insights

Why a 'Grantor Trust' is a good addition to every estate plan

The Internal Revenue Code is a long, complicated law with many subtitles, chapters, parts and sections. Although we are all aware of income taxes, few care that they are depicted by Subtitle A of the Code. Many are equally aware of estate taxes and gift taxes, and again few care that they are depicted by Subtitle B of the Code, Chapters 11 and 12 respectively.

Even fewer care about Subchapter J of Chapter 1 of Subtitle A of the Code, which depicts how the income of trusts is taxed. Savvy estate planning attorneys are the few individuals who study these subtitles, chapter and subchapters of the Code and use the lack of coordination between the rules for income taxes, estate taxes and gift taxes to the benefit of their clients.

Background

The individual who establishes a trust is called the settlor or grantor. Similar to any individual, an established trust is a separate entity that must pay income taxes on its income. In 1954, Congress enacted Subpart E of Part 1 of Subchapter J of Chapter 1 of Subtitle A. This Subpart E is commonly known as the "Grantor Trust Rules." The Grantor Trust Rules depict when the grantor of a trust rather than the trust itself will be deemed the "owner" of the trust assets and therefore responsible for paying the income taxes on the income generated by such assets. The Grantor Trust Rules were enacted to prevent abuses by taxpayers who were shifting income to taxpayers in lower income tax brackets. In years past, trust income rates were more favorable than those rates applied to individuals.

Today, tax brackets are much more favorable for individual taxpayers. The tax brackets for trusts are very compressed causing a trust to pay higher taxes at lower income amounts.

Trusts that are subject to the Grantor Trust Rules are commonly referred of as "Grantor Trusts." Grantor Trusts can take advantage of the benefits offered by a trust and simultaneously avoid the higher income taxes imposed on non-grantor trusts.

Common types of Grantor Trusts:

1. **Revocable Living Trust**: A revocable living trust which holds title to the grantor's assets during the grantor's lifetime is a Grantor Trust during the grantor's life. A revocable living trust is testamentary in nature and acts as a will substitute. A benefit of a revocable living trust is its nature as a private document that is not filed with the Probate Court upon the grantor's death, thus ensuring that the grantor's testamentary disposition will remain private rather than a matter of public record. In addition, a revocable living trust can prevent court involvement in the case of the grantor's incapacity. The grantor of a revocable living trust is deemed to own the trust assets by virtue of many Grantor Trust Rules.

   One example is § 676(a) because the grantor may revoke the trust at any time. During the grantor's lifetime, the grantor reports all the income of the revocable living trust on the grantor's income tax return. The trust uses the grantor's social security number as its tax identification number. A revocable living trust provides many advantages and creates no additional tax reporting requirements.

2. **Irrevocable Life Insurance Trust**: An irrevocable life insurance trust ("ILIT") is subject to Grantor Trust Rule §677(a)(3) if the trust income may be applied toward the payment of premiums on policies insuring the grantor's life (or the grantor's spouse's life). Again the grantor reports all the income of the ILIT on the grantor's income tax return and the ILIT uses the grantor's social security number as its tax identification number. This kind of Grantor Trust is often referred to as an Intentionally Defective Grantor Trust (IDGT").

   An IDGT is drafted specifically so that the grantor is deemed the owner of trust assets for income tax purposes while the same trust assets are not included in the grantor's estate for estate tax purposes.

Gifts to an IDGT are completed gifts and not included in the grantor's estate. In addition, the grantor may sell assets to an IDGT at deeply discounted prices without making a gift or recognizing any gain or loss.

3. **Spousal Lifetime Access Trust**: A Spousal Lifetime Access Trust ("SLAT") is an irrevocable trust created by one spouse for the benefit of the other spouse. A SLAT is similar to a bypass trust; the difference being that a SLAT is funded via gift while the grantor spouse is still alive, as opposed to a bypass trust that is funded by bequest when a spouse dies.

   The grantor spouse can indirectly benefit from the SLAT as long as the non-grantor spouse is living and remains married to the grantor spouse. In addition, a SLAT can be drafted as a Grantor Trust. As the donor spouse will be required to pay the income taxes generated by the SLAT, the grantor spouse's gross estate will be further reduced for estate tax purposes. As with a bypass trust, the SLAT can provide access to just a spouse or a spouse and children, may automatically distribute income or make distributions of income, principal or both discretionary.

   The fundamental goal of a SLAT, similar to a bypass trust, is to get assets into a trust that can still provide some financial assistance to a grantor, but done in a manner that those assets – and any future growth upon them – will not be included in the grantor's estate.

Next Steps

A Grantor Trust should be considered for every estate plan. Please contact one of the members of our Private Client Group for more information about revocable living trusts or to discuss whether an IDGT is appropriate for you.

If you have any questions about this topic, please contact private client chairs Steve Cupples or Ed McGillen.

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