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Grantor Trusts Revisited

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On April 17, 2008, Revenue Ruling 2008-22 was issued -- adding substantial clarity to an issue that is often raised in drafting sophisticated estate plans -- how to create a "defective" grantor trust without causing the trust to be included in the grantor's estate. The Ruling addressed whether there would be estate tax inclusion where the grantor of an irrevocable trust retained the power to substitute assets under §675(4)(c). The editorial team at WealthCounsel followed up immediately with an update to provide language that should come within the "safe harbor" of Revenue Ruling 2008-22. After analyzing the Ruling, this article briefly describes what this author believes are the "safe" powers for creating a defective grantor trust. Revenue Ruling 2008-22 should be read carefully by every estate planner drafting defective grantor trusts.

Specifically, the Ruling held:

A grantor's retained power, exercisable in a nonfiduciary capacity, to acquire property held in trust by substituting property of equivalent value will not, by itself, cause the value of the trust corpus to be includible in the grantor's gross estate under §2036 or §2038, provided:

- the trustee has a fiduciary obligation (under local law or the trust instrument) to ensure the grantor's compliance with the terms of this power by satisfying itself that the properties acquired and substituted by the grantor are in fact of equivalent value, and

- further provided that the substitution power cannot be exercised in a manner that can shift benefits among the trust beneficiaries. A substitution power cannot be exercised in a manner that can shift benefits if:

  (a) the trustee has both the power (under local law or the trust instrument) to reinvest the trust corpus and a duty of impartiality with respect to the trust beneficiaries; or

  (b) the nature of the trust's investments or the level of income produced by any or all of the trust's investments does not impact the respective interests of the beneficiaries, such as when the trust is administered as a unitrust (under local law or the trust instrument) or when distributions from the trust are limited to discretionary distributions of principal and income.

It is important (interesting?) to note that the IRS did not address or cite §2042 (power of life insurance policies) in its holding, nor did it address one way or the other the issue of the grantor's status as NOT BEING a trustee. However, in its legal analysis of the *Jordahl* case, the IRS makes mention that under the facts of the current ruling the grantor was prohibited from being a trustee, while in the Jordahl case the grantor was a trustee. Either the IRS did not want to touch this issue, or the IRS felt it to be immaterial. Either way, it was not part of the holding itself.

The facts, taken directly from the Ruling (but separated for readability) are:

1. D, a United States citizen, established and funded Trust.

2. Trust is an irrevocable inter vivos trust for the benefit of D's descendants.

3. T is the trustee of Trust, and D is prohibited from serving as trustee under the terms of Trust.

4. The governing instrument provides that D has the power, exercisable at any time, to acquire any property held in Trust by substituting other property of equivalent value.

5. The power is exercisable by D in a nonfiduciary capacity, without the approval or consent of any person acting in a fiduciary capacity.

6. To exercise the power of substitution, D must certify in writing that the substituted property and the trust property for which it is substituted are of equivalent value.

7. In addition, under local law, T has a fiduciary obligation to ensure that the properties being exchanged are of equivalent value.

8. Under local law, if a trust has two or more beneficiaries, the trustee has a duty to act impartially in investing and managing the trust assets, taking into account any differing interests of the beneficiaries.

9. Further, under local law and without restriction in the trust instrument, T has the discretionary power to acquire, invest, reinvest, exchange, sell, convey, control, divide, partition, and manage the trust property in accordance with the standards provided by law.

Comments:

The IRS specifically cites *Estate of Jordahl v. Commissioner*, 65 T.C. 92 (1975), acq. in result, 1977-2 C.B. 1, as authority for its ruling. In *Jordahl*, the Tax Court held that,

> "Decedent did not have the power to alter, amend, or revoke the trust as defined under sec. 2038(a)(2), I.R.C. 1954, because his power of substitution was no greater than a settlor's power to direct investments. Nor were the insurance proceeds includable under sec. 2042(2), I.R.C. 1954, because the right to substitute other policies "of equal value" did not give him a right to the "economic benefits" of the policies and because his powers as trustee were strictly limited."

It is not clear from the facts whether the trust in question owned any life insurance policies. It is clear that the IRS did not address the §2042 issue since it is absent from its legal analysis. At least one commentator has suggested that to be safe when relying on this Ruling, the power should explicitly exclude life insurance polices on the life of the grantor.

What Powers Should (Can) Be Used Without Causing Estate Tax Inclusion:

The Ruling, as most rulings, addressed only a specific, narrow issue -- the power of substitution. However, there are many other grantor trust powers that can be used. The question remains - which powers can we use without causing the entire trust to be included in the grantor's estate? The following powers are preferred by this author (this is not a complete legal analysis):

1. Have someone else possess the power to substitute assets. The statute itself -- §675(4)(C) -- states that "any person" has the power to substitute assets. Numerous private letter rulings have also ruled that a non-grantor (3rd party) possessing this power would cause grantor trust status.

2. Grant the substitution power to the grantor's spouse. Spousal attribution under §672(e)(1)(A) would treat the non-grantor spouse's power of substitution as if it were held by the grantor directly. There is no spousal attribution rule for estate tax purposes that would cause estate tax inclusion here.

3. Give an Independent Trustee (or a trust protector) the power to add to the class of beneficiaries designated to receive income or corpus, except to provide for after-born or after-adopted children. Section 674(b)(5)(A) and Reg. §1.674(b)-1(b)(5)(iii), Example (1), and Reg. §1.674(d)-2. Adding a charitable beneficiary, or spouses of existing beneficiaries, for example. NOTE -- Grantor should not have this power.

4. Permit the grantor to Borrow trust assets Without Adequate Security -- but make sure that any such loans carry adequate interest. Section 675(2). Uncollateraled loans should not be a problem. Adequate interest should be mandated to avoid any §2036 or §2038 arguments by the IRS.

5. If the estate planner wants to be conservative, then to be extra safe -- permit the grantor's spouse to borrow trust assets without adeqate security. Again -- §672(e)(1)(A) imputes this power to the grantor without risking estate tax inclusion.

6. Make the grantor's spouse as an income beneficiary -- Again -- §672(e)(1)(A) imputes this benefit to the grantor without risking estate tax inclusion.

7. Where the income of the trust "MAY BE" applied to the payment of premiums on policies of insurance on the life of the grantor or the grantor's spouse. Section §677(a)(3). Some commentators have suggested that income must "actually be used" to pay life insurance premiums, and at a minimum, the trust should at least own a life insurance policy. The commentators making this statement cite case law interpreting a predecessor statute with wording that is different from §677(a)(3). It is this author's opinion that the statute's wording is clear on its face and that the mere power to use trust income to pay life insurance premium will create a grantor trust.

Final word (and caveat): using the spouse to create a grantor trust can backfire in unstable marriages or in the event the spouse dies before the grantor. No single planning technique is perfect.

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