

Toggling Made Easy—Modifying a Trust to Create a Grantor Trust



Grantor trusts are extremely popular devices for family wealth transfers, but a grantor may not always recognize the appeal of paying taxes on trust income that he or she does not receive. This raises the question of how to change a regular trust into a grantor trust after the trust has been executed and is irrevocable and unamendable. The answer is illustrated in Ltr. Rul. 200848017.

Background

In the letter ruling, the grantor created and funded an irrevocable trust for the benefit of the grantor's children. The trust was not a grantor trust.

In accordance with applicable state law, the grantor and all the beneficiaries of the trust proposed to execute a modification of the trust instrument, giving the grantor the nonfiduciary power to reacquire any property contained in the trust by substituting other property of equivalent value. This, the grantor contended, should cause the trust to become a grantor trust, under Section 675(4)(C).

IRS approves conversion to grantor trust

The IRS explained that the power to substitute trust assets for other

assets of equivalent value is a grantor trust power under Section 675(4)(C), if exercisable in a nonfiduciary capacity. Whether a power is exercisable in a fiduciary capacity is a factual question to be determined from an examination of all relevant facts and circumstances, and the IRS does not rule on such questions.¹ The IRS stated that this modification would create a grantor trust if the facts and circumstances established that the grantor's new power was actually exercisable in a nonfiduciary manner.

The IRS declined to rule on the gift tax consequences of the proposed transaction or of the future exercise of the substitution power. This caveat, however, should cause practitioners little concern, as the creation and exercise of the substitution power would not normally have gift tax consequences, because the exercise of that power does not affect the value of the interests of any of the beneficiaries.

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The only situation in which the exercise of the substitution power would create adverse gift tax results involves a beneficiary entitled only to an income or remainder interest. If the trust does not permit the trustee to reinvest the trust assets or to modify the trust investments, a grantor's exercise of the substitution power could increase or decrease the income to the advantage of other beneficiaries. The beneficiary, however, does not consent to the exercise of the power, only to the creation of the power, and the creation of the power does not itself affect the value of the beneficiary's interest.² This suggests that neither the consent to the grant of the power nor the exercise of the power has gift tax consequences.

The IRS also declined to rule on whether future activities involving the grantor, the trust, and the substitution power were substantially similar to the "transaction of interest" identified in Notice 2007-73.³ The toggling of the trust between grantor and nongrantor status in Notice 2007-73, however, was specifically orchestrated to claim excessive tax losses without concomitant economic risk, and the conversion of a trust into a grantor

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trust merely to enable the grantor to make enhanced taxable gifts seems to be an entirely different type of transaction.

The letter ruling also did not address whether the grantor's new power would constitute a power to alter, amend, revoke, or terminate the trust under Section 2038. Section 2036 would not apply because the power is not actually retained by the grantor, but Section 2038 has no such requirement. Section 2036(a) should not apply under Rev. Rul. 2008-22.⁴

Comments

The reformation in Ltr. Rul. 200848017 appears to have been undertaken under Uniform Trust Code ("UTC") section 411, which permits the grantor and all beneficiaries of a trust to modify or terminate the trust "even if the modification or termination is inconsistent with a material purpose of the trust." Court approval is

required under one authorized variation of the UTC generally, except in Alabama, Maine, Nebraska, New Mexico, Ohio, and Virginia's versions of the UTC. In these states, the court reviews the agreement only to assure that the grantor and beneficiaries have all agreed to the change.⁵

Reformation is still possible in non-UTC states. It is common for the local courts to deem their general equity powers to include the power to approve trust modifications, if the modifications do not contravene the grantor's original intentions, the parties agree to the modification, and the modification is appropriate to meet changing tax or nontax conditions. Such powers should generally enable the modification of a trust in a non-UTC state to meet the same end as achieved in Ltr. Rul. 200848017.⁶

Modifying a trust to make it a grantor trust may be very useful for several reasons. First, this enables the grantor to pay the income taxes on income earned by the trust and held for or distributed to the trust beneficiaries. The IRS has ruled that

such payments are not themselves additional taxable gifts, and that they do not cause the trust assets to be includable in the grantor's gross estate, as long as the trustee cannot be compelled by the grantor's creditors to reimburse the grantor for such taxes.⁷ Thus, a trust modification to cause the trust to become a grantor trust should usually be accompanied by a modification to direct that all the income taxes on the trust will be paid by the grantor, without reimbursement or payment by the trustee.

Second, a grantor trust the assets of which are not included in the grantor's gross estate becomes a very good entity to which the grantor may sell appreciating assets. An installment sale of appreciating assets to a grantor trust is not a taxable sale for income tax purposes.⁸ Consequently, the grantor shifts future appreciation from his or her gross estate, in exchange for interest payments at the applicable federal rate. This may be an excellent way to move future value from the grantor's gross estate, without either gift or generation-skipping taxes.⁹

It is usually better to include in a trust a provision that would enable an independent third-party to confer on the grantor or a non-adverse party a power to reacquire trust assets by substituting assets of equivalent value, and thus create a grantor trust. In the absence of such advance planning, however, Ltr. Rul. 200848017 provides a good technique for achieving the same result with relatively little additional effort. ■

¹ Section 675(4)(C); Reg. 1.675-1(b)(4)(iii).

² See, by analogy, Rev. Rul. 2008-22, 2008-16 IRB 796.

³ Notice 2007-73, 2007-36 IRB 545. See also "Other Tax Developments," 34 ETPL 47 (Nov. 2007).

⁴ Rev. Rul. 2008-22, *supra* note 2. See also Madden, Hayes, and Baldino, "Power to Substitute Trust Assets Does Not Cause Estate Tax Inclusion, Rules IRS, Rev. Rul. 2008-22, 2008-16 IRB 796," 35 ETPL 34 (Sept. 2008); and Mulligan, "Power to Substitute in Grantor Does Not Cause Inclusion, With a Significant Caveat," 109 J. Tax'n 32 (July 2008).

⁵ See Ala. Code § 19-3B-411; 18-B Me. Rev. Stat. § 411; Neb. Rev. Stat. § 30-3837; N.M. Stat. Ann. § 46A-4-411; Ohio Rev. Code § 5804-11; Va. Code § 55-544.11.

⁶ See, e.g., Bieber and Hodgman, "Trust Severances and Other Planning Under the New Final and Prop. GST Regs.," 35 ETPL 3 (Jan. 2008); Hodgman and Blickenstaff, "Judicial

Reformation of Trusts—The Drafting Tool of Last Resort," 28 ETPL 287 (June, 2001); Schindel, "How to Modify or Terminate an Irrevocable Trust," 22 ETPL 323 (Nov./Dec. 1995).

⁷ Rev. Rul. 2004-64, 2004-1 CB 7. See also Gans, Heilborn, and Blattmachr, "Some Good News About Grantor Trusts: Rev. Rul. 2004-64," 31 ETPL 467 (Oct. 2004).

⁸ Rev. Rul. 85-13, 1985-1 CB 184.

⁹ See also Aucutt, "Installment Sales to Grantor Trusts," 4 Bus. Entities 28 (Mar./Apr. 2002); Balakrishna, "Defective Grantor Trusts: Greater Flexibility and Income Tax Leverage," 32 ETPL 30 (Dec. 2005); Mulligan, "Sale to a Defective Grantor Trust: An Alternative to a GRAT," 23 ETPL 3 (Jan. 1996); Mulligan, "Defective Grantor Trusts Offer Many Tax Advantages," 19 ETPL 131 (May/June 1992); Mulligan, "The Reinvigorated GRAT: Is a Sale to a Defective Trust Still Superior?," 29 ETPL 379 (Aug. 2002).