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TAX & TRANSACTIONS BULLETIN

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- On April 17, 2008, IRS issued favorable Revenue Ruling 2008-22 on "Grantor Trusts."
- The new Ruling holds that an individual may establish a Grantor Trust without causing any Trust assets to be included in the individual's gross estate at death.
- Thus, an individual may create a Grantor Trust for income tax purposes, and avoid estate tax on Trust assets.
- On July 1, 2004, IRS also issued favorable Revenue Ruling 2004-64 on "Grantor Trusts".
- These Rulings allow Families to reduce their overall Tax Liability.
- Mom or Dad can fund the "Grantor Trust" and pay its income taxes.
- The assets of a "Grantor Trust" then compound tax-free for the Children's benefit.
- Careful planning may reduce the Family's effective income tax rate.

Inside this Volume:

- The Supreme Court's ruling in *Knight v. Commissioner* resolved a split among the federal circuit courts.

IRS ESTATE TAX RULING ON "GRANTOR TRUSTS" IS A VICTORY FOR TAXPAYERS

Families often create Trusts to hold their assets. Certain types of Trusts help achieve Family Goals. For instance, a Trust may keep assets within the Family, protects assets from creditors, and reduce income or estate tax. One highly popular type of Trust, which can provide significant benefits to Families, is known as the "Grantor Trust". A Grantor Trust is any trust whose income is taxed directly to the person funding the trust.[1]

On April 17, 2008, IRS issued favorable Revenue Ruling 2008-22 on "Grantor Trusts." The new Ruling holds that an individual may establish a Grantor Trust without causing any Trust assets to be included in the individual's gross estate at death.[2] Thus, an individual may create a Grantor Trust for income tax purposes, and avoid estate tax on Trust assets.

Revenue Ruling 2008-22 provides greater certainty for Families setting up Trusts. Prior to the Ruling, practitioners were uncertain as to the estate tax status of a Grantor Trust. Revenue Ruling 2008-22 confirms that an individual may create a Grantor Trust for income tax purposes, and avoid estate tax on Trust assets.

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[1]With a non-Grantor trust, the income is taxed to the trust itself, and the trustee pays the tax.

[2]Revenue Ruling 2008-22, 2008-16 IRB 796 (04/17/2008). More precisely, the Ruling holds that 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 Code Sections 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. Since the grantor's retained power is exercisable in a nonfiduciary capacity, it triggers "Grantor Trust" status under Code Section 675(4)(C). Thus, an individual may create a Grantor Trust for income tax purposes, and avoid estate tax on the Trust assets. [Note: Revenue Ruling 2008-22 resolves a grey area under prior law, which ruled favorably but only where the power was exercisable in a fiduciary capacity. (See *Jordahl's Est. v. CIR, 65 TC 92, 96–98 (1975) (acq.)*)].

To comply with Revenue Ruling 2008-22, the Trust Agreement should contain the following written provisions:

1. The grantor has the power, exercisable at any time, to acquire any property held in Trust by substituting other property of equivalent value. The power is exercisable by grantor in a nonfiduciary capacity, without the approval or consent of any person acting in a fiduciary capacity;

2. The grantor is prohibited from serving as trustee;

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

4. The trustee also must certify in writing that the substituted property and the trust property for which it is substituted are of equivalent value; and

5. The substitution power cannot be exercised in a manner that can shift benefits among the trust beneficiaries due to the fact that the trustee has both (i) the power (under local law or the trust instrument) to reinvest the trust corpus and (ii) a duty of impartiality with respect to the trust beneficiaries.[3]

Revenue Ruling 2008-22 permits a Family to reduce its taxes. To fully appreciate a Family's opportunity to reduce tax, Revenue Ruling 2008-22 should be read in conjunction with Revenue Ruling 2004-64.[4]

In Revenue Ruling 2004-64, Dad establishes an Irrevocable[5] Grantor Trust for his Children. At year-end Dad includes Trust income in his personal income. Dad then pays the tax on Trust income. Since Dad personally paid the tax, Trust has more money available for Children. The Trust cannot reimburse Dad for his payment.

Based on these facts, IRS held that: (1) Dad's payment is not a taxable gift to the Children, and (2) Trust is generally not included in Dad's Estate for estate tax purposes. Revenue Ruling 2004-64 allows Families to reduce their overall tax liability. By setting up an Irrevocable Grantor Trust, Dad ensures certain assets are not subject to his estate tax. And by paying Trust income taxes each year, Dad reduces his Estate and provides more money for his children gift tax-free. Since Dad pays Trust income taxes each year, Trust principal compounds tax-free. The Children ultimately benefit.

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[3]There is an alternative test which can satisfy Requirement #5.

[4]Revenue Ruling 2004-64 was issued on July 1, 2004.

[5]Although many individuals establish Revocable Trusts for estate planning purposes, Irrevocable Trusts are an additional tool which can reduce Income and Estate Taxes.

Grantor Trusts are flexible. For instance, Dad can decide at the outset whether he wants to pay Trust income taxes each year.[6] Also, Dad can likely establish a Grantor Trust initially, and later decide he no longer wants to pay Trust income taxes. Dad may then "renounce" Grantor Trust status, and for all subsequent years the Trust will pay its own taxes.[7] This safety feature protects Dad from unexpectedly large tax bills in the future.

<u>The following Example illustrates the benefits of Revenue Ruling 2008-22 and Revenue Ruling 2004-64</u>:

Dad establishes a Grantor Trust for his Children and Grandchildren. Dad initially funds the Trust with $1,000,000. At the end of Year 1, Trust has $60,000 of taxable income. Dad personally pays the $24,000 income tax liability. There are at least four (4) major tax advantages to Dad's strategy. <u>First</u>, Dad's payment reduces his estate, saving Dad an extra $12,000 in estate tax.[8] <u>Second</u>, Trust saves $24,000 of income tax, and Trust principal compounds Tax-Free. As this program continues, the annual compounding may create substantial wealth for the Family. <u>Third</u>, Trust principal remains outside Dad's estate tax. <u>Fourth</u>, in the event Dad later decides he no longer wants to pay Trust income taxes, Dad can "renounce" Grantor Trust status and "switch" tax liability to the Trust.

Revenue Ruling 2008-22 and Revenue Ruling 2004-64 are a victory for taxpayers. By providing certainty in this area, IRS allows Families to implement tax planning which benefits their Children and Grandchildren. Grantor Trusts will remain an important part of Income and Estate Tax Planning.

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[6] In the event Dad does not want to pay Trust income taxes, he can establish a non-Grantor Trust.

[7] Although practitioners generally agree on the ability to "renounce," no official Ruling endorses this strategy.

[8] Assumes (i) 6% rate of return, (ii) 40% combined federal & state income tax rate, and (iii) 50% combined federal & state estate tax rate. Note that Dad's $12,000 estate tax savings effectively <u>reduces</u> the income tax rate on Trust income by 50%.

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U.S. SUPREME COURT RULES THAT COSTS PAID TO AN INVESTMENT ADVISOR BY A NONGRANTOR TRUST OR ESTATE GENERALLY ARE SUBJECT TO THE 2-PERCENT FLOOR (*KNIGHT V. COMMISSIONER)*

On January 16, 2008, the U.S. Supreme Court ruled in *Knight v. Commissioner* that costs paid to an investment advisor by a Nongrantor Trust or Estate generally are subject to the 2-percent floor for miscellaneous itemized deductions.[9] The Supreme Court's ruling resolved a split among the federal circuit courts. The Court's analysis focused on two (2) categories of costs: fully-deductible costs, and costs subject to the 2 percent floor.

As explained in *Knight*, Nongrantor Trusts and Estates generally may deduct the following two (2) categories of costs:

I. **Costs which are fully deductible:** Costs which (1) are paid or incurred in connection with the administration of the estate of trust and (2) would be uncommon or unusual or unlikely for an individual to incur.[10]

II. **Costs which are deductible subject to the 2 percent floor:** Costs which are miscellaneous itemized deductions allowable only to the extent that the aggregate of such deductions exceeds 2 percent of adjusted gross income.[11]

Category I costs provide a greater tax benefit because they are fully deductible. Category II costs provide a lesser tax benefit because they are only deductible to the extent the aggregate of such costs exceeds 2 percent of adjusted gross income.

In *Knight* the U.S. Supreme Court ruled that costs paid to an investment advisor by a Nongrantor Trust or Estate generally are Category II costs. The costs in *Knight* failed to qualify for favorable Category I treatment because individuals commonly pay fees for investment advice.

The Supreme Court conceded, however, that some Trust-related investment advisory fees may be fully-deductible Category I costs "if an investment advisor were to impose a special, additional charge applicable only to its fiduciary accounts."[12]

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[9] *Michael J. Knight, Trustee of William L. Rudkin Testamentary Trust v. Commissioner*, 128 S. Ct. 782 [101 AFTR 2d 2008-544] (January 16, 2008). See Internal Revenue Code Sections 67(a) and 67(e).

[10] Code Section 67(e), as modified by the decision in *Knight*, supra.

[11] Code Section 67(a).

[12] *Knight, supra,* quoting Brief for Respondent 25.

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The IRS expects to issue Final Regulations consistent with the Supreme Court's holding in *Knight*.[13] The IRS has also provided interim guidance on the treatment of a Bundled Fiduciary Fee. Pursuant to Notice 2008-32, taxpayers will not be required to determine the portion of a Bundled Fiduciary Fee that is subject to the 2-percent floor under Code Section 67 for any taxable year beginning before January 1, 2008. Instead, for each such taxable year, taxpayers may deduct the full amount of the Bundled Fiduciary Fee without regard to the 2-percent floor. Payments by the fiduciary to third parties for expenses subject to the 2-percent floor are readily identifiable and must be treated separately from the otherwise Bundled Fiduciary Fee.[14]

[13] The Final Regulations will be issued under 1.67-4. The Final Regulations also will address the issue raised when a nongrantor trust or estate pays a Bundled Fiduciary Fee for costs incurred in-house by the fiduciary, some of which are subject to the 2-percent floor and some of which are fully deductible without regard to the 2-percent floor. The Final Regulations, however, will not be issued prior to the due date for filing 2007 income tax returns (determined without regard to extensions), and will apply only prospectively. Accordingly, in light of the Supreme Court's decision in *Knight*, the IRS is providing interim guidance that specifically addresses the treatment of a Bundled Fiduciary Fee. IRS Notice 2008-32.

[14] The IRS anticipates that Final Regulations under 1.67-4 may contain one or more safe harbors for the allocation of fees and expenses between those costs that are subject to the 2-percent floor and those that are not. Any safe harbors in the Final Regulations for determining the allocation of a bundled fiduciary fee between costs subject to the 2-percent floor and those not subject to the 2-percent floor may be available for taxpayers to use for taxable years beginning on or after January 1, 2008. IRS Notice 2008-32.

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