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IRS Throws in the "Grantor Trust" Towel

After fifty years, the IRS finally announced in 2004 that it is "giving in" on an issue regarding the income taxation of "grantor trusts" that should be a boon to certain taxpayers. The IRS announcement came in the form of Rev. Rul. 2004-64, dated July 6, 2004.

Background -- Since at least the 1930's, taxpayers have arranged their affairs so that some of a family's income could be taxed at a bracket lower than that applicable to the principal breadwinner or big investor. A common technique was to put assets in a trust benefiting children or a spouse and to require that the trustee return the trust property, after a period of time, to the person who created the trust. In basic terms, the goal was to separate ownership from income, and trusts were a favorite means of achieving the goal.

In 1954, Congress added sections 671, 672 *et seq.* to the Internal Revenue Code. These sections spelled out the rules governing when a trust creator (technically, the "grantor") retained so much control over a trust that the grantor might fairly be taxed as the "owner" of the trust's income. Augmented in 1976 by section 679 relating to foreign trusts, these Code sections became known as the "grantor trust rules."

Two Kinds of Taxes -- The grantor trust rules apply only to ***income*** taxation. They don't determine who "owns" a trust for purposes of the ***transfer*** taxes (gift tax, estate tax and generation-skipping transfer tax[1]). A trust might be "owned" by its grantor for ***income*** tax purposes but not for ***estate*** tax purposes.

"Magic" in the Differences -- Not surprisingly, the differences between the income tax and transfer tax regimes created opportunities for taxpayers. Imagine what would happen if Sarah completely gave away -- for gift tax purposes -- property in a trust for Ben but was still required by the grantor trust rules to pay the trust's income tax. Assume that the income of a trust in the 35% bracket is $1,000. Sarah's check to the IRS in payment of the $350 tax effectively relieves Ben of a financial burden. In a meaningful economic sense, she has enriched Ben by $350. What Sarah did is a lot like putting 350 one-dollar bills in an envelope, handing it to Ben and saying, "Don't spend this all in one place."

The IRS has long recognized this issue, and for years and years has tried to figure out how to collect a ***gift*** tax on the amount paid as an ***income*** tax. The problem has been that the Internal Revenue Code itself is pretty clear about what happens when a person is treated as the owner of a

[1] Though "dormant" in 2010, the estate tax and the generation-skipping transfer tax will surely awake in some form.

trust under sections 672 through 679: " . . . those items of income, deductions, and credits against tax of the trust which are attributable to the [owned] portion of the trust . . ." are to be " . . . included in computing the taxable income and credits **of the grantor**. . .." Simply put: **If you own it, you own it**.

Leveraging the "Magic" -- The magic of grantor trusts goes beyond just being able to relieve a trust beneficiary of an economic burden (the income tax owed on trust income). A taxpayer can "leverage" transfers to a grantor trust by selling assets to it. Returning to Sarah as the trust grantor (and let's make Jean the trustee), we see that if Sarah sells an asset to a trust which she owns, there won't be any income tax on that transaction.

Federal tax law doesn't recognize a taxpayer's making a sale to herself. Therefore, if Sarah "sells" an appreciated asset to her grantor trust, "designing" the terms of the sale (first and foremost) to be commercially reasonable and, secondarily, to match her cash flow expectations from the asset being sold, all of the inherent gain on the sale of the asset escapes income taxation.

Taxation of the transactions inside the trust is pretty straightforward: As trustee, Jean simply issues to Sarah a form "K-1" for each year in which the trust has income, deductions or credits, and the form K-1 tells Sarah where to report *those* transactions on her own 1040.

Often called a "sale to a defective trust" (or "GDOT" sale or something similar), this technique has been no more popular with IRS than the one described above (the grantor's payment of a grantor trust's income tax while avoiding any gift tax implications of the payment). An experienced advisor can lead you safely through the obstacles the IRS has created along the way to a successful leveraging of the grantor trust magic. One key to success is making sure that the trustee is not ***required*** by the terms of the trust to reimburse the grantor for tax payments. An optional reimbursement arrangement squares nicely with the grantor trust rules in the Internal Revenue Code.

But that's hardly a "news flash," at least not for careful readers of the Code. The big news -- and it *is* good news -- is that the IRS has finally agreed to enforce a provision of the law exactly as Congress has written it. Taxpayers will benefit as a result.

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