



WHAT IS A GRANTOR TRUST AND HOW ARE GRANTOR TRUSTS USED IN ESTATE PLANNING?

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Estate planners and accountants often use the phrase “Grantor Trust.” The term Grantor Trust is a term of art used to describe the tax treatment of certain trusts under the income tax code. A Grantor Trust is essentially a trust arrangement where all of the income tax consequences (the items of income and deduction) are ultimately reported on the personal income tax return of the person who is deemed the “owner” of the trust under the Grantor Trust rules of the Internal Revenue Code. Most commonly, the person who created or funded the trust is the “Grantor” and treated as the “owner.”

Originally the Grantor Trust rules were enacted as a means of preventing tax avoidance. Absent these rules, individuals with significant income could establish multiple trusts, each being taxed as a separate entity at the lowest tax rates rather than all of the income being aggregated on the individual’s tax return at higher tax rates. Under the Grantor trust rules, the Grantor remains liable for the income taxes of these trusts even though the grantor no longer owns the assets that are generating the taxable income.

While the Grantor Trust rules partially solved the income tax avoidance problem, they also opened the door to using Grantor Trusts to an estate and gift tax advantage. By relying on these rules, individuals can gift assets to trusts for their family and other beneficiaries, removing the assets from the Grantor’s taxable estate, but leaving the income tax liability with the donor/grantor rather than the trust. Under current law, the payment of the trust’s tax liability is not considered an additional gift to the trust because the Grantor is legally obligated to pay the income tax liability of the trust. This allows the trust to grow undiminished by the income tax drag while further reducing the size of the donor’s taxable estate. Of course, the Grantor must be willing and able to absorb the trust’s income tax liability.

Estate planning attorneys create Grantor Trusts by including certain powers in the trust instruments. These powers include, among others, the ability of the grantor to reacquire and substitute assets of equal value in and out of the trust or the ability of an independent party to expand the class of beneficiaries, perhaps allowing charities or more remote family members to be added. The existence of these powers are what make the trust a Grantor Trust. The powers do not actually have to be exercised.

There are many uses for Grantor Trusts and many trusts that qualify as Grantor Trusts are designed to do so for reasons unrelated to income tax shifting and gifting. However, if gifting assets to a trust and continuing to be liable for the income taxes on trust property to maximize trust growth and reduce your taxable estate is an appealing idea, a Grantor Trust may be right for you.