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Non-Grantor Trust Resurgence &Avoiding an Unintended Switch to Grantor Trust status

by: Joy Matak, JD, LLM, Lisa Mela, CPA, MST, and Martin M. Shenkman, Esq.

The tax rules governing trusts have evolved over time as taxpayers and the government chiseled the landscape through countless cycles of planning, regulations, court cases, and IRS rulings. Wealth transfer practitioners use the rules to gain advantages for taxpayers, implementing strategies that are regulated and challenged by the IRS, and then litigated in the courts. Congress then breaks the cycle by passing new legislation that changes the rules, starting yet a new cycle.

A Wild Ride for Grantor Trusts Tax Consequences

For grantor-type trusts, the cycle has been a winding roller coaster stretching over generations. The grantor trust rules were originally created to stop wealthy taxpayers from using trusts to shift their income tax burdens back when trust income tax rates increased at the same rate as individual income tax rates. Congress imposed upon the settlor the obligation to pay the taxes on the income earned by any such trust when the settlor retained certain powers over the trust. With the advent of the grantor trust rules, the era of shifting income to a trust from the assets transferred to the trust came to an end.[1]

However, just as Congress closed this income tax loophole by imposing the grantor trust rules on wealthy taxpayers, many more planning opportunities were developed. The estate planning community realized that shifting an asset out of an estate for estate tax purposes, while retaining the income tax burden, could be advantageous to an estate plan as a result of the burn on the settlor's estate. While many clients may not appreciate remaining responsible for the income taxes of assets transferred to the trust, this characteristic of the grantor trust could be the most valuable estate tax minimizing feature. Tax burn over many decades could provide greater benefit than even valuation discounts. Under current law, grantor- trusts allow wealth to accumulate outside of the settlor's taxable estate, all while decreasing the value of the settlor's taxable estate by the income tax payments on the income earned inside the trust. Thus, a grantor trust enables taxpayers to make tax-free gifts in the form of income tax payments on behalf of the trust. Further, for so long as the grantor trust status remained intact, sale or swap of assets from the trust with the settlor can generally be made without income or transfer tax consequences. Finally, distributions to beneficiaries from the trust can be made without pushing out income to the beneficiary.

Grantor trusts have become ubiquitous in modern estate planning. For most wealthy taxpayers, grantor trusts are viewed as a vehicle for leveraging wealth to the next generation. Assets owned by a grantor trust can accumulate value outside of the settlor's taxable estate while the settlor depletes her taxable estate by the amount of taxes being paid

New opportunities appeared for taxpayers when the Service concluded that a sale of assets between a grantor and a grantor trust would not be recognized for income tax purposes.[2] This ruling lent support

[1] See IRC Sec. 671-678, generally, and related regulations.
[2] See Rev. Rul. 85-13.

to sales to an intentionally defective grantor trust" strategy which allowed taxpayers to freeze the value of their estates for estate tax purposes by selling assets to grantor trusts in exchange for a promissory note. There may be no gift tax consequences so long as the transaction is properly structured. That includes the trust paying fair value for the asset sold to it, the note bearing an adequate rate of interest, and the interest and payments actually being made in accordance with the promissory note, adequate seed gifts in the trust, the transactions being respected, etc. In other words, taxpayers could transfer appreciating assets, retain a fixed return, and avoid both income and transfer taxes.

Recent proposals reduce or eliminate efficacy of grantor trust planning

As grantor trusts continued to be used in planning, regulations, court cases, and IRS rulings, various legislative proposals seeking to limit the benefits of grantor trust planning have emerged.

Attacks on grantor-type trusts are not new. President Obama also included restrictions on grantor trusts in his Green Book proposals throughout his presidency. The proposals currently being considered bear much resemblance to the Obama Green Book proposals.[3]

On March 25, 2021, Senate Budget Committee Chairman Bernie Sanders (I-VT) introduced his "For the 99.5% Act"[4] (the "Act"), which would create "Special Rules for Grantor Trusts" that would require the assets of certain Grantor trusts to be included in the estate of the settlor.[5] The Act at Sec. 8 carefully constructs a new Chapter 16 to Subtitle B of the Internal Revenue Code of 1986 which, if enacted, would apply transfer taxes upon the value of those assets owned by grantor-type trusts, reduced only by taxable gifts made by the deemed owner to the trust.

Sec. 8 would create a new Sec. 2901 of the Code which reads, in relevant part: "(a)(1) the value of the gross estate of the deceased deemed owner of such portion shall include all assets attributable to that portion at the time of the death of such owner …" A "deemed owner" is defined under the new Sec. 2901 (d) as "any person who is treated as the owner of a portion of a trust" under the grantor trust rules.[6] While the Act contemplates a "reduction for taxable gifts" made to the trust by the deemed owner, the result is that all appreciation is included in the settlor's estate defeating any planning benefit. This potential change presents two possible planning approaches at this juncture. First, practitioners should broadly consider creating grantor trusts prior to the date of enactment, as it appears that these will be grandfathered under current law to avoid estate inclusion. The second approach represents a significant shift in estate planning from historic norms. If an initial gift were to be made to a non-grantor trust, inclusion of the appreciation may be avoided as the Act is currently written and as the law is contemplated to be changed by the Act. Using non-grantor trusts in lieu of grantor trusts will require tax practitioners to rethink many tax planning considerations of trust planning, as explored below.

[3] The Treasury department issues a list of revenue proposals commonly referred to as a "Green Book." This is typically an annual occurrence as part of budget negotiations between the White House and Congress.
[4] For the 99.5% Act, S. 994, 117th Cong. (2021), available: https://www.sanders.senate.gov/wp-content/uploads/For-the-99.5-Act-Text.pdf.
[5] See the Act at Section 8.
[6] The Act refers to "subpart E of part 1 of subchapter J of chapter 1." These are the grantor trust rules which can be found at IRC §§671-679.

The Act at Sec. 8 would treat transfers from a grantor trust during the life of the deemed owner as a gift.[7] Further, if a grantor trust ceases to be treated as a grantor trust during the lifetime of the deemed owner, proposed Sec. 2901(a)(3) would treat the assets in the trust as if they were transferred by gift, less any reduction for taxable gifts that might be applicable under the proposed Sec. 2901(e). Thus, a gift tax could be imposed on the change in status. Consider the difficulties of planning for this potentially costly tax consequence. An unintentional act that negates grantor trust status could trigger substantial gain. This possibility alone will heighten the importance of regular review meetings to monitor trust administration. These provisions would also seem to prevent an individual from converting a grantor trust to a non-grantor trust to circumvent the full effects of the law. Finally, Sec. 8 of the Act introduces Sec. 2901(f) to clarify that "any tax imposed pursuant to subsection (a) shall be a liability of the trust." By making the trust liable for the tax, the Act ensures that any taxes paid will reduce trust assets rather than reducing the owner's taxable estate.

Two other relevant proposals in Congress, introduced contemporaneously with the For the 99.5% Act, would impose a capital gains tax on gift transfers, including those to a grantor-type trust.[8] These "deemed realization" proposals would treat all assets transferred by gift as though they had been sold for fair market value. Similarly, President Biden included deemed realization for gift transfers in his recently released "General Explanations of the Administration's Fiscal Year 2022 Revenue Proposals," commonly called the Treasury Department's "Green Book."[9] Under Biden's proposal, the donor of an appreciated asset would realize a capital gain at the time of the transfer to the extent that the asset's fair market value on the date of the gift exceeded the donor's basis in that asset.[10] Distributions from grantor trusts to beneficiaries would also be deemed realization events, subject to capital gains tax to the extent that the fair market value exceeds the basis at the time of the distribution.

The deemed realization proposals cast a very wide net to catch bad actors but may inadvertently injure taxpayers of more modest means. By way of example, consider the small business owner who may not have an estate that is large enough to be subject to an estate tax, even though her or she is ready to retire from working and transfer ownership to their adult children. For this taxpayer, a deemed realization on the transfer of the business could be devastating, even if an exemption would apply and the taxpayer may satisfy the tax obligation over a term of years, as in the two proposals that are currently being considered in Congress.[11]

Practitioners should consider and educate clients about the potential for changes to grantor trust treatment as proposed under the For the 99.5% Act and deemed realization tax change to be enacted. In aggregate, these two proposals, if enacted, could trigger capital gains tax and estate tax on the same trust assets. That is a dramatic difference from that which exists under the current tax environment.

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[7] The Act at Sec. 8, proposed Sec. 2901(a)(2).

[8] H.R. 2286, 117th Cong. (2021), available: https://www.congress.gov/117/bills/hr2286/BILLS-117hr2286ih.pdf (the "Pascrell bill"). The Sensible Taxation and Equity Promotion (STEP) Act, introduced by Sen. Van Hollen, summary can be found here: https://www.vanhollen.senate.gov/imo/media/doc/One%20pager%20-%20STEP%20Act.pdf (the "STEP Act").

[9] https://home.treasury.gov/system/files/131/General-Explanations-FY2022.pdf

[10] Id. at 68.

[11] The STEP Act provides closely held business owners with 15 years to satisfy the tax on the deemed realization, whereas the Pascrell bill requires payment in full within 7 years. See *supra* note 8.

All of these legislative proposals appear destined to create extra responsibilities on the trustee to engage with a professional planning team comprised of an attorney, accountant, and financial advisor who can monitor different situations and advise on potential administrative decisions or other actions that could inadvertently create a grantor-type trust, where a non-grantor trust is what is planned for as part of the estate plan.

Resurgence of Non-grantor trusts

This potential legislative backlash against grantor-type trusts may lead to an increased planning emphasis on the use of non-grantor trusts. Non-grantor trusts are entities that pay income taxes on income earned, subject to certain rules as set forth in the Code and related regulations.[12]

In a non-grantor trust, ordinary income from the trust can be from various sources, including interest, dividends, rental income, royalties, and so on, and this income can be distributed to the beneficiaries, or retained by the trust (assuming that the terms of the trust permit) and the trust will pay taxes on the income. Generally, capital gains and losses will remain inside the trust until its expiration, though there may be some exceptions (e.g. if the trust instrument permits distributions of corpus). The trust instrument will thus determine whether tax on distributions are payable by the trust or by the individual beneficiary. Practitioners should be aware that if the terms of the trust are not supportive of the current tax objectives of the client, there may be an ability to modify those terms. In some instances, the trust might include a trust protector that has the power to modify administrative provisions (if the desired changes fall within that ambit). In other instances, the trust may be decanted (merged) by the trustee into a new trust. Therefore, practitioners should be alert to the potential to modify trusts to improve tax results. While this is not always possible, it may be worth exploration.

All non-grantor trusts must be classified in one of two ways for the purpose of paying federal income taxes – as a simple trust or a complex trust. A "simple trust" requires the distribution of all income. A "complex trust" gives the Trustee discretion to either distribute the income or to hold the income within the trust. The word complex means that the trustee has more discretion, rather than the trust's terms are more complicated.

Non-grantor trusts can generally take a deduction for income that is distributed to beneficiaries.[13] In turn, when a beneficiary receives income from a non-grantor trust, the income that they receive must be reported as income when they file taxes for the calendar year that the income was received.

A non-grantor trust will be taxable in states based on the laws of each state.

SALT deduction

A non-grantor trust may be a powerful planning tool; not just for the super wealthy, but for many people who are looking to save state and/or federal income tax, while also making completed gifts for the benefit of their heirs that use up the current high lifetime exemptions before it declines. By way of example, the Tax Cuts and Jobs Act (TCJA) enacted at the end of 2017 and effective beginning in 2018

[12] See, generally, Subchapter J of the Internal Revenue Code and related regulations.

[13] This is the income distribution deduction, based upon the concepts of Fiduciary Accounting Income ("FAI") and Distributable Net Income ("DNI"). A discussion about FAI, DNI and how the income distribution deduction is calculated is beyond the scope of this article.

limited an individual's itemized deductions by capping the deduction for state and local taxes (SALT) to $10,000. Clients in high tax states (such as California, New Jersey, and New York) started to consider using their high lifetime exemptions to gift income-producing assets to a non-grantor trust situated in a state with no state income tax in order to bypass the SALT cap. Additionally, non-grantor trusts can deduct property taxes. Trusts funded with real estate provide the opportunity to deduct real estate taxes. These taxes are subject to the $10,000 annual limitation unless the property is business or investment property, in which case there is no ceiling. Note that some of the pending tax proposals including capping itemized deductions at 28%. That will create a substantive gap if the income rates are increased to 39.6%. Further, reinstating the PEAS limitation could serve to further limit deductions. These changes, if enacted, could reduce the income tax benefits of nongrantor-trust planning.

QBI deduction Section 199A

The TCJA also created a deduction for qualified business income under a newly created Section 199A (the "QBI deduction"). To the extent that a trust does not exceed an income threshold of $164,900 in 2021, the trust will be eligible to take a twenty percent deduction for qualified business income earned, so long as the taxpayer meets certain tests.[14]

Charitable giving

Non-grantor trusts which are not required to distribute all income to its beneficiaries (so-called "complex" trusts) may generally take larger charitable contribution deductions than individuals. Complex trusts may deduct up to 100% of its net income for charitable gifts that meet a three-part test: i) the amount must be paid for a charitable purpose; ii) the gift must have been made pursuant to the stated terms of the governing interest and iii) the gift amount must be traceable to income.[15] Further, because the requirements of IRC Sec. 170(a) are not applicable, trusts may be able to take a charitable contribution deduction for transfers to foreign charities.[16]

Charitable contributions made by a trust will not be deductible when the parameters of Sec. 642(c) are not met. By way of example, only complex trusts with specific language allowing for charitable contributions to be made from income are permitted to take a charitable contribution deduction. Trusts which are required to distribute all of its income annually, commonly referred to as simple trusts, may not take a charitable contribution deduction. Further, the charitable contribution must be made from income. The trust will not be permitted to take a charitable contribution deduction for transfers made from the trust's principal. Finally, non-grantor trusts are permitted to make a special election under certain circumstances to treat a contribution as paid in the preceding year, allowing for more flexible income tax planning.[17]

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[14] A detailed discussion of Section 199A is beyond the scope of this article. Please refer to IRC Sec. 199A and related regulations.

[15] See generally IRC §642(c)(1) and I.R.S. Pub. 526, Cat. 15050A (March 12, 2019). https://www.irs.gov/pub/irs-pdf/p526.pdf.

[16] This is not an exhaustive listing of the income tax benefits of using complex trusts to make charitable contributions.

[17] Treas. Reg. Sec. 1.642(c)-1(b).

Non-grantor trust administration

If the For the 99.5% Act becomes law, non-grantor trusts may become more important to estate planning to avoid the estate inclusion rules applying to grantor trusts. If the use of non-grantor trusts increases, it will become even more important that practitioners understand the rules governing them, particularly if the plan depends upon the trust being treated for income tax purposes as a non-grantor trust. Failure to properly administer a non-grantor trust can subvert the purposes of the planning by causing an involuntary conversion into a grantor-type trust and, if some recent proposals become law, included in the settlor's estate.

Collaboration among professionals involved in the planning is important to endeavor to safeguard non-grantor status. The attorney drafting the trust instrument as a non-grantor trust may not necessarily be consultedby the Trustee and others involved as post-signing decisions are made about the administration of the trust. The accountant, financial planner and trustee should all be made aware that ensuring that the trust remains a non-grantor trust is vital to the estate plan. Each professional should also understand how a non-grantor trust could inadvertently be recharacterized as a grantor trust if improperly administered so that they can avoid such circumstances and a toggling on of grantor trust status.

Grantor/grantor's spouse borrow from trust without adequate security

A non-grantor trust that makes a loan to the settlor or the settlor's spouse should ensure that the loan has both adequate interest and adequate security. To the extent that the trust makes a loan back to the settlor without adequate interest or security, the trust may be considered a grantor-type trust for so long as the loan remains outstanding. It is relatively easy for trustees to ensure that the loan bears an adequate interest rate, since the Applicable Federal Rates are issued monthly by the Internal Revenue Service.[18] However, ensuring that the loan is appropriately secured may be more of a challenge, particularly for settlors who have undertaken significant estate planning that has removed many of their most valuable assets from their personal estates. The practical issue is determining what suffices to constitute adequate security. This is why the safest route may be to assure that no loans are made to the settlor or settlor's spouse.

Additionally, loans to the settlor could be the type of transaction where an individual trustee may try to "go it alone" without professional advice. Many clients prefer to enlist friends to serve as trustees, even when it may be preferable to choose professional trustees who are more sophisticated and presumably have sufficient knowledge to avoid engaging in transactions that could taint the planning.,.

Professional advisors may be uniquely positioned to assist in the protection of the trust's non-grantor status. Perhaps a financial advisor managing the trust accounts can identify an issue when the trustee attempts to make a large transfer from the trust account back to the settlor. By understanding the issue, a financial advisor may be able to stop the loan and encourage the trustee to consult tax counsel concerning the risks of the transaction and possibly support the loan by ensuring the correct interest rate is charged and that the loan is properly secured.

Similarly, the CPA handling the income tax returns and financial records for the trust may have an opportunity to guide the client to consult with counsel to correct a loan transaction. Sometimes by the

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[18] Rev. Rul. 2021-9.

time the loan becomes known to the tax preparer, it could be late in the life of the transaction: the terms of the arrangement would have been decided; money would have already exchanged hands; and one or more payments on the obligation may have already occurred. Nonetheless, if the CPA identifies the issues, it may still be feasible to endeavor to correct the transaction. If the issue is identified during the same tax year, the inappropriate or uncertain transaction may be able to be rescinded and unwound.

Trustee becomes related/subordinate

A non-grantor trust can become a grantor trust if the trustee becomes someone who is related or subordinate to the settlor. Pursuant to IRC Sec. 672, when the trustee is related or subordinate to the settlor, the trust will be a grantor-type trust and the settlor will be taxed as the owner of the assets in the trust.

Non-grantor trusts have been recharacterized as grantor trusts when the settlor and the trustee get married. Note also that the members of the new spouse's family may also be considered related for these purposes. Certainly, this is a possibility that may need to be considered when a settlor chooses a close friend to serve as trustee of a non-grantor trust.

In these situations, it is advisable to engage in proactive planning and remove the trustee before the date on which such an individual would become related or subordinate. In other words, wedding plans may need to involve reviewing outstanding trust agreements and confirming that the upcoming nuptials will not throw the estate plan into chaos.

Another way for a trust to become a grantor trust under this provision is where the trustee becomes an employee of the settlor or a company in which the settlor owns a controlling interest. Before hiring someone, who is serving as trustee, the professionals should review the terms of the trust instrument and determine how best to replace a trustee in advance of such individual's hire date. While this will add a new element of complexity to the hiring process, it could be essential when maintaining non-grantor trust status is a crucial element in the estate plan.

Note that where a trustee is a professional whose services are engaged by the settlor, as in the case where a settlor names an institutional or professional trustee, this will not, in and of itself, turn the trust into a grantor trust. A professional in this case may not be considered "subordinate" to the settlor even though the professional is providing services to the settlor in exchange for a fee. Presumably, an attorney or CPA would be required to exercise independent judgment under a code of professional conduct. Additionally, the professional must not be an actual employee, as is the case with an in-house counsel or CPA serving as a controller of a closely held business controlled by the settlor. So long as the trustee-professional had her own independent practice, such an individual would not be considered to be controlled by the settlor even to the extent the settlor hired such professional for professional services. An independent professional is generally not considered to be subordinate.

Where the status of a trust as a non-grantor trust is important to the estate plan, the drafting attorney should also ensure that language in the trust instrument would prevent the appointment of a substitute or replacement trustee who is related or subordinate to the settlor.

Section 678 ownership

Assets in a trust could be included in the estate of any individual who becomes a deemed owner of a trust by operation of IRC Sec. 678. The For the 99.5% Act takes deliberate aim at sales to Beneficiary Defective Inheritor's Trust (BDITs) strategies, requiring inclusion of some portion of the asset in a trust over which a person, other than the settlor of the trust, is deemed the owner for income tax purposes, to the extent that such a person engages in a "sale, exchange or comparable transaction" with the trust.[19]

Under the regulations, any person who "directly or indirectly makes a gratuitous transfer … of property to a trust" may be considered to be a grantor of the trust.[20] Such person may be a deemed owner, subject to the grantor trust rules, as to "any portion of a trust, with respect to which such person has a power exercisable solely by himself to vest the corpus or the income therefrom in himself, or such person has previously partially released or otherwise modified such a power and after [which] retains such control as would, within the principles of [IRC] sections 671 to 677 , inclusive, subject a grantor of a trust to treatment as the owner thereof."[21] Where the original settlor is taxable as the deemed owner of the trust assets, no other person would be deemed to be the grantor under Sec. 678.

On those occasions where individuals other than the original settlor could be considered a grantor for grantor trust purposes, the Act would require inclusion of the assets in these trusts in the estate of such beneficiary-owners, even where such individual may not have ever held title to the bulk of the assets held in the trust.

Death of the QSST

The For the 99.5% Act has a stated intention of ending "a Rigged Tax Code" that, according to the Act's sponsor, Senate Budget Committee Chairman Bernie Sanders (I-VT) has resulted in "an economic absurdity of two people in this country, Jeff Bezos and Elon Musk, owning more wealth than the bottom 40%" of American people and the "rigged and corrupt tax code that gives trillions of dollars in tax breaks to the wealthy and huge corporations."[22] However, the terms of the Act may result in certain inequities against small business owners who may decide to engage in planning not to avoid or minimize taxes but rather for business succession purposes.

Specifically, small businesses which are taxed as subchapter S corporations are limited in the types of shareholders they may have.[23] Transferring shares in an S corporation to an ineligible person could jeopardize the S corporation election, subjecting the entity and its owners to a double layer of tax, retroactive to the date on which the ineligible shareholder first took ownership. There are a multitude of reasons why an owner may prefer to transfer shares of stock in a closely held S corporation to a trust rather than outright to individuals. Perhaps the owner's children are too young to handle the responsibility of running the company. Maybe the owner is concerned about how the business would fare if subject to the risks of her child's divorce or other creditors. A trust may be a valid solution, but a grantor trust would not work unless the owner has sufficient other assets to pay the income taxes flowing from the income generated by the S corporation after transferring the shares. Further, as

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[19] The Act, *supra* note 4 at Sec. 8.
[20] Treas. Reg. Sec. 1.671-2(e)(1).
[21] IRC Sec. 678(a)(1) and (2).
[22] Ending a Rigged Tax Code, 117th Cong (2021).
[23] IRC Sec. 1361(c)(2).

discussed in this article, the grantor trust structure may become a disfavored vehicle for transferring assets. In any event, a grantor trust is not available to be used when the transfer of interests occurs at the death of the S corporation owner.

Planners should be careful to understand the S corporation rules and implement strategies that will not risk the election.[24] Collaboration will be key to ensure that all elections are timely made and tax returns filed appropriately to reflect that the transfer was within the S corporation rules.

If the For the 99.5% Act were enacted as written, options for an S corporation shareholder to protect the closely held business from the creditors of her heirs would become very limited. In general, there are three specific types of trusts that are eligible to be S corporation shareholders: grantor trusts, qualified subchapter S trusts (QSSTs), and electing small business trusts (ESBTs).

QSSTs are subject to stringent requirements limiting the number of beneficiaries to one and requiring annual distributions of all S corporation income to the beneficiary.[25] Because all income is required to be distributed annually, there can be no accumulation of that income inside the trust. So, even though the trust itself will not be paying taxes, the same benefits of a regular grantor trust wherein the income may be accumulated but taxable to the deemed owner do not exist for a QSST.

The Act does not appear to account for the distinction between a QSST and a typical grantor-type trust structure. As written, the Act would require inclusion of the value of the S corporation shares owned by the QSST in the beneficiary's taxable estate, less any contribution made by the QSST beneficiary. This is because the QSST beneficiary is a deemed owner of the trust by operation of IRC Sec. 678, so a QSST would presumably be subjected to the same harsh consequences as a BDIT if the Act were to become law.

It is unusual for the QSST beneficiary to make any contribution to the QSST, particularly where the QSST was funded on death of the original owner. If such a taxing construct were allowed to be imposed, the QSST beneficiary could be charged an estate tax on the full value of the shares of stock in the S corporation owned by the QSST which could be worth substantially more than when the trust had been funded, due to the QSST beneficiary's own sweat equity and efforts in sustaining and growing the business.

As a result, it may be that ESBTs will be the only proper trust vehicle remaining to own S corporation shares. An ESBT has more flexibility than the QSST but it is subject to tax at the highest individual income tax rate.[26] ESBTs are not entitled to a deduction for distributions made to the beneficiaries and are subject to very specific rules of administration.[27]

Toggling grantor trust status on and then considering whether to turn it off again

Where a non-grantor trust inadvertently switches to a grantor trust, the trust will likely experience a realization event on the deemed transfer from one taxpayer (the non-grantor trust) to another (the

[24] A thorough discussion about transferring S corporation shares is beyond the scope of this paper. Please see IRC Sec. 1361 and related regulations.

[25] For details about settling and administering a QSST, please see IRC Sec. 1361(d), and related regulations.

[26] For details about settling and administering an ESBT, please see IRC Sec. 1361(e), and related regulations.

[27] A discussion of the rules governing ESBTs is beyond the scope of this article. Please see IRC Sec. 1361(e), and related regulations.

deemed owner of the grantor trust). To the extent that any of the deemed realization proposals are enacted as written, the conversion of a non-grantor trust into a grantor-type trust would seem to result in a capital gains tax on the amount by which the fair market value of the assets exceeds the basis.

Flipping the switch back off to turn the now-grantor trust into a non-grantor trust could be troublesome if the For the 99.5% Act is enacted as written. The switch would be a deemed transfer for gift tax purposes from the grantor-type trust to a non-grantor trust, subject to a $1 million gift tax exemption. On the other hand, leaving the assets in a grantor trust could presumably result in inclusion of some part of the assets in the trust in the settlor's estate. This could be true even to the extent that the original non-grantor trust was settled before enactment of the For the 99.5% Act. It is unclear whether the executor of the settlor's estate would have the opportunity to deduct some of the value included to account for the time during which the trust was a non-grantor trust and therefore not subject to the provisions of the new Sec. 2901, if enacted.

Obviously, the legislation has not been enacted yet and there are no regulations lending any clarity as to how any such new laws might be administered. What is apparent is that professionals will need to exercise extreme caution as they consider all possible tax implications before attempting to "fix" any trust that had been involuntarily converted from a non-grantor trust to a grantor-type trust.

Conclusion

It continues to be acomplex and potentially problematic ride for grantor trusts, with many ups and downs along the way. Planners have planned, the IRS has challenged, and courts have ruled. The only step left in this cycle is for Congress to act and change the rules, so that a new cycle of planning, challenges and rulings can begin anew. If non-grantor trusts will become the new normal, it is important for practitioners to become more nimble in identifying and helping trustees to avoid those circumstances that can turn the most carefully orchestrated plan into chaos, by inadvertently forfeiting non-grantor trust status. Working together as a collaborative team, attorneys, tax preparers, accountants, and financial advisors can help avoid pitfalls and keep the trustees educated throughout the trust administration.

Author bios:

Joy Matak, JD, LLM leads the Trust and Estate Practice at Sax, LLP. Joy has more than 20 years of diversified experience as a wealth transfer strategist with an extensive background in recommending and implementing advantageous tax strategies to accomplish estate and business succession goals. She also performs tax compliance including gift tax, estate tax, and income tax returns for trusts and estates. Joy Matak holds her Masters of Laws in Taxation from Georgetown University and is admitted to the bar in New Jersey.
Lisa Mela is a Senior Tax Manager at Sax LLP and a vital member of the firm's Trusts & Estates Practice. Lisa specializes in fiduciary compliance, estate and trust tax planning, fiduciary accountings (informal and formal), estate and gift planning, gift tax compliance, income tax planning and tax compliance for high-net-worth individuals. Lisa is a Certified Public Accountant in New Jersey. She obtained her Bachelor's Degree from Villanova University, where she graduated cum laude, and received her Masters

in Taxation from Fairleigh Dickinson University. She is a member of the Association for Corporate Growth (ACG) – NJ Chapter and a member of the Estate Planning Council of Northern New Jersey.
Martin M. Shenkman, CPA, MBA, PFS, AEP, JD is an attorney in private practice in Fort Lee, New Jersey and New York City who concentrates on estate and closely held business planning, tax planning, and estate administration. He is the author of 42 books and more than 1,200 articles. He is a member of the NAEPC Board of Directors (Emeritus), on the Board of the American Brain Foundation, the American Cancer Society's National Professional Advisor Network and Weill Cornell Medicine Professional Advisory Council.