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

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Default is Non-Grantor Trust

- A trust is by default a non-grantor trust
  - A non-grantor trust is a taxable entity that files an income tax return for its income and expenses using Form 1041
  - A non-grantor trust pays taxes on its taxable income
  - However, if the trust distributes income to or on behalf of a beneficiary of the trust the trust would be entitled to deduction for the amount of income distributed (but no greater than the DNI (Distributable Net Income) of the trust

Default is Non-Grantor Trust

- A trust is by default a non-grantor trust
  - If ALL income is distributed to or for the benefit of a beneficiary of the trust, the deduction for the distributed income would cause the trust to have no taxable income. The only exception would be capital gain income, which, depending on the definition of income contained in the trust, or state law, could be retained in the trust and taxes paid on the capital gain from trust income or assets.
Grantor Trust

- If a grantor of a trust retains certain powers outlined under Internal Revenue Code §§ 673 – 679, the trust is classified as a grantor trust
  - A grantor trust is disregarded for income tax purposes and the income of the trust is taxable to the grantor whether the income is retained in the trust or distributed to a beneficiary of the trust, even if the beneficiary is someone other than the grantor

Termination of Grantor Trust

- Upon termination of the retained power, the grantor trust reverts to a non-grantor trust
  - The grantor of a revocable trust dies, making the trust irrevocable. The trust is now taxed as a non-grantor trust
  - Irrevocable trust provides that income is to be paid to the spouse of the grantor. The spouse of the grantor dies. Assuming no other power is present that would cause the trust to continue to be characterized as a grantor trust, of a trust is now taxed as a non-grantor trust
First Party Special Needs Trusts

- IRS says (d)(4)(A) First Party Special Needs Trusts are grantor trusts.
  - PLRs 200620025, 200826008, and 201116005
- IRC § 677(a)(2) provides that if a grantor creates a trust that holds or accumulates the income for future distribution to the grantor (special needs beneficiary) or the grantor's spouse, the trust is taxed as a grantor trust

As a grantor trust, the income of the special needs trust, whether accumulated or distributed for the benefit of the special needs trust beneficiary, the income should be taxed to the grantor / special needs trust beneficiary
**First Party Special Needs Trusts**

- Creates a potential disconnect
  - Fiduciary accounting income as calculated under trust provisions or state law (Uniform Principal and Income Act)
  - Trust income taxable to grantor / beneficiary whether used for his benefit or accumulated in the trust
  - Income for purposes of eligibility for SSI and other needs based government assistance

**Third Party Special Needs Trusts**

- In some circumstances, can be drafted as grantor trust or as non-grantor trust
  - Testamentary Special Needs Trust – always non-grantor trust
    - Can be created by Will or as a sub-trust of a revocable living trust. Cannot be a grantor trust because grantor is dead
  - Revocable Stand Alone Special Needs Trust
    - Grantor trust because revocable – created while grantor is alive

- Irrevocable Stand Alone Special Needs Trust
  - Created while grantor is alive
  - Grantor Trust
    - Grantor retains LPOA
    - Causes estate tax inclusion
  - Grantor or third party given power of substitution
    - Does not cause estate tax inclusion
  - Grantor gives non-adverse party power to add beneficiary
    - Causes estate tax inclusion
  - Grantor gives third party to add charitable beneficiaries
    - Causes estate tax inclusion
Third Party Special Needs Trusts

- Irrevocable Stand Alone Special Needs Trust
  - Created while grantor is alive
  - Non-Grantor Trust
    - Default except if a grantor power is added to the trust provisions
    - Trust could be drafted to avoid inclusion in the grantor’s estate
    - Trust could be drafted to include the trust assets in the grantor’s estate
      - Grantor should retain LPOA that is exercisable only be Will
        - IRC §§ 674(b)(3); 2036

Example

- Grandparents have special needs grandson
- Grandparents have portfolio of appreciated stocks paying qualified dividends
- Grandparents are high income earners
- Son and daughter-in-law have average taxable income of around $40,000

Example, continued

- Capital gain rates depend on regular income tax rate of taxpayers – 0% to 20%
  - Internal Revenue Code § 1(b)(1)(B)
<table>
<thead>
<tr>
<th>Income Tax Rate</th>
<th>Maximum Income – Married</th>
<th>Capital Gain Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>10%</td>
<td>$18,550</td>
<td>0%</td>
</tr>
<tr>
<td>15%</td>
<td>$75,300</td>
<td>0%</td>
</tr>
<tr>
<td>25%</td>
<td>$151,900</td>
<td>15%</td>
</tr>
<tr>
<td>28% - 39.6%</td>
<td>Over $151,900</td>
<td>20%</td>
</tr>
</tbody>
</table>

Example, continued

- Qualified dividends paid by certain stocks are taxed at capital gain rates
  - Internal Revenue Service §1(h)(11)(B)

Example, continued

- Grandparents to make in-kind gift of appreciated stocks to son and daughter-in-law
- Son and daughter-in-law create Stand Alone Third Party Special Needs Trust that will be characterized as a grantor trust
  - Revocable
  - Retain LPOA
  - Add power to substitute assets
  - Add power to add charitable beneficiaries
• Son and daughter-in-law fund Stand Alone Third Party Special Needs Trust with gifted appreciated dividend paying stocks
• Trust income taxed to son and daughter-in-law whether trust income accumulated or distributed for the benefit of son
• Qualified stock dividends are taxed at capital gain rates rather than ordinary income tax rates
• SNT pays 0% tax on dividends up to $35,300. 15% rate on excess dividends

• Trust remains a grantor trust as long as son or daughter-in-law remain alive
• Upon death of last to die of son or daughter-in-law, SNT converts to non-grantor trust. Trust would pay tax at capital gain rate (maximum of 20% if dividends are accumulated. If income is distributed for the benefit of son, taxed at capital gain rate based on son’s income tax bracket – 0% to 20%