To Create or Not Create a Grantor Trust:
That is The Question

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Grantor Trust or Non-Grantor Trust

A trust is by default a non-grantor trust. A non-grantor is a separate entity that pays income tax on the income of the trust. The non-grantor trust is entitled to a deduction\(^2\) for any income distributed by the trustee to one or more beneficiaries entitled to the income from the trust.\(^3\) The default non-grantor trust rules do not apply to a trust in which the grantor has retained certain powers designated under Internal Revenue Code §§ 673 – 679. In that case, the trust, known as a grantor trust, is disregarded for income tax purposes and the income is taxable to the grantor, whether the income is retained in the trust or distributed to the grantor or even a beneficiary other than the grantor.

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1. Dennis is a Fellow of the National Academy of Elder Law Attorneys. He is the only attorney in California certified as a Certified Estate Planning, Trust, and Probate Law Specialist, Certified Taxation Law Specialist and Certified Elder Law Attorney. He is also an Accredited Estate Planner. He has an LL.M. degree in Tax. He serves as the Director of Education for the American Academy of Estate Planning Attorneys and the Boards of Director of various legal organizations, including the Special Needs Alliance, as well as various local and national charitable organizations. Dennis has been named a Southern California Super Lawyer for the past six years and was a finalist for the Christopher and Dana Reeve Foundation’s Best Dad on Wheels competition in 2012, 2013, and 2014.

2. Internal Revenue Code § 661 provides for a deduction of DNI or distributable net income paid to an income beneficiary of the trust. If all income is distributed from the trust, the non-grantor trust would owe no taxes and the trust income would be fully taxable to the income beneficiaries (unless the trust principal generated taxable income, such as through the sale of trust assets, the proceeds of which are to be retained by the trustee pursuant to the terms of the trust or the Uniform Income and Principal Act of the state whose law governs the interpretation of the trust).

3. Internal Revenue Code § 662 requires the beneficiary to include in his or her income that amount of DNI required to be paid to the beneficiary by the trustee, whether the income is actually distributed to the beneficiary or not. Even if the trustee elects to retain the income in the trust despite a provision in the trust requiring the trustee to distribute income (“the trustee shall pay the income, in convenient monthly installments, to . . .”) the trust will be entitled to a distribution deduction and the income will be taxable to the income beneficiary.
Upon the death of the grantor, or the termination of the power that causes the trust to be characterized as a non-grantor trust, the trust will revert to non-grantor trust status.

**First Party Special Needs Trusts**

In at least three Private Letter Rulings\(^4\), the IRS has concluded that a first party special needs trust is a grantor trust for income tax purposes. They base their ruling on the provisions of Internal Revenue Code § 677:

(a) General Rule. The grantor shall be treated as the owner of any portion of a trust, whether or not he is treated as such owner under section 674, whose income without the approval or consent of any adverse party is, or, in the discretion of the grantor or a nonadverse party, or both, may be—

(1) distributed to the grantor or the grantor’s spouse;
(2) held or accumulated for future distribution to the grantor or the grantor’s spouse; or
(3) applied to the payment of premiums on policies of insurance on the life of the grantor or the grantor’s spouse (except policies of insurance irrevocably payable for a purpose specified in section 170(c) (relating to definition of charitable contributions)).

This subsection shall not apply to a power the exercise of which can only affect the beneficial enjoyment of the income for a period commencing after the occurrence of an event such that the grantor would not be treated as the owner under section 673 if the power were a reversionary interest; but the grantor may be treated as the owner after the occurrence of the event unless the power is relinquished.

Since the disabled beneficiary’s assets are being used to fund the first party trust, he or she is the grantor of the trust (even if the trust is being created by the court, parent, grandparent or guardian). The income and assets are being accumulated to use for the (present and) future needs of the grantor (the special needs beneficiary) and therefore a

\(^4\) PLRs 200620025, 200826008, and 201116005.
(d)(4)(A) Trust is a grantor trust for income tax purposes. Whether the income, in whole or part, is retained in the first party special needs trust or distributed for the benefit of the special needs beneficiary, the income from the trust should be reported on the special needs beneficiary’s income tax return. This creates a potential disconnect between income for fiduciary accounting purposes, government benefit purposes, and income tax purposes. Some commentators have suggested it may be able to create a non-grantor first party special needs trust, but the author is skeptical as to whether this could be accomplished given the introduction to the first sentence of IRC § 677(a) (“The grantor shall be treated as the owner of any portion of a trust, whether or not he is treated as such owner under section 674) emphasis added.

**Third Party Special Needs Trust Can Be Grantor Trust or Non-Grantor Trust**

A third party special needs trust drafted to come into existence under the terms of a Will or trust would be a non-grantor trust. After the death of the grantor, a third party special needs trust will always be classified as a non-grantor trust (due to the lack of a living grantor). A third party special needs trust created during the lifetime of the grantor can be drafted as either a grantor trust or a non-grantor trust.

**Drafting a Grantor Third Party Special Needs Trust**

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5. For further discussion, see Sandoval, *Income By Any Other Name is Still Income . . ., Or Is It?*, 2014 Stetson Special Needs Conference Tax Intensive materials.

6. All trusts are presumed to be non-grantor trusts by default, and given that the grantor has died under this scenario, the trust would have to be a non-grantor trust. A trust for a beneficiary can characterized as a grantor under the provisions of IRC § 678. However, this would require the beneficiary to have a withdrawal power over the trust assets. The beneficiary of a special needs trust cannot have a withdrawal power over his or her trust over the special needs trust or it would be characterized as an available resource for needs based government assistance purposes.
Various provisions can be used in order to cause a third party special needs to be characterized as a grantor trust. One provision would be to draft the trust as a revocable trust. A revocable trust is a grantor trust under Internal Revenue Code § 675. The trust would lose its grantor trusts status and become a non-grantor trust upon the earlier of the trust becoming irrevocable7 (unless there was some other retained power in the trust that caused grantor trust status) or upon the grantor’s death.

Another provision that would cause grantor trust status is the retention by the grantor of a limited power of appointment. This would cause the gift to the trust to be incomplete (if it was an irrevocable trust) and would cause inclusion of the trust assets in his or her estate under the provisions of Internal Revenue Code § 2036.

Where a step up in basis is not needed and the third party special needs trust is being drafted as an irrevocable trust, other powers that can be used by the drafting attorney to create a grantor trust. These powers include the power to substitute trust assets for non-trust assets of equivalent value and the power to add charitable beneficiaries to the trust.

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The grantor shall be treated as the owner of any portion of a trust in respect of which—

\[ \ldots \]

(4) General powers of administration.

A power of administration is exercisable in a nonfiduciary capacity by any person

\[ 7. \text{The grantor could either amend the trust to make it irrevocable or he or she could become incapacitated.} \]
without the approval or consent of any person in a fiduciary capacity. For purposes of this paragraph, the term “power of administration” means any one or more of the following powers: (A) . . . ; (B) . . . ; (C) a power to reacquire the trust corpus by substituting other property of an equivalent value.

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(b) Exceptions for certain powers

Subsection (a) shall not apply to the following powers regardless of by whom held:

(4) Power to allocate among charitable beneficiaries

A power to determine the beneficial enjoyment of the corpus or the income therefrom if the corpus or income is irrevocably payable for a purpose specified in section 170(c) (relating to definition of charitable contributions) . . .

**Example of Benefit of Lifetime Grantor Third Party Special Needs Trust**

An example of how drafting a lifetime special needs trust as a

Grandparents have special needs grandson. Grandparents desire to leave a portfolio of highly appreciated dividend paying stocks to special needs trust for grandchild. Grandparents are very high income earners and cannot take advantage of zero percent tax rate on capital gain distributions. Son and his wife, however, average about $40,000 of taxable income after deductions. As such, son and his wife could add approximately $35,300 of taxable income (including qualifying dividends) to their income and remain in

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8. The capital gain tax rate for taxpayers in the 10% and 15% tax brackets is 0%. Internal Revenue Code § 1(h)(1)(B). For 2016, the 15% tax bracket for married couples ends at taxable income of $75,300. Revenue Procedure 2015-53. Qualified dividends from stocks are taxed at capital gain rates. Internal Revenue Code § 1(h)(1)(B). Internal Revenue Code § 1(h)(11)(B).
the 15% tax bracket.

Grandparents propose making an in-kind gift of the portfolio of qualified dividend paying stocks to son and daughter-in-law. Son and daughter-in-law would then create a lifetime grantor special needs trust for grandchild. Son and daughter-in-law would then fund the trust with the stocks. Because the trust is a grantor trust as to son and daughter-in-law, the trust income would be taxable to them as long as either of them is alive. The trust would become irrevocable and a non-grantor-trust upon the death of son and daughter-in-law.

It is anticipated grandparents would fund grandson’s needs during their lifetimes, so no distributions would be needed from the special needs trust to pay for grandson’s needs for at least ten years. After grandparents’ deaths, but while son and daughter are still alive, any distributions of income from the trust to pay for grandson’s needs would be taxable at the parents’ tax rates. The plan is for the corpus of the trust to grow tax free for at least ten years. After the grandparent’s death, it is desired that the trust continue to grow tax-free, but should any distributions of the income from the trust be needed to provide for grandson’s needs, those distributions would also be tax-free.9 After the death of son and daughter-in-law, the trust would be characterized as a non-grantor trust, but any income used for the benefit of grandson would be taxed at the grandson’s income tax rate.10

Non-Grantor Third Party Special Needs Trust

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9 This assumes that the distributions are funded using the qualified dividend income, that parents remain in the 15% tax bracket, and that the taxation of qualified dividend income remains the same as it is currently.

10 This is because of the DNI distribution deduction rule discussed above.
If non-grantor trust status was desired for some reason, but a step up in basis was also desired, the trust could be drafted to include a TESTAMENTARY limited power of appointment that could only be exercised by Will. The retention of the power of appointment would cause inclusion in the estate of the grantor, but would not cause grantor trust status because of the provisions of Internal Revenue Code § 674 (b)(3):

674(a) General rule.
The grantor shall be treated as the owner of any portion of a 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, or both, without the approval or consent of any adverse party.

684(b) Exceptions for certain powers
Subsection (a) shall not apply to the following powers regardless of by whom held:

(3) Power exercisable only by Will.
A power exercisable only by will, other than a power in the grantor to appoint by will the income of the trust where the income is accumulated for such disposition by the grantor or may be so accumulated in the discretion of the grantor or a nonadverse party, or both, without the approval or consent of any adverse party.

If a step up in basis is not needed, other powers that can be used by the drafting attorney to create a grantor trust include the power to substitute trust assets for non-trust assets of equivalent value.
Exhibits

Exhibit A
Grantor Trust Rules

§ 671 Trust Income, Deductions, and Credits Attributable to Grantors and Others as Substantial Owners

When the grantor or another person is deemed the “owner” of any portion of a trust, such owner is then required to include in computing his or her taxable income those items of income, deductions, and credits against tax of the trust which are attributable to that portion of the trust. Remaining items of income, deductions and credits against tax are taxed to the trust, or beneficiary, as applicable, in determining taxable income.

§ 672 Definitions and Rules

Section 672 contains the general definitions and rules for implementing the remaining sections within in the grantor trust rules.

1. “Adverse party” is any person having a substantial beneficial interest in the trust which would be adversely affected by the exercise or nonexercise of the power which he possesses respecting the trust. A person having a general power of appointment over the trust property shall be deemed to have a beneficial interest in the trust. IRC §672(a). Of course, that means that a "nonadverse party" is any person who is not an adverse party. IRC §672(b). A "related or subordinate party" is any nonadverse party who is the grantor’s spouse if living with the grantor or any one of the following: grantor’s 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; a subordinate employee of a corporation in which the grantor is an executive. IRC §672(c).

2. A person shall be considered to have a power described in §§671-678 even though the exercise of the power is subject to a precedent giving of notice or takes effect only on the expiration of a certain period after the exercise of the power. IRC §672(d).

3. Attribution: A grantor shall be treated as holding any power or interest held by such grantor’s spouse (if married to the grantor at the time of the creation of such power or interest), or any individual who became the spouse of the grantor after the creation of such power or interest, but only with respect to periods after such individual became the spouse of the grantor. IRC §672(e).

4. Income Tax Stays in US: In general, only a U.S. citizen, resident, or domestic corporation can be taxable as the owner of a trust under the grantor trust rules. IRC §672(f).

§ 673 Reversionary Interests

For transfers made in trust after March 1, 1986, the grantor shall be 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. For transfers made on or before to March 1, 1986, the grantor was treated as the owner of the trust unless the reversionary interest would not vest in present possession within a term of 10 years or within the life of the income beneficiary.

§ 674  Power to Control Beneficial Enjoyment

1. The general rule states that the grantor is treated as the owner of any portion of a 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, or both, without the approval or consent of any adverse party. §674(a). However, there are eight major exceptions which require more discussion than the general rule. Such exceptions delineate powers which the grantor or any other person may hold, two powers which an independent, nonadverse trustee may exercise, and one power which a nonindependent, nonadverse trustee (other than the grantor or the grantor's spouse) may exercise, without causing the grantor to be taxable as the owner of the trust.

2. A grantor is not taxable as the trust’s owner merely because a trustee or the grantor, in a fiduciary capacity as trustee or co-trustee, may use trust income to discharge a legal support obligation of the grantor. §674(b)(1); Regs. Section 1.674(b)-(1)(b)(1). The grantor is taxable as the trust’s owner only to the extent the trust income is actually used to discharge the support obligation described in §677(b), discussed below. Regs. Section 1.677(b)-1.

3. A postponed power to affect a trust's beneficial enjoyment will create a grantor trust unless it is postponed for a period which, were it a reversionary interest it would have a value that did not exceed five percent (5%) of the value of the trust or portion of the trust.

4. A power to direct the enjoyment of the trust exercisable solely by one's will does not create a grantor trust, even if the grantor or a nonadverse person (or both) holds the power and the power is exercisable without an adverse person's approval or consent. IRC §674(b)(3). However, what the Code provides the regulations take away. A grantor (not a nonadverse person) who holds a power exercisable without an adverse person's approval or consent to appoint the trust principal by his or her will is still taxed as the owner of those items of trust income, deduction, and credit properly allocated to the trust principal. Regs. Section 1.674(b)-1(b)(3). Further, if the grantor or a nonadverse person (or both) holds a power to dispose by will of the trust's accumulated income, and the same or another person holds the power to accumulate income for ultimate disposition, the trust is a grantor trust regarding such income under §674(b)(3). Additionally, a power to appoint to one's estate or the creditors of one's estate could also reasonably be viewed as a reversionary interest in the trust, causing the trust to be a grantor trust under §677(a). Regs. Section 1.674(b)-1(b)(3).

5. A grantor is not taxed as a trust's owner if the grantor retains a power to allocate the beneficial enjoyment of trust corpus or income among charitable beneficiaries if such charitable beneficiary are described in section 170(c) (relating to definition of charitable contributions) or to an employee stock ownership plan (as defined in section 4975(e)(7)) in a qualified gratuitous transfer (as defined in section 664(g)(1)).

6. A grantor is not taxed as a trust's owner if such grantor or a nonadverse person (or both) has 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 which is set forth in the trust instrument (a.k.a. “ascertainable standard”) §674(b)(5)(A); Regs.
§1.674(b)-1(b)(5)(i); or to or for any current income beneficiary, provided that the distribution of corpus must be chargeable against the proportionate share of corpus held in trust for the payment of income to the beneficiary as if the corpus constituted a separate trust. A power does not fall within the powers described in this paragraph if any person has a power to add to the beneficiary or beneficiaries or to a class of beneficiaries designated to receive the income or corpus, except where such action is to provide for after-born or after-adopted children.

7. A grantor is not taxed as a trust's owner if such grantor or a nonadverse person (or both) has a power to distribute or apply income to or for any current income beneficiary or to accumulate the income for him, provided that any accumulated income must ultimately be payable to the beneficiary from whom distribution or application is withheld, to his estate, or to his appointees (or persons named as alternate takers in default of appointment) provided that such beneficiary possesses a power of appointment which 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 termination of the trust, or in conjunction with a distribution of corpus which is augmented by such accumulated income, to the current income beneficiaries in shares which have been irrevocably specified in the trust instrument. Accumulated income shall be considered so payable although it is provided that if any beneficiary does not survive a date of distribution which could reasonably have been expected to occur within the beneficiary's lifetime, the share of the deceased beneficiary is to be paid to his appointees or to one or more designated alternate takers (other than the grantor or the grantor's estate) whose shares have been irrevocably specified. A power does not fall within the powers described in this paragraph if any person has a power to add to the beneficiary or beneficiaries or to a class of beneficiaries designated to receive the income or corpus except where such action is to provide for after-born or after-adopted children. §674(b)(6).

8. A grantor is not taxed as a trust's owner if such grantor or a nonadverse person (or both) reserves a power, exercisable without an adverse person's consent or approval, to withhold income from a current income beneficiary during any legal disability of the beneficiary or until such beneficiary attains age 21. §674(b)(7).

9. A power held by the grantor or a nonadverse person (or both) to allocate receipts and disbursements as between corpus and income, even though expressed in broad language, does not constituted a power to dispose of the beneficial enjoyment of the trust corpus or income that would cause the grantor to be taxed as the trust owner. §674(b)(8).

10. Under §674, a grantor is not taxed as a trust's owner 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). An independent trustee is not the grantor, nor a related or subordinate party who is subservient to the wishes of the grantor. §674(c).

11. A grantor is not taxed as a trust's owner if a nonadverse trustee holds the power to distribute, apportion or accumulate income to or for a beneficiary, if the power is limited by a reasonably definite external standard. The exception to grantor trust treatment for this permissible trustee power is not available if the grantor or the grantor's spouse (if living with the grantor) is a trustee; however, unlike the §674(c) exception, any of the trustees may be related or subordinate to the grantor. §674(d).
12. **Trustee Removal/Replacement**: A power in the grantor to remove, substitute, or add trustees (other than a power exercisable only upon limited conditions which do not exist during the taxable year, such as the death or resignation of, or breach of fiduciary duty by, an existing trustee) may prevent a trust from qualifying under section 674 (c) or (d). For example, if a grantor has an unrestricted power to remove an independent trustee and substitute any person including himself as trustee, the trust will not qualify under section 674 (c) or (d). On the other hand if the grantor's power to remove, substitute, or add trustees is limited so that its exercise could not alter the trust in a manner that would disqualify it under section 674 (c) or (d), as the case may be, the power itself does not disqualify the trust. Thus, for example, a power in the grantor to remove or discharge an independent trustee on the condition that he substitute another independent trustee will not prevent a trust from qualifying under section 674(c). Treas. Regs. §1.674(d)-2(a).

§ 675 Administrative Powers

Certain administrative powers exercisable by the grantor or a nonadverse person, or both, for the benefit of the grantor rather than for the trust beneficiaries, or powers exercisable in a nonfiduciary capacity, will cause the trust to be taxable to the grantor as owner of the trust. Such powers include:

1. The power to deal with trust assets for less than adequate and full consideration
2. The power to borrow trust assets without adequate interest and security
3. The grantor actually borrowing trust assets without adequate security interest and not repaying such loan during the taxable year
4. Certain additional administrative powers exercised in a nonfiduciary capacity by any person without the approval or consent of any person in a fiduciary capacity, including:
   a. a power to vote or direct the voting of stock or other securities of a corporation in which the holdings of the grantor and the trust are significant from the viewpoint of voting control;
   b. a power to control the investment of the trust funds either by directing investments or reinvestments, or by vetoing proposed investments or reinvestments, to the extent that the trust funds consist of stocks or securities of corporations in which the holdings of the grantor and the trust are significant from the viewpoint of voting control;
   c. a power to reacquire the trust corpus by substituting other property of an equivalent value.

§ 676 Power to Revoke

If a grantor (or grantor's spouse) or any other nonadverse person retains the power to revest the title to the trust assets in the grantor, then the grantor shall be treated as the owner of such portion, even though no other provision of Sections 671-678 apply.

§ 677 Income for Benefit of Grantor

The grantor is taxable as the owner of any trust or trust portion as to which the grantor, or any nonadverse person (or both) has the ability to use the trust income for the benefit of the grantor or the
grantor's spouse in one or more specified ways, without the consent or approval of an adverse person. Grantor trust status results when income may be used for the grantor's benefit in the following ways:

1. distributed, either actually or constructively, to the grantor or the grantor's spouse;

2. accumulated for future distribution to the grantor or the grantor's spouse;

3. applied, either actually or constructively, to pay premiums on policies of insurance on the life of the grantor or the grantor's spouse, other than certain charitable policies; or

4. actually applied or distributed to discharge the grantor's or his or her spouse's legal obligation of support.