LEADING PRACTITIONER COMMENTARY

Letter Ruling 201039010 — The Latest Beneficiary Grantor Trust Ruling

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A beneficiary grantor trust — an irrevocable trust treated as owned by the beneficiary for income tax purposes but not for estate tax purposes — can be a very useful tool. For example, your client owns a business that is expanding. Her mother creates a beneficiary grantor trust, making a $5,000 gift. The trust forms a limited liability company (LLC). The LLC makes a deal with the business — the LLC builds the building, and the business will rent the building from the LLC. The LLC takes the lease to a lender and obtains financing for the purchase of land and construction of the building.

Over time, the LLC uses the rental income to pay down the mortgage, acquiring equity in the building. When the mortgage is retired, the trust continues receiving rental income and gaining equity. The annual income taxes the beneficiary pays reduces the beneficiary's estate. Eventually the beneficiary might get to the point where her other assets are depleted, so that her estate is reduced to the estate tax applicable exclusion amount. She can then live off the trust comfortably, without having a conflict between having plenty of retirement income and avoiding estate tax, because her primary source of income — the trust — is outside of the estate tax system.

The above is just one application of this technique. Regardless of the technique, the structure generally follows a pattern. The beneficiary needs to be granted a withdrawal right, which makes the beneficiary the initial owner for income tax purposes. The withdrawal right lapses, but the lapse must be the lesser of $5,000 or 5% of the trust, and the typical arrangement uses a gift of no more than $5,000 to establish the trust. [1] After the lapse, the beneficiary must have benefits or direct or indirect control of the trust, using a power that would make the beneficiary the deemed owner if the beneficiary had been the grantor, which power cannot be one that makes the settlor the deemed owner.

The latest ruling on beneficiary grantor trusts is Letter Ruling 201039010. The beneficiary had the power to withdraw each gift, but the amount that can be withdrawn by the primary beneficiary in any one calendar year was limited to the maximum amount as to which the power of withdrawal can lapse without the lapse constituting the release of a general power of appointment under Code §§2041(b)(2) and 2514(e). [2] The independent trustee had absolute discretion to distribute part or all of the net income as the trustee deems appropriate to any one or more of the beneficiaries, in amounts and proportions as the trustee determines. The IRS ruled that the trust will be taxable to the beneficiary and will qualify to hold stock in an S corporation if all gifts will be subject to the initial withdrawal power.

Letter Ruling 201039010 did not address whether the trust's assets would be included in the beneficiary's estate. What if there is a pattern of the independent trustee making distributions each year, once the beneficiary can no longer afford to pay the trust's taxes? For some indirect guidance, consider Rev. Rul. 2004-64. The ruling held that, if the trustee has discretion to reimburse the grantor of a grantor trust for the grantor's income tax liability with respect to trust income, the existence of that discretion, by itself (whether or not exercised), will not cause the value of the trust's assets to be includible in the grantor's gross estate. However, Situation 3 of the revenue ruling included some important caveats. The revenue ruling assumed no understanding, express or implied, between the grantor and the trustee regarding the trustee's exercise of discretion. It also said that inclusion might apply if the discretion to make distributions is combined with other facts, including without limitation an understanding or pre-existing arrangement between the grantor and the trustee regarding the trustee's exercise of this discretion, a power retained by the grantor to remove the trustee and name the grantor as successor trustee, or applicable local law subjecting the trust assets to the claims of the grantor's creditors. Thus, a pattern of distributions might show such an understanding or pre-existing arrangement.

How safe is the Letter Ruling 201039010 fact pattern for income tax purposes? That fact pattern, as well as any other beneficiary grantor trust not structured as Letter Ruling 200949012, [3] does not literally follow the language of §678(a)(2). Letter Ruling 201039010 is consistent with the IRS’s prior letter rulings governing beneficiary grantor trusts, so the IRS’s position is unlikely to change. However, if the IRS were to change its position, it could assert that the beneficiary is not the deemed owner after the withdrawal right lapses and therefore the trust is no longer qualified to hold stock in the S corporation. If the trust holds stock in an S corporation, as in Letter Ruling 201039010, the trustee should consider electing to treat the trust as an electing small business trust (ESBT). [4] ESBT income taxation is unfavorable, [5] but the grantor trust rules trump ESBT taxation during the beneficiary's life. [6] When the beneficiary dies, ordinarily the trust would be subject to regular income taxation for the first two years after the death of the beneficiary (as the deemed owner for income tax purposes); [7] however, if the ESBT election is already in place, ESBT income taxation would kick in upon the beneficiary's death.

Letter Ruling 201039010 might also have been the precursor to a sale from the beneficiary to the trust. Such a sale would not be subject to income tax, since the seller would be the deemed owner of the trust for income tax purposes. [8] Again, however, if the client does not obtain a private letter ruling, the client is risking that the IRS might change its §678(a)(2) position and tax the sale. Therefore, in planning such a transaction, one should advise the client of the costs and benefits of obtaining a private letter ruling and let the client decide.

Footnotes

[1] Generally, the beneficiary should have no withdrawal rights in any other trust that lapse in the same year as the year of the lapse.

[2] “Code” refers to the Internal Revenue Code of 1986, as amended.

[3] The structure provided in Letter Ruling 200949012 is very sound from a §678 perspective, but note that the ruling did not say that the assets would not be included in the beneficiary's estate for estate tax purposes. I have significant estate tax concerns with the structure of Letter Ruling 200949012, but a full discussion of why a favorable estate tax ruling was not obtained is beyond the scope of this article.

[4] §§1361(c)(2)(A)(v), 1361(e).

[5] §641(c).

[6] Regs. §1.641(c)-1(c).

[7] §1361(c)(2)(A)(ii).

[8] Rev. Rul. 85-13, 1985-1 C.B. 184.