

Probate Practice™

REPORTER

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Grantor Trusts and Income Tax Reporting Requirements: A Primer

By Jonathan G. Blattmachr and Bridget J. Crawford

A trust is a "grantor trust" for income tax purposes to the extent that under the rules articulated in subpart E (sections 671 through 679) of part 1 of subchapter J of chapter 1 of the Internal Revenue Code of 1986, as amended, the trust's income, deductions and credits against tax are attributed to its grantor or its beneficiary. A trust may be a grantor trust in its entirety or only in part, and may be a grantor trust with respect to one or more taxpayers.

Historically, the grantor trust rules were designed to inhibit taxpayers in high tax brackets from shifting income to trusts in lower tax brackets. In fact, for many decades it was regarded generally as so adverse for a trust's income, deductions, and credits to be attributed back to its grantor, that grantor trusts were and still are referred to as "defective" trusts. Yet today, because income tax brackets are compressed and estate and gift tax rates have diverged from income tax rates, taxpayers now commonly use these trusts to effect or enhance estate planning. It is common, for example, to structure as a grantor trust a lifetime trust designed to be excluded from a grantor's estate for federal estate tax purposes; thus, the income earned by the trust will be taxed to the grantor, rather than to the trust or its beneficiaries — thereby permitting the trust to grow tax free. In *Private Letter Ruling 94-44-033*, the IRS suggested that the payment of income tax by the grantor on income of a grantor trust may result in an additional gift to the trust. However, by *Private Letter Ruling 95-43-049*, the IRS reissued *Private Letter Ruling 94-44-033* to delete the discussion of that issue.

In the last decade, grantor trusts have become a cornerstone of many sophisticated estate plans, as grantor trusts play a key role in shifting assets from a senior family member, for example, to a trust for the benefit of younger family members. This is often accomplished by means of an asset sale to a trust that is a grantor trust with respect to the seller. From an income tax perspective, such a sale is treated as not having occurred. Yet from a transfer tax perspective, because the asset has been sold to a grantor trust for a note, for example, appreciation on the sold asset, beyond the interest due on the note, can be shifted to younger generations with minimal, if any, gift, estate, or generation-skipping transfer tax consequences, and with no income tax consequences. See Michael D. Mulligan, *Sale to a Defective Grantor Trust: An Alternative to a GRAT*, 23 EST. PLAN. 3 (1996).

This tax result occurs because a sale between a grantor and a trust having certain characteristics is treated for income tax purposes as a sale by the grantor to himself or herself. Under I.R.C. sections 671 through 679, retention by a trust's grantor or another person of certain powers over trust property will cause that grantor or other person to be deemed to be the owner for income tax purposes of some or all of the trust property. Frequently, sophisticated planners draft grantor trusts in such a way that transfers to the trust will be deemed to be complete for federal estate tax purposes — that is, will not be includable in the transferor's estate — but incomplete for federal income tax purposes — that is, the grantor continues to be the owner of the income, deductions, and credits of the trust. This result is typically achiev-

ed by drafting a trust instrument with one or more of the following characteristics: (1) the grantor retains the power to reacquire trust property by substituting assets of equivalent value (I.R.C. § 675(4)(C)); (2) some individual holds the power to add to the class of beneficiaries who are eligible or entitled to receive income and principal from the trust (I.R.C. § 674(a)); (3) the grantor has the power to borrow trust principal and/or income without adequate security (I.R.C. § 675(2)); (4) the grantor's spouse may be paid income from the trust (I.R.C. § 677). See also Arthur D. Sederbaum & Karen C. Hunter, *Reversal of Fortune: The Use of Grantor Trusts in Estate Planning*, THE CHASE J. (1999); Jerold Horn, *Avoiding and Attracting Grantor Trust Treatment*, 24 ACTEC NOTES 204 (1998); Burton W. Kanter & Michael J. Leganaro, *The Grantor Trust: Handmaiden to the IRS and Servant to the Taxpayer*, TAXES Dec. 1997 at 706. The most common method for causing a grantor to be taxed on the income of a trust is to provide that without the consent of an adverse party, trust income may be distributed to the grantor or the grantor's spouse. I.R.C. § 677(a).

Then, during ongoing trust administration, because of the way the trust is structured, the trust's grantor is subject to federal income tax on all of the trust's income, including capital gain. As a consequence, more wealth may accumulate inside the trust for the benefit of the trust's beneficiaries.

Although clients and their advisors employ grantor trusts with great frequency and success, few taxpayers and not all estate planning professionals are fully conversant with the income tax

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reporting requirements for grantor trusts. Some erroneously assume that because grantor trusts are "ignored" for purposes of calculating taxable income, they are also ignored for purposes of reporting taxable income. This is not always the case, however. Historically, the income, deductions, and credits of trusts were reported, if at all, on Form 1041, the United States Income Tax Return for Estates and Trusts. Because of the rise in popularity of revocable trusts, however, general income tax reporting requirements for trusts were modified to provide that, at least in the case of a revocable trust when the grantor is the trustee, no income tax return need be filed with respect to the trust. Then, at least partly in response to the rise in popularity of grantor trusts, effective January 1, 1996, the IRS issued final regulations on the income tax reporting requirements of grantor trusts. Because these regulations are mandatory — Treasury Regulation section 1.671-4(a) — taxpayers and their advisors need to ensure that they comply with these complex rules.

Generally, Treasury Regulation section 1.671-4 provides that the trustee of a trust that is a grantor trust in its entirety has two basic options for reporting a trust's income. The trustee may either file Form 1041, the U.S. Income Tax Return for Estates and Trusts, or comply with the provisions of Treasury Regulation section 1.671-4. A trustee may not utilize Treasury Regulation section 1.671-4, however, if the trust can be characterized as any one of the following: (i) a common trust fund as defined in I.R.C. section 554; (ii) a trust that has its situs or any of its assets located outside the United States; (iii) a trust that is a qualified subchapter S trust; (iv) a trust all of which is treated as owned by one grantor or one other person who is a fiscal year taxpayer; (v) a trust all of which is treated as owned by one grantor or one other person who is not a United States person (a trust is treated as "owned" by the person to whom the income, deductions, and credits against tax are imputed under the grantor trust rules — see I.R.C. §§ 671-679); or (vi) a trust all of which is treated

as owned by two or more grantors or other persons, one of whom is not a United States person — Treas. Reg. § 1.671-4(b)(7).

Determine the Number of Trust "Grantors"

Assuming that the trust does not fall into one of these ineligible categories, to ascertain the precise steps a trustee must take in order to comply with Treasury Regulation section 1.671-4, the trustee of a particular grantor trust must first determine whether the trust is treated for income tax purposes as owned by only one person or by more than one person. If the trust has just one grantor or just one other person who is treated as owner of the trust assets, the trustee must follow a particular set of rules. Treas. Reg. § 1.671-4(b)(2). If the trust is treated as owned by two or more grantors or other persons, the trustee follows a different set of rules. Treas. Reg. § 1.671-4(b)(3). See Figure B below.

Single-Grantor Trust, Option A — Furnish Grantor's TIN

In the case of a trust that is a grantor trust in its entirety with respect to one person only, a trustee has two options for complying with Treasury Regulation section 1.671-4. First, the trustee may furnish to all income payors the grantor's name and taxpayer identification number, as well as the trust's address. The payors then deliver to the trustee the Forms 1099. The trustee delivers those to the grantor, who then presumably files them with his or her income tax return.

It is important to note that in order for a trustee to be able to report to any income payor the required taxpayer identification information with respect to the trust's grantor as opposed to the trust itself, the trustee must require the grantor to provide the trustee with a complete Form W-9 or an acceptable substitute Form W-9 signed under the penalties of perjury. If that Form W-9 then indicates that the grantor or other person is subject to backup withholding, the trustee has an affirmative duty to notify all payors of reportable interest and dividend payments of their obligation to backup

withhold. Treas. Reg. § 1.671-4(e). Interestingly, however, the trustee does not have a corresponding duty to notify payors that backup withholding is *not* required, in the event that the Form W-9 does *not* indicate that the grantor or other person is subject to backup withholding.

In the case of a trust that is a grantor trust in its entirety as to one taxpayer, once the trustee has furnished to each payor the grantor's name and taxpayer identification number, along with the trust's address, whether the trustee has any further reporting obligations turns on yet another variable: whether the trust's grantor is the trustee or co-trustee of the trust. If the grantor is the trustee or co-trustee, the trustee has no further reporting requirements, once the trustee provides the income payors with the grantor's name, taxpayer identification number, and the trust's address. Treas. Reg. § 1.671-4(b)(2)(i)(A). (Presumably, this is because the IRS assumes that as a trustee, the grantor has sufficient access to information about the trust's available income, deductions, and credits, so that it would be redundant to require the grantor, as trustee, to furnish this information to himself or herself.)

If the grantor is not the trustee or co-trustee of a particular grantor trust, however, the Regulations require the trustee to take another step, after providing the payors with the taxpayer identification information with respect to the grantor described above. The trustee must furnish to the grantor a statement with the following characteristics:

- The statement shows all of the trust's items of income, deduction and tax credit for the taxable year.
- The statement identifies the payor of each item of income.
- The statement provides the grantor with the information necessary to take the items into account (for example, cost basis) when

determining the grantor's own taxable income.

- The statement informs the grantor that the grantor is treated as the owner of all of the trust's income, deductions and credits for the taxable year, and that such information must be included on the grantor's income tax return for that year. Treas. Reg. § 1.671-4(b)(2)(ii).

Upon providing this information to the grantor, the trustee has satisfied its reporting obligation and is not required to make any further filings with the IRS. Treas. Reg. § 1.671-4(b)(2)(ii)(B). See Figure A below for a sample notice.

A Single-Grantor Trust, Option B — Furnish Trust's TIN

Instead of furnishing to income payors the grantor's name and taxpayer identification number, along with the trust's address, the trustee may choose instead to furnish to all payors the trust's name, taxpayer identification number, and address. Treas. Reg. § 1.671-4(b)(i)(B). If so, each income payor will then issue a Form 1099 to the trustee, showing the trust as payor of the particular item of income. Treas. Reg. § 1.671-4(b)(2)(iv) Example 2 (ii)(A). The trustee must then file with the IRS the appropriate Forms 1099, reporting the income and gross proceeds received during the taxable year, showing the trust as the payor and the grantor as both the owner of the trust and as payee.

Generally, the trustee has the same obligations for filing Forms 1099 with the IRS as any payor would have, except that the trustee must report income aggregated by type, and must report each item of gross proceeds separately. Treas. Reg. § 1.671-4(b)(2)(iii). It is important to note, however, that the amounts that must be included on the Forms 1099 filed by the trustee do not include any information that the original payor would not have

reported on a Form 1099. Treas. Reg. § 1.671-4(b)(5)(i). Thus, in the case of a grantor trust that holds partnership units, for example, because the partnership itself does not report its income to its partners on Forms 1099 (it reports income to its partners on Forms K-1), the grantor's share of partnership income and gain is not included on any Forms 1099 filed by the trustee. See Treas. Reg. § 1.671-4(b)(5)(ii) Example (ii)(A). Note that in choosing to furnish each payor with the name and taxpayer identification number of the trust, instead of those of the grantor, the trustee has added another layer to the trustee's administrative responsibilities. The trustee must shift through each item of income and deduction in order to categorize and report it correctly to the grantor. Furthermore, the trustee must understand whether, in the hands of the original payor, the income would have been reportable by the original payor on Form 1099 or not. That may require a commitment of time and expertise that many trustees, including institutional trustees with hundreds of trusts under administration, may not want to make.

Assuming that the trustee has furnished the payors with the trust's name and taxpayer identification number, once the relevant Forms 1099 have been filed by the trustee with the IRS, whether the trustee has any further reporting obligation again turns on whether the grantor is the trustee or co-trustee of the trust. If the grantor is a trustee, the trustee has satisfied its responsibilities under Treasury Regulation section 1.671-4. If the grantor is not a trustee, however, the trustee again must provide the grantor with a statement that shows the trust's income, deductions, and tax credits; identifies the payor of each item of income; provides the grantor with information needed to compute the grantor's own taxable income; and informs the grantor that he or she is treated as the owner of all the trust's income, deductions, and credits, and that such information must be included in the grantor's income tax return for that year. Treas. Reg. § 1.671-4(b)(3)(ii). See Figure A below.

Multiple Grantors — Furnish Trust's TIN

In the case of a trust that is treated as owned in its entirety by two or more grantors or other persons, the trustee does not have the option to report to all income payors the grantor's name and taxpayer identification number. Instead, the trustee is limited to furnishing to the payors the trust's name, taxpayer identification number, and address. Treas. Reg. § 1.671-4(b)(3). Presumably, that is because in the case of a trust for which the income, deductions, and tax credits are attributable to more than one person, the IRS has decided that the trustee, not the initial payor, should be responsible for the allocation of income, for example, between or among trust grantors.

Treasury Regulation section 1.671-4 provides that, after furnishing to each payor the trust's name, taxpayer identification number, and address, each payor will then issue a Form 1099 to the trustee, showing the trustee as payor. Treas. Reg. § 1.671-4(b)(3)(ii). The trustee then files with the IRS the appropriate Forms 1099, reporting the income paid to the trustee as payor, and each grantor as payee, in proportion to the grantor's deemed ownership of the trust assets. Here again the trustee has the same obligations for filing Forms 1099 with the IRS as any payor would have, except that the trustee must report income aggregated by type and each item of gross proceeds separately.

Once Forms 1099 have been filed with the IRS, in the case of a trust with multiple owners for income tax purposes, there is no question that the trustee has further reporting obligations. Unlike the case of a single-grantor trust, when a trustee is not required to furnish further information to the grantor, if the grantor is also a trustee of the trust, the trustee or trustees of a trust that is treated as owned in its entirety by two or more grantors or other persons must always furnish statements to each grantor of the trust. Treas. Reg. § 1.671-

4(b)(3)(ii)(B)(1). As in the case of the statements furnished to a single-grantor trust's owner, each owner of a multiple-grantor trust must receive a statement of the items of income, deductions, and credits attributable to the portion of the trust owned by the grantor, the information necessary to compute the grantor's taxable income, and a statement that the grantor must take into account the items of income, deduction, and credit shown on the statement.

The Preferred Method of Compliance

The provisions of Treasury Regulation section 1.671-4 are in many ways unnecessarily complex and create layers of administrative duties that many taxpayers and trustees will find burdensome. Therefore, in structuring grantor trusts, taxpayers and their advisors should consider the steps that can be taken to minimize difficulties with compliance. First, unless there are compelling reasons suggesting otherwise, a grantor trust should be structured so that there is only one person who is deemed to own, for income tax purposes, any portion or all of the trust property. Second, the grantor should be made a co-trustee of the trust. In naming the grantor co-trustee, it should be possible to limit the grantor's role significantly, for example, limiting the grantor to circumscribed powers only, so as to avoid estate tax inclusion — see, for example, I.R.C. section 2038 — or any possible attachment of the grantor's interest by a creditor of the grantor. See Jonathan G. Blattmachr & Bridget J. Crawford, *Wilderness No More: Alaska as the New "Offshore" Trust Jurisdiction*, J. OF SOC'Y ADVANCED LEGAL STUD., Nov. 1999. It is important to note that the Regulations do not specify the extent to which the grantor must have fiduciary authority under the trust instrument, in order to escape the requirement that a report be furnished to the grantor. Accordingly, it might be enough, for example, that as co-administrative trustee, the grantor has the power to choose a tax preparer for the trust, even if the grantor has no other powers.

Third, the trustee should furnish to each payor the grantor's name, taxpayer identification number, and the trust's address. If these three steps are taken, compliance with Treasury Regulation section 1.671-4 is the least burdensome possible. No further filings with the IRS need be made by the trustee, and no statement need be furnished by the trustee to the grantor. Thus, the relationship between the grantor and the grantor trust from an administrative perspective matches its substantive treatment: the trust is "ignored" for purposes of both calculating and reporting taxable income.

Switching Methods of Income Tax Reporting

For taxable years beginning on or after January 1, 1996, trustees of grantor trusts that are treated as wholly owned by one or more persons may choose to report trust income, deductions, and credit on Form 1041 or to meet the requirements of Treasury Regulation section 1.671-4. As discussed above, the reporting methods described in Treasury Regulation section 1.671-4 are not available in the case of (i) a common trust fund as defined in I.R.C. section 554; (ii) a trust that has its situs or any of its assets located outside the United States; (iii) a trust that is a qualified subchapter S trust; (iv) a trust all of which is treated as owned by one grantor or one other person who is a fiscal year taxpayer; (v) a trust all of which is treated as owned by one grantor or one other person who is not a United States person; or (vi) a trust all of which is treated as owned by two or more grantors or other persons, one of whom is not a United States person. Treas. Reg. § 1.671-4(b)(7). In most cases, compliance with Treasury Regulation section 1.671-4 will be simpler from an administrative perspective and is likely to be the preferred method of reporting trust income. Nevertheless, it is possible to switch between and among methods.

Changing From Filing Form 1041 to Complying With Treas. Reg. § 1.671-4. Many trustees who in prior years filed a Form 1041 may wish to change

their reporting methods to the methods described in Treasury Regulation section 1.671-4(b). In such a case, the Regulations explicitly detail the steps that the trustee must take. The trustee must file a final Form 1041 for the taxable year immediately prior to the year in which the trustee wishes to begin reporting under Treasury Regulation section 1.671-4(b). Treas. Reg. § 1.671-4(g)(1). On the front of that Form 1041, the trustee must write: "Pursuant to section 1.671-4(g), this is the final Form 1041 for this grantor trust."

Changing From Complying With Treas. Reg. § 1.671-4 to Filing Form 1041. If, in contrast, a trustee has in the past reported trust income pursuant to Treasury Regulation section 1.671-4(b) specifically by furnishing the grantor's name and taxpayer identification number to all payors, and the trustee wishes to report in future years by means of Form 1041, the trustee must furnish to the income payors the trust's name, taxpayer identification number and address. Treas. Reg. § 1.671-4(g)(2). Similarly, if the trustee was reporting pursuant to Treasury Regulation section 1.671-4(b)(2)(i)(B), or (b)(3)(i) (and therefore furnished to the payors the trust's name, taxpayer identification number, and address and filed Forms 1099 with the IRS), but the trustee wishes to switch to reporting on Form 1041, in the last taxable year of its compliance with Treasury Regulation section 1.671-4(b), the trustee must file with the IRS Form 1096, Annual Summary and Transmittal of U.S. Information Returns, on which it indicates that it is making its final return by such method. Form 1096 is used to transmit paper Forms 1099 to the IRS. This form must be filed by income payers, among others. Other persons required to file this form include a recipient of mortgage interest payments or student loan interest, an educational institution, a broker, a person reporting real estate transactions, and a lender who acquires an interest in secured property or who has reason to know that such property has been abandoned.

Changing Methods of Complying With Treas. Reg. § 1.671-4. In addition to having the flexibility to report trust income either on Form 1041 or under Treasury Regulation section 1.671-4(b), if a trustee chooses to report trust income in one manner described in the Treasury Regulation section 1.671-4(b), a trustee may switch to reporting in another manner described therein. In other words, the trustee may report first under Treasury Regulation section 1.671-4(b)(2)(i)(A) (furnish the grantor's name and taxpayer identification number to all payors), and then switch to reporting under Treasury Regulation section 1.671-4(b)(2)(i)(B) or (b)(3)(i) (furnish to income payors the trust's name, taxpayer identification number, and address). This is accomplished simply by furnishing to the income payor the trust's name, taxpayer identification number, and address in the taxable year for the taxable year in which the trustee wishes to begin complying by this method, and in all subsequent years. Treas. Reg. § 1.671-4(g)(3)(i); see Treas. Reg. § 1.671-4(g)(4) Example (i).

The opposite is true as well. For example, if the trustee wishes to switch from furnishing the trust's name and taxpayer identification to furnishing to the payors the grantor's name and taxpayer identification number, the trustee does so by furnishing the grantor's name for the taxable year in which the trustee wishes to begin complying by this method, and all subsequent years. Treas. Reg. § 1.671-4(g)(3)(ii). In this particular scenario, however, on the Form 1096, Annual Summary and Transmittal of U.S. Information Returns, which the trustee files for the final taxable year in which it will be furnishing the trust's name and taxpayer identification number, the trustee further must indicate that such Form 1096 is being filed for the final taxable year in which the trustee is reporting pursuant to Treasury Regulation section 1.671-4(b)(2)(i)(B).

Although the Regulations refer to the filing of "final" Forms 1041 and "final" Forms 1099 with

respect to a trust, they do not contemplate explicitly that an election to report income either by means of Form 1041 or pursuant to Treasury Regulation section 1.671-4(b) is irrevocable. Indeed, by implication, a trustee may comply by a different method from year to year. Therefore, within the realm of compliance with Treasury Regulation section 1.671-4(b), it appears that a trustee could report pursuant to Treasury Regulation section 1.671-4(b)(2)(i)(A) in one taxable year, and pursuant to Treasury Regulation section 1.671-4(b)(2)(i)(B) the next year. Accordingly, if otherwise permitted, most trustees likely will elect to

report under Treasury Regulation section 1.671-4(b)(2)(i)(A) (furnishing the grantor's name and taxpayer identification number). That way, the trustee's income tax reporting requirements will be least burdensome, and yet the Regulations permit the trustee maximum flexibility to change reporting methods, if the need arises.

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FIGURE A

FORM OF STATEMENT TO BE FURNISHED BY TRUSTEE TO GRANTOR UNDER TREAS. REG. § 1.671-4(B)

[INSERT NAME OF GRANTOR]
[INSERT ADDRESS OF GRANTOR]

RE: [INSERT NAME OR OTHER IDENTIFICATION OF TRUST], TAX INFORMATION FOR CALENDAR YEAR [INSERT YEAR NO.]

Dear [INSERT APPROPRIATE SALUTATION OR "TAXPAYER"]:

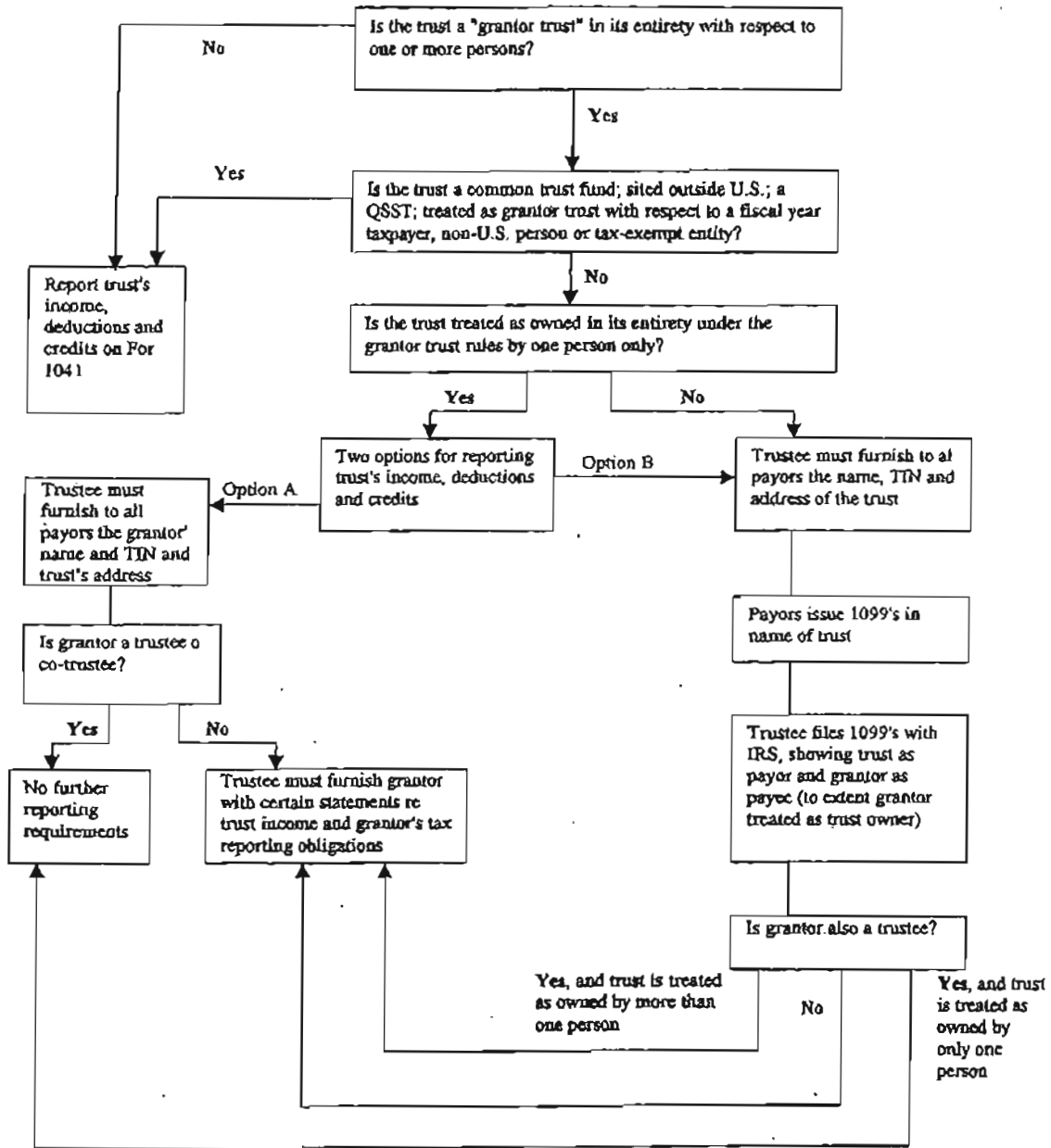
You are treated under the grantor trust rules of the Internal Revenue Code as the owner of [INSERT "PART OF," IF APPROPRIATE] the above-referenced trust. As a result, [INSERT "ALL" OR PROVIDE SPECIFIC PERCENTAGE OF] the trust's income, deductions, and tax credits, as shown on the attached statement, are attributed to you, and you must include those items in computing your taxable income and credits on your income tax return for the calendar year [INSERT YEAR NUMBER].

The attached statement contains a list of all items of income, deduction, and tax credit of the trust for the calendar year [INSERT YEAR NUMBER]. The attachment includes the information (such as basis) which you will need in order to take the items into account in computing your taxable income.

Sincerely yours,

[INSERT NAME OF TRUSTEE],
as Trustee of the [INSERT NAME OR OTHER IDENTIFICATION OF TRUST]

FIGURE B
COMPLIANCE WITH TREASURY REGULATION §1.671-4(b)



* Note that a trustee may choose to report the trust's income, deductions and credits on Form 1041, regardless of whether the trust is a "grantor trust" in its entirety with respect to one or more persons, and this option should be considered at each stage in the analysis.

