spousal limited access trust" or "SLAT" has become almost as ubiquitous as grantor trusts. The SLAT describes a completed gift trust like any other but one in which the grantor's spouse is a permissible beneficiary. The idea is that the SLAT affords clients the opportunity to use their higher exemptions but with the appeal of a possible "exit valve" in the event of any givers' remorse (and any liquidity needs, including for income tax payments) in the future. By including the spouse as a beneficiary, gifted assets can be made available to the marital unit in the future through distributions to the non-grantor spouse-beneficiary.

Including the spouse as a beneficiary also (almost always) means that the trust will be taxed as a grantor trust because of IRC Sections 677 and 672(e).[24]

IRC Section 677 provides, among other things, that a grantor will be treated as the owner of a trust if the trust's income is, or in the discretion of either the grantor or a nonadverse party, may be distributed to the grantor or the grantor's spouse or held or accumulated for future distribution to the grantor or the grantor's spouse.

IRC Section 672(e)(1) then provides the so-called "spousal unity rule": the grantor will be treated as holding any power or interest held by: "(A) any individual who was the spouse of the grantor at the time of the creation of such power or interest, or (B) any individual who became the spouse of the grantor after the creation of such interest, but only with respect to periods after such individual became

[23] *See* Rev. Rul. 67-241, 1967-2 C.B. 225.

[24] There are some structures – namely the so-called "SLANT" – that aim to include the spouse as a beneficiary under circumstances that do not trigger grantor trust treatment. Discussion of this structure is beyond the scope of this article.

the spouse of the grantor." IRC Section 672(e)(2) provides that for purposes of IRC Section 672(e)(1)(A), an individual legally separated from his spouse under a decree of divorce or of separate maintenance shall not be considered as married.

The interpretation of IRC Sections 677 and 672(e) while the grantor and the spouse-beneficiary are married is clear; absent imposition of a structure that requires adverse party consent, trusts with a spouse-beneficiary will be grantor trusts, even in the absence of any other retained grantor trust power.

The question of the treatment on divorce is where the analysis becomes more interesting and a full discussion requires a small review of history. IRC Section 682 *used* to provide that the income of a grantor trust payable to a former spouse was taxable to that former spouse (and not to the grantor). Public Law 115-97, or, as it is more popularly called, the "Tax Cuts and Jobs Act" or "TCJA" of 2017 repealed IRC Section 682 effective January 1, 2019. That repeal left the question of how SLATs should be treated post-divorce. Namely, does IRC Section 677 continue to apply, notwithstanding the divorce?

Most practitioners believe that it does and this derives from the specific language of IRC Section 672(e)(1) which provides that the operative time to determine grantor trust status is as of the time the interest was created. If the grantor was married to the spouse at that time, then the grantor is treated as retaining that spouse's interest (for purposes, for example, of IRC Section 677) even when the grantor has divorced the spouse-beneficiary. As a practical matter, this could mean that our grantor has to pay income tax liabilities on a trust of which the grantor is not a beneficiary, but the grantor's ex-spouse is!

Now, not all practitioners believe that this is, or should be, the consequence.[25] However, given the severity of the consequence for the non-donor spouse and the ambiguity (at best) of the result under current law, planners should discuss the grantor trust status, post-divorce, with clients, and consider solutions to explore.[26] The following three are a non-exhaustive list of possible considerations.

First, if the client wants ongoing grantor trust treatment, additional grantor trust powers (other than the spouse as beneficiary) should be retained by the grantor. These will ensure that regardless of the spouse as beneficiary, the trust will continue to be a grantor trust.

Second, the client (and planner) should consider including an "Effect of Divorce" or similar clause in the trust agreement. Typically this will treat a spouse-beneficiary as predeceased upon any divorce event (including the commencement of any divorce event). This will have the benefit of avoiding the grantor having to pay ongoing income tax liabilities for a trust of which grantor's ex-spouse is a

[25] See, e.g., ACTEC Comments to Joint Committee on Taxation, House Ways and Means, and Senate Finance Committee re: Repeal of I.R.C. Section 682 and ACTEC Comments on Guidance in Connection with the Repeal of Section 682 (Notice 2018-37). See, also, *Parducci v. Commissioner*, o. 20894-19, 2023 BL 358017 (T.C. Oct. 5, 2023) (in which the Tax Court restates the relevant law in dicta as follows: "Pursuant to IRC Section 677, income distributed to [the spouse] or held for future distribution to her is likewise considered to be distributed or held for [the Settlor] unless they were legally separated. Individuals are determined to be legally separated and thus not determined to be married for purposes of IRC Section 677 when there is a divorce decree or separate maintenance filing.")

[26] This planning issue and these potential solutions are not unique to SLATs. Indeed, the same issue can arise in a host of trusts, including inter vivos QTIPs and QPRTs. Similar planning solutions should be explored in each of these instances.

beneficiary. It also may help preserve the grantor's ability to "toggle off" grantor trust treatment post-divorce, if the income tax liability becomes too rich for the client post-divorce.

Third, the client may wish to incorporate the ability for a trust protector (or other disinterested person) to add a future spouse as a beneficiary. This power, alone, may trigger grantor trust treatment under IRC Section 674, and should be explored carefully and/or be subject to relinquishment if non-grantor trust treatment is desired.

In short, consistent with the theme of this article, the "power" of grantor trust status must be carefully weighed and managed in order to avoid tax and economic consequences for clients that are inconsistent with their planning goals.

C. S Corporation stock held in grantor trusts at death of grantor

An entity formed and taxed as an S corporation can offer the business and legal benefits of a corporation with many of the pass-through tax characteristics of a partnership. However, the eligible shareholders of an S corporation are confined to individuals, estates, certain trusts and certain exempt organizations.[27] IRC Section 1361(c)(2)(A)(i) provides that a trust is an eligible shareholder of an S corporation if all of the trust is treated as owned by an individual who is a citizen or resident of the United States, i.e., a grantor trust.

Once a grantor trust converts to a nongrantor trust, the trust will need to qualify as an eligible S corporation shareholder as a Qualified Subchapter S Trust ("QSST") under IRC Section 1361(d) or qualify under an alternative provision of IRC Section 1361(c)(2)(A):

- A trust which was a grantor trust immediately before the death of the deemed owner and which continues in existence after such death, but only for the 2-year period beginning on the day of the deemed owner's death.
- A trust with respect to stock transferred to it pursuant to the terms of a will, but only for the 2-year period beginning on the day on which such stock is transferred to it.
- A trust created primarily to exercise the voting power of stock transferred to it.
- An electing small business trust ("ESBT").

A foreign trust is excluded from qualifying as an eligible S corporation shareholder under the categories listed above.[28]

If a trust becomes a nongrantor trust due to the owner's death, the trust will continue to be treated as an eligible S corporation shareholder for a 2-year period beginning on the owner's date of death. Upon the expiration of the 2-year period, S corporation treatment will only continue if the trust is an eligible shareholder at that time, i.e., a QSST or an ESBT.[29] While the estate will be considered the

[27] IRC § 1361(b)(1)(B).
[28] IRC § 1361(c)(2)(A).
[29] Treas. Reg. § 1.1361-1(h)(3)(i)(B).

shareholder during this time for S corporation eligibility qualification, the trust and/or its beneficiaries will report any income or loss passed through from the corporation for income tax purposes.[30]

An election under §645 may also be made for certain trusts to treat the trust as part of the estate. This may also provide an extended period of time for the trust to hold the S corporation stock beyond two years as Reg. §1.645-1(e)(2)(i) and §1.645-1(e)(3)(i) state that the trust is treated as part of the estate during the period of the election, and such election may be in place for longer than two years in certain circumstances.

If the trust becomes a nongrantor trust for a reason other than the death of the owner, the trust has a two-month-and-fifteen-day period to elect to qualify as either an QSST or an ESBT.

A QSST is a special type of trust, the terms of which require that (i) during the life of the current income beneficiary, there shall only be one income beneficiary of the trust, (ii) any principal distributed during the life of the current beneficiary may be distributed only to such beneficiary, (iii) the income interest of the current income beneficiary in the trust shall terminate on the earlier of such beneficiary's death or the termination of the trust, and (iv) upon the termination of the trust during the life of the current income beneficiary, the trust shall distribute all of its assets to such beneficiary.[31] The current income beneficiary must be a United States citizen or resident.[32] Under IRC Section 678, the QSST shall be treated as a grantor trust as to the income beneficiary.[33] The QSST beneficiary must make an election to have the QSST rules apply,[34] and the election must be made within two months and fifteen days of the QSST owning the S corporation stock and, once made, is irrevocable.[35]

An ESBT is defined under IRC Section 1361(e) and applies to trusts if: (a) such trust does not have as a beneficiary any person other than (i) an individual, (ii) an estate, (iii) or certain tax-exempt organizations, (b) no interest in such trust was acquired by purchase, and (c) an election is made to treat the trust as an ESBT.[36] In the case of an ESBT, each beneficiary of the trust will be treated as a shareholder of the S corporation.[37] The ESBT trustee must make an election to have the ESBT rules apply, and the election must be made within two months and fifteen days of the ESBT owning the S corporation stock and, once made, is irrevocable.[38] An ESBT is treated as two separate trusts for purposes of determining its tax liability. The two separate trusts are referred to as the "S portion" and the "non-S portion." The ESBT's S portion of the trust is treated as a separate taxpayer subject to special rules under §641(c). The non-S portion (that is not otherwise taxed under subpart E) is treated as a normal trust subject to tax under the rules of subchapter J, subparts A through D.

If a trust does not make a timely election (either by the applicable deadline or two years or two months and fifteen days, depending on the triggering event), the S corporation election will be

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[30] Treas. Reg. § 1.1361-1(h)(3)(ii). See also Treas. Reg. § 1.1361-1(k)(1) Ex. 2(ii).
[31] IRC § 1361(d)(3)(A).
[32] IRC § 1361(d)(3)(B).
[33] IRC § 1361(d)(1).
[34] IRC § 1361(d)(3)(B).
[35] IRC § 1361(d)(2)(C), § 1361(d)(2)(D).
[36] IRC § 1361(e)(1)(A).
[37] IRC § 1361(c)(2)(B)(iv).
[38] IRC § 1361(d)(2)(C), §1361(d)(2)(D).

terminated as of the date that the trust became an ineligible shareholder. Late QSST and ESBT election relief may be available under Rev. Proc. 2013-30.

III. Other Potential Planning Pitfalls with Grantor Trusts

A. Select Real Estate Issue[39]

Earlier in this article we discussed the income tax ease and efficiencies when a grantor transacts with a wholly-grantor trust of which a single grantor is the only grantor. This *income tax* ease does not translate to all potential taxes. This becomes particularly apparent in the context of planning with real estate. This section highlights issues that arise in three select jurisdictions – California, Florida and New York – when planning with real estate and grantor trusts. It does not purport to be a comprehensive survey of all jurisdictions and all issues but merely a sample of the issues that practitioners must look out for across jurisdictions.

1. California – Property Tax Re-Basing

Understanding the nuances of beneficial ownership and the exclusions provided under California law is essential for anyone involved in the transfer of real property to trusts within California – even when that transfer is to a wholly-grantor trust that may not implicate US federal income tax consequences. The implications of Proposition 13 make it especially important to consider whether a proposed transfer will trigger a reassessment, as this can have substantial financial consequences.

In California, any change in the beneficial ownership of real property may trigger a reassessment of the property's value for tax purposes. This issue is particularly significant due to the constraints imposed by Proposition 13, formally known as the "People's Initiative to Limit Property Taxation," which was enacted in 1978. Proposition 13 generally limits annual increases in the assessed value of real property to a maximum of 2% per year, unless there is a change in ownership or new construction. As a result, properties that have not changed hands for many years often have assessed values (and therefore property taxes) that are substantially lower than their current market values.

The concept of beneficial ownership is central to determining whether a reassessment is required. The beneficial owner of real property is the individual or entity that enjoys the primary benefits of ownership, such as the right to use, occupy, and derive income from the property, even if they are not the legal owner of record. For example, if an individual transfers real property into their own revocable trust, there is no change in beneficial ownership because the individual retains the right to revoke the trust and remains the primary beneficiary. Consequently, such a transfer does not result in a reassessment under California law.

California law also provides exclusions from reassessment for specific types of transfers. Notably, transfers between spouses are generally excluded. So, if an individual transfers property to an irrevocable trust for the benefit of their spouse, this transfer does not constitute a change in beneficial ownership for property tax purposes, and therefore does not trigger reassessment.

[39] Many thanks to Sabrina Schloss and Dara Howard, both associates at Proskauer Rose LLP, for their contributions to this section.

However, if property is transferred to a trust in which the present beneficiary is someone other than the original owner or the owner's spouse, this may be considered a change in beneficial ownership. This is true even if the transfer is to a wholly-grantor trust. Such a transfer could result in the property being reassessed at its current market value, which would likely lead to a significant increase in property taxes due to the removal of the protections afforded by Proposition 13.

2. Florida – Homestead Issues

When planning with Florida homestead property, irrevocable grantor trusts raise several unique risks. The Florida Constitution imposes strict restrictions on the alienation and devise of homestead if a decedent is survived by a spouse or minor child. A transfer to trust that fails to preserve these rights—or is not supported by a valid spousal waiver—can be void. In addition, ad valorem tax benefits and the "Save Our Homes" assessment cap may be lost unless the trust is drafted to provide a qualifying present possessory interest. Creditors' protections, normally a hallmark of homestead, may also be jeopardized if the property is no longer considered the residence of a natural person. From a transfer tax standpoint, if the grantor wishes to preserve the right to live in the homestead, the transfer to the trust must be structured as an incomplete gift; otherwise, a completed gift coupled with retained possession triggers gift tax concerns and potential estate tax inclusion under IRC Sections 2036 and 2038. Finally, practical issues such as mortgage due-on-sale clauses, title insurance complications, and trustee authority over occupancy and expenses can further complicate administration. In short, Florida homestead in the context of irrevocable trusts is a constitutional and statutory minefield, and failure to address these nuances can undo otherwise solid planning.

3. New York – Real Property Transfer Tax

This article previously addressed the particular appeal of installment sales to intentionally defective grantor trusts. When the trust is wholly-grantor trust (as to a single grantor), the sale by the grantor will not trigger a realization event for US federal income tax purposes.

Unfortunately, the same is not true with respect to New York State (and City) real property transfer taxes. New York State and City both impose real property transfer taxes on the sale or conveyance of real property located in the State (or City). The calculation and specifics of these taxes is beyond the scope of this article, but can amount to a significant cost, especially given the high value of many New York State and City real estate properties. Transfers of real property made without consideration are exempt from these transfer taxes.[40] However, an installment sale unfortunately does not meet this definition, even if it is a sale to a wholly-grantor trust by the grantor, ignored for federal income tax purposes. Therefore, careful consideration must be given when planning with New York real estate and grantor trusts. (For example, clients may consider structuring the sale through an entity and limiting the sale to a "non-controlling interest" in that entity. This may avoid the real property transfer tax, but how and when an interest will be respected as a "non-controlling interest" must be carefully reviewed in the context of relevant regulations. The State and City have different aggregation rules and multiple transfers may be aggregated unless carefully structured. A full discussion is beyond the scope of this article.)[41]

[40] New York Tax Law Section 1405(b)(4); Rules of the City of New York tit. 19 Section 23-03(j)(1).

[41] New York Tax Law Section 1401 and 1402; N.Y. Comp. Codes R. & Regs. Tit. 20 Section 575.1; Rules of the City of New York tit. 19 Section 23-02.

B. Business Certification Issues

In the event that a grantor trust receives an interest in a business that has a U.S. Small Business Administration (SBA) or private-sector certification, ownership qualifications should be taken into account so as to not cause the business to lose the qualification upon the transfer. An SBA certification is typically required to compete for federal government contracts set aside for a specific type of certified business, such as Women-Owned Small Businesses or Veteran-Owned Small Businesses. Private certifications also exist that may provide a business greater access to corporate supplier diversity programs with large private-sector buyers.

In order for a trust to be an eligible majority owner of a qualifying business for SBA purposes, the trust must be limited to revocable trusts where the owner(s) are the grantor, trustees, and beneficiaries of the trust. No other type of trust is eligible to be a majority owner under the SBA rules.[42] Therefore, it is imperative that any trust planning involving these business interests be limited to transfers to irrevocable grantor trust to minority interests, and the certifying owner should always retain 51% or more of the business in order to maintain the certification.

Private section certifications generally mirror the SBA regulations, disallowing irrevocable grantor trusts from qualifying as the majority owner. However, a small number of private-sector certifiers expand the eligibility of majority owners to include irrevocable trusts under limited circumstances. For instance, the Women's Business Enterprise National Council (WBENC), certifying Women-Owned Businesses for private sector purposes, allows an irrevocable grantor trust to be considered a "woman, for certification purposes, so long as the following criteria are met: (i) ownership held for the benefit of a woman who is not a minor and who is a beneficiary with a present interest in the trust may be counted as owned by women, and (ii) all the trustees must be women, provided that a financial institution may act as trustee. A beneficiary has a present interest in a trust if he or she is currently eligible to receive distributions of income or principal from the trust. If more than one beneficiary has a present interest in the trust, each beneficiary shall be deemed to have an equal interest unless the instrument that creates the trust provides otherwise."[43]

C. Securities Law Issues

Special considerations may also apply if a grantor trust holds stock subject to security regulations.

1. Section 16

Section 16 of the Securities and Exchange Act governs the changes of ownership of stock owned by insiders and imposes short-swing profit forfeiture if an insider purchases and sells, or sells then purchases, company stock within a six-month period. Section 16 applies to any person who is the beneficial owner, directly or indirectly, of more than ten percent of any class of equity securities and any director or officer of the issuer of such securities ("Insiders").[44] A trust shall be subject to section 16 of the Act with respect to securities of the issuer if the trust is a beneficial owner of more than ten percent

[42] https://sbaone.atlassian.net/wiki/spaces/UCPUKB/pages/3451322369/Part+1+All+Applicants+Ownership+and+Control+Documents

[43] https://www.wbenc.org/wp-content/uploads/docs/WBENC_Standards__Procedures_2018-1.pdf

[44] 17 C.F.R. 240.16a-2.

of any class of equity securities of the issuer registered.[45] Section 16 requires reporting upon the event triggering the owner qualifying as an Insider and additional reporting to the SEC is required if there is a change in beneficial ownership of the shares. Transfers to a grantor trust may or may not be considered a change in beneficial ownership. If the grantor trust is revocable by the settlor, or if the settlor is the trustee and the sole current beneficiary, like the case of a GRAT, no change of beneficial interest is considered when property is transferred into such a trust or when property is distributed back out to the settlor.[46] However, if the trustee and/or the beneficiaries are different persons, transfers to the trust may trigger reporting. Typically gifts to irrevocable trusts would allow for deferred reporting if there was a deemed change in beneficial interest, but a sale to an irrevocable trust or the grantor's exercise of a swap power under IRC 675(4)(C) would be considered a transfer for consideration, and depending on the identity of the trustee and beneficiaries, may be considered a change in beneficial interest and require immediate reporting.[47]

2. Rule 144

Rule 144 stock applies to restricted stock (i.e., stock not purchased through a stock exchange on the open market).[48] If a shareholder is subject to Rule 144 (also called an affiliate), they must retain the restricted securities for a certain period of time prior to selling them, either six-months or one year depending on the stock issuer. The relevant holding period begins when the securities were bought and fully paid for.

An *affiliate* is a person that directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with, the issuer of the restricted securities.[49] A trust or estate will be subject to Rule 144 if persons qualifying as affiliates own 10 percent or more of the total beneficial interest or if such persons serve as trustee, executor or in any similar capacity.[50]

When restricted stock is gifted to a trust, the stock is deemed to be acquired when it was originally acquired by the donor.[51] However, if the trust purchases the securities, the holding period does not begin until the full purchase price or other consideration is paid.[52] Further, if the restricted stock is purchased with a promissory note, the promissory note shall not be deemed full payment of the purchase price unless it: (i) provides for full recourse against the trust; (ii) is secured by collateral, *other than the securities purchased*, having fair market value at least equal to the purchase price of the securities purchased; and (iii) is discharged by full payment prior to the sale of the purchased stock.[53]

3. Accredited Investor

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[45] 17 C.F.R. 240.16a-8(a)(1). Certain attribution rules also apply, such as attributing the Insider's ownership with the ownership of the Insider's immediately family living in the same household.
[46] *See Peter J. Kight* SEC No-Action Letter, Fed. Sec. L. Rep. (CCH) Section 77,403 (Oct. 16, 1997); *Nosirrah Management LLC v. Autozone, Inc*., Case No. 2:24-cv-2167 (W.D. Tenn. April 14, 2025). GRAT terminations typically involve property being distributed to beneficiaries other than the grantor and will likely cause a change in beneficial ownership of the shares subject to reporting.
[47] *See Donoghue v. Smith*, 2022 U.S. Dist. LEXIS 76071; 2022 WL 1225338 (S.D. N.Y. April 26, 2022); *Dreiling v. Kellett*, 281 F. Supp. 2d 1215 (W.D. Wash. 2003).
[48] 17 C.F.R. 230.144(a)(3).
[49] 17 C.F.R. 230.144(a)(1).
[50] 17 C.F.R. 230.144(a)(2)(ii).
[51] 17 C.F.R. 230.144(d)(3)(v); 17 C.F.R. 230.144(d)(3)(vi).
[52] 17 C.F.R. 230.144(d)(1)(iii).
[53] 17 C.F.R. 230.144(d)(2).

Certain securities offerings that are exempt from registration may only be offered to, or purchased by, persons who are "accredited investors." Any trust, with total assets in excess of $5,000,000, not formed for the specific purpose of acquiring the securities offered qualifies as an accredited investor.[54] A trust may alternatively qualify if all of the deemed equity owners of the trust are themselves accredited investors.[55] A grantor trust that is revocable will qualify as an accredited investors, so long as the grantor is themself an accredited investor. However, whether the grantor's status as an accredited investor is attributed to an irrevocable trust is facts and circumstances dependent.

IV. Conclusion

While grantor trusts are among the most versatile estate planning tools, caution is required in both the drafting and the administration. Certain actions – such as loans without proper terms, distributions to the grantor or spouse, or contributions to foreign trusts with U.S. beneficiaries – can trigger unwanted tax results. Likewise, while obtaining a separate EIN for a trust may improve administrative clarity, it does not prevent estate inclusion if the grantor retains too much control. Ultimately, successful planning depends on aligning the trust's design with its purpose: transferring wealth while avoiding retained rights that would cause estate inclusion. When drafted and administered carefully, grantor trusts remain a powerful way to reduce estate taxes and pass assets efficiently to future generations.

[54] 17 CFR 230.501(a)(7).
[55] 17 CFR 230.501(a)(8).