Conversion From Non-Grantor to Grantor Trust: Tax Issues

The conversion of irrevocable non-grantor trusts into grantor trusts can facilitate estate planning without triggering adverse tax consequences.

DAVID L. CASE

The use of "grantor trusts" in estate planning has been on a steady climb for the last three decades, as numerous tax planning benefits can be achieved by this arrangement. The term "grantor trust" is commonly used to refer to a trust for which the settlor or trustor[1] is treated as the owner of trust assets for income tax purposes under one or more of the provisions of IRC Sections 671 to 678.[2] Of course, a typical revocable living trust is a grantor trust, due to the trustor being the lifetime beneficiary and the trustor's ability to amend or revoke the trust. Planning in this area deals with irrevocable trusts, and there are numerous ways to "fail" (often intentionally) the grantor trust rules so that an irrevocable trust is a grantor trust. While it may seem inconsistent to someone who is not a tax attorney or CPA, most often this planning is designed so that although the trustor is the owner of trust assets for income tax purposes, the transfer of the assets is complete for property law purposes and for gift, estate, and generation-skipping transfer (GST) tax purposes.

Significant tax savings can be achieved where the trustor or settlor of an irrevocable trust is likely to have a taxable estate for estate tax purposes and is amenable to grantor trust planning. The trustor will be liable for all the income tax on the trust's income, which in turn can result in further "transfer" of economic benefit to the trust beneficiaries without wealth transfer tax consequences. Sales and exchanges between a grantor trust and the trustor establishing it are not recognized for income tax purposes, which can provide many tax planning opportunities. If the Section 675(4)(C) substitution-of-assets power is included in the trust provisions to intentionally make an irrevocable trust a grantor trust for income tax purposes, which currently is very popular, this power in and of itself can provide tax planning and general estate planning flexibility and opportunity.[3] One example of the planning opportunities is the ability to exchange high-income-tax-basis assets of the trustor for low-income-tax-basis assets in the trust before death to allow more Section 1014 "step up" at death.

Structuring an irrevocable trust as a grantor trust at the time it is established requires skills and knowledge to ensure that the proper results and tax effects occur. The focus of this article is on the ability to convert an existing non-grantor, complex trust to a grantor trust for income tax purposes, for which additional issues must be analyzed. The good news is that the authority examined appears to strongly support the conclusion that later conversion of a funded irrevocable trust to a grantor trust should not

DAVID L. CASE is a tax and estate planning attorney at Tiffany & Bosco, P.A., in Phoenix, Arizona.

cause adverse income, gift, estate, or GST tax results.

Because of the complexity of this planning and the various tax rules that come into play, clients often cannot immediately absorb all the nuances without substantial tax planning background, although many clients have heard of the benefits of grantor trusts. Most all practitioners familiar with this area do believe that if the Section 675(4)(C) substitution-of-assets power is used to create grantor trust status, whether at the time of creation of the trust or upon its later conversion to a grantor trust, that the trust agreement can include a right to terminate the power of substitution and thereby end grantor trust status without creating an additional tax issue. If there is uncertainty in the benefits of or desire to continue grantor trust status, having this termination right and the flexibility it brings seems to make the client's decision to use grantor trust planning easier.

Background and history

Perhaps the beginning of the heightened interest in this planning was Rev. Rul. 85-13.[4] In that Revenue Ruling, as analyzed in more detail below, the taxpayer trustor's receipt of the entire corpus of the trust in exchange for his unsecured promissory note was held to be an indirect borrowing of the trust corpus, which in turn caused the taxpayer to be treated as the owner of the trust's assets for income tax purposes under Section 675(3). As a result, the IRS ruled that, because the trustor was considered the owner of the trust assets, the transfer of them to him was not a sale or exchange that would be recognized for federal income tax purposes. Since that time, use of the planning technique of sales of assets to "intentionally defective" grantor trusts, and other related planning techniques, has become more and more common.

Of course, Section 675(3) is only one of many options under the grantor trust rules of Sections 671 to 678 to create "intentionally defective" grantor trusts, and to fail on purpose a requirement for the trust to be taxed on its own income from its assets. As additional helpful authority has developed over the years on corollary issues, the increased use of this planning has accelerated. This is especially true after the IRS issued the very important Rev. Rul. 2004-64[5] (holding that payment of the income tax by the trustor is not a taxable gift to the trust beneficiaries) and Rev. Rul. 2008-22[6] (holding that the Section 675(4)(C) substitution-of-assets power does not cause estate tax inclusion), which are explained in more detail below. This has allowed tax planners to become more comfortable that this planning can be accomplished with minimal risk, as clients most often require.

In addition to the continuing development and evolution of the tax law in this area, including that regarding conversion of a non-grantor irrevocable trust to a grantor trust, there also has been significant development in the methods to update and modify existing irrevocable trusts. Many states now have clear statutory authority providing options not only for modifying irrevocable trusts, but also to have judicial review and approval of such changes, which of course can provide more certainty and finality for beneficiaries and trustees, and their advisors.

For several reasons, this author prefers using statutory methods for specific modification, such as those contained in the Uniform Trust Code prepared by the Uniform Laws Commission,[7] presently adopted in approximately two-thirds of the states, some of which have made certain variations deemed appropriate. However, many practitioners prefer to use "decanting" techniques pursuant to statutes enacted in several states to accomplish desired changes to existing irrevocable trusts.[8] The Uniform Laws Commission also recently has published the Uniform Trust Decanting Act, now adopted in seven states, which in section 19 thereof specifically addresses issues relating to converting a non-grantor trust to a grantor trust, and vice versa.

Obtaining court approval of trust modification

Petitioning the appropriate court for approval of a modification to an irrevocable trust is common where there is an important tax issue involved, such as converting an existing irrevocable trust to a grantor trust for income tax purposes. Not only does court approval provide proof that the change is authorized by law and gives the optics of permanence, in addition, under Rev. Rul. 73-142,[9] it may bind the IRS for some purposes. Although there is some debate on the issue of whether a lower court's order will be binding on the IRS if it is not a party to the action, Rev. Rul. 73-142 held that a lower state court's decision on a federal tax issue that occurs before the effective date of the event for tax purposes (in that case, the death of the taxpayer with respect to estate tax), where the decision is controlling as between the parties to the action, can also be binding on the IRS. The IRS so ruled despite reference to *Bosch*,[10] in which the U.S. Supreme Court held that in some cases only a decision by the highest state court would be binding on the IRS if it was not a party to the action.

Where tax planning is involved in modification of an existing, funded irrevocable trust, it is often advisable not to have the trustor be a party to, or even directly consent to, the court petition for approval. Arizona intentionally varied from the original UTC in this regard in structuring its legislation so that the trustor cannot be a party to the petition or action under these provisions.[11] Subsequent to this change in Arizona, UTC § 410(b) now has optional provisions to consider whether the trustor/settlor can bring the "proceeding to approve or disapprove a proposed modification."

The law in many states requires that modification of an irrevocable trust does not undermine the intent of the trustor, and it is important for the court petition to state this. The language of the UTC is that the "modification is not inconsistent with a material purpose of the trust."[12] With respect to converting a non-grantor trust to a grantor trust, this certainly enhances the tax planning goal of possibly reducing estate tax (and perhaps income tax), which is frequently the main reason for establishing an irrevocable trust.[13] However, where an irrevocable trust is being converted to a grantor trust, the income of which will be taxed to the trustor, if the trustor is not a petitioner and not consenting to the petition (which the author believes is prudent) the court nevertheless may want some indication of trustor non-objection.

Many states now have clear statutory authority providing options not only for modifying irrevocable trusts, but also to have judicial review and approval of such changes.

Also, the commonly included right of the trustor/grantor to terminate grantor trust status should give the court comfort that the trustor will not be disadvantaged.

Overview of tax issues

Currently, the most popular method of conversion to a grantor trust is changing the trust by statutory modification or decanting to add a Section 675(4)(C) substitution-of-assets power, especially since the issuance of Rev. Rul. 2008-22.[14] The tax issues raised by some tax planners and some corporate trustees relating to conversion of a non-grantor, complex trust to a grantor trust appear to be raised more to show the possible but remote issues to be considered, and appear to be more academic than real, but nevertheless deserve analysis. Specifically, the issues raised are whether adding the Section 675(4)(C) power to a non-grantor trust (or making another modification to cause intentional conversion to a grantor trust) can cause any of the following:

1. Current recognition of gain by the trustor for income tax purposes on trust assets due to a "deemed sale or exchange" of the assets.
2. Inclusion of trust assets in the estate of the trustor for estate tax purposes at death.
3. A current taxable gift to be deemed to have occurred.
4. A loss of GST exemption for the trust.

It seems relatively clear that if an irrevocable trust contains the substitution-of-assets power at time of creation, there is little question that it is a grantor trust under Section

1 For consistency and convenience, this article uses the term "trustor" for the person establishing the trust.

2 These rules are known as the grantor trust rules. The legislative history behind these rules is very interesting, but beyond the scope of this article. Hereafter, all references to "Sections" are to the IRC, unless indicated otherwise.

3 See discussion of Rev. Rul. 2008-22, 2008-16 IRB 796, for guidance on how to properly structure such power. Among other requirements, the trustor must certify that the exchanged assets have an "equivalent" value, exercise of the power must not cause a shifting of benefits between or among beneficiaries, and the power must be exercised in a non-fiduciary capacity.

4 1985-1 CB 184.

5 2004-27 IRB 7.

6 2008-16 IRB 796.

7 The Uniform Trust Code (UTC) was originally published by The National Conference of Commissioners on Uniform State Laws (also referred to as the Uniform Laws Commission) in 2000, and thereafter it has made several updates and amendments. It seems to be gaining further traction and even more states (in addition to the two-thirds already adopting it) are considering it.

8 The statute for "decanting" in Arizona is A.R.S. § 14-10819. Similar to that of other states, the Arizona statute involves the trustee exercising a "special power of appointment" to transfer part or all of a trust's assets to a new trust with the desired updated provisions. BNA Tax Management Portfolio, *Trust Decanting*, No. 871-1st has broad coverage of the tax planning in this area. For an excellent article on the tax analysis on use of decanting for this type of planning and related tax issues, see also Willms, "Decanting Irrevocable Trusts," Texas Tax Lawyer (Fall 2012).

9 1973-1 CB 405. More specifically, the IRS concluded that trust property was excluded from the decedent's gross estate where his power to appoint himself as trustee was eliminated by the court despite the fact the court's ruling appeared to be inconsistent with existing authority on termination of the power of the state's highest court, and the current decision was not appealed.

10 387 U.S. 456 (1967).

11 See A.R.S. § § 14-10410 to -10417. The operative provision for filing, A.R.S. § 14-10410.B., provides that the petition "may be commenced by a trustee or beneficiary," intentionally excluding the settlor/trustor. And for example, A.R.S. § 14-10411 regarding petitioning the court for approval of a modification or early termination by the beneficiaries intentionally does not reference involvement by the trustor. Interestingly, this was one of the primary reasons for repeal in Arizona before its effective date of the originally passed UTC in order to allow time for Arizona to "fix" this and other issues deemed important for tax planning purposes.

12 There are now alternative provisions in the UTC which allow modification even if there is departure from a "material purpose," where the trustor/settlor is involved, but that may add to tax planning risks to have a trustor involved in the process. See UTC § 411 and Comments thereto.

13 As mentioned, UTC § 410 is the operative provision for petitioning for court approval of a modification. For the substantive reasons for the action for petitioning to convert the irrevocable trust to a grantor trust for income tax purposes, the petition can tap into UTC § 411 (by consent of beneficiaries), UTC § 412 (for unanticipated circumstances), UTC § 416 (to further the trustor's tax planning objectives), or perhaps all three. Of course, the language and requirements of the statute of the applicable state's law must be used and followed in the petition.

14 2008-16 IRB 796. See note 3 *supra*.

671 et seq., and with the existence of various rulings and cases, barring some other unusual issues being involved, it also seems clear that the Section 675(4)(C) power does not create a gift, estate, GST, or income tax problem. In Rev. Rul. 2008-22, the IRS not only ruled that if properly drafted such a power retained by the trustor will not cause estate tax inclusion, it also provided guidelines for how to structure the power:

> 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 § 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. A substitution power cannot be exercised in a manner that can shift benefits if: (a) the trustee has both the power (under local law or the trust instrument) to reinvest the trust corpus and a duty of impartiality with respect to the trust beneficiaries; or (b) the nature of the trust's investments or the level of income produced by any or all of the trust's investments does not impact the respective interests of the beneficiaries, such as when the trust is administered as a unitrust (under local law or the trust instrument) or when distributions from the trust are limited to discretionary distributions of principal and income.

In addition, since 2004, it has been clear that payment of the income tax liability of the grantor trust by the trustor is not a taxable gift transfer, even though it has the effect of bestowing a direct economic benefit to the trust and its beneficiaries. The rationale is that since income tax rules make such tax the liability of the trustor, his or her payment of the tax cannot be a gift. In Rev. Rul. 2004-64,[15] the IRS ruled:

> When the grantor of a trust, who is treated as the owner of the trust under subpart E, pays the income tax attributable to the inclusion of the trust's income in the grantor's taxable income, the grantor is not treated as making a gift of the amount of the tax to the trust beneficiaries.

Conversion should not trigger gain

It also seems rather clear that transactions between a trustor and the grantor trust that he or she has established will not be recognized for income tax purposes. For example, gain from the sale of assets by the trustor to a grantor trust for which the trustor is treated as the owner of trust assets (for income tax purposes) will not be recognized for income tax purposes. Similarly, the interest payable to the grantor on a carryback note for such a sale also will not be taxable income.

Long ago, Rev. Rul. 85-13,[16] which also involved the conversion of a non-grantor trust to a grantor trust, established solid planning authority for this proposition. In that Revenue Ruling, which remains in effect, the trustor received the entire corpus of the trust in exchange for his unsecured promissory note. This was found to be an indirect borrowing of the trust corpus causing the trustor to be the owner of the entire trust for income tax purposes under Section 675(3). As a result, the IRS concluded that because he became the owner of the trust property, that the transfer of trust assets to the trustor could not be a sale or taxable exchange that would be recognized for income tax purposes. And thus, contrary to the taxpayer trustor's desire, he did not acquire a new cost basis in those assets.

In addition, in CCA 20092 3024,[17] a Chief Counsel Advice Memorandum, the IRS stated that even if a transaction "appears to be an abusive transaction, it should not take the position that the mere conversion of a non-grantor trust to a grantor trust results in taxable income to the grantor." Each of these two important pieces of authority involved the conversion to a grantor trust resulting from transactions between the trustor and the trust. In Rev. Rul. 85-13, it was from acquiring trust assets for an unsecured promissory note, and in CCA 200923024, from changing trustees to a subservient party. From the breadth of the basis of the conclusions in each situation, it would not appear to make a difference in result where conversion to a grantor trust results from a petition for modification or decanting, since in each situation the conversion occurs as a result of intentional actions. Thus, it logically follows, based on this authority, that the conversion from a non-grantor, complex trust to a grantor trust through modification by court petition should not cause a "deemed sale" or taxable exchange of trust assets to the Trustor, and there is no federal income tax recognition event.

Step-transaction implications. CCA 200923024 also stated the IRS did not express an opinion on a possible "step-transaction" argument, the result for which might be gain being attributed back to the trustor of the trusts. This case involved an elaborate set of transactions, starting with a family-owned S corporation that had filed a Form S-1 for an IPO,[18] and the family subsequently contributing the stock to a family limited liability company (LLC) (in this case, a partnership for income tax purposes). The family members then sold the LLC interests to non-grantor family trusts established by each of them in exchange for private annuities at which time a Section 754 election was filed in order to receive a step up of "inside" basis for partnership assets (i.e., the income tax basis of the S corporation stock). Then the LLC sold the stock pursuant to the IPO that was in process before all these transactions occurred. After that, they replaced the trustee with a subservient party (an employee) which the CCA found converted the trusts to grantor trusts, and thereby shifted the income tax liability for the trusts to the grantors, to the economic benefit of the trust beneficiaries, whose trusts no longer would be taxed on the annuity payments.

If there was ever a case for the IRS to state it did not express an opinion on a possible step-transaction scenario, or that the scheme might be considered "abusive," this was it! Nevertheless, the IRS specifically found that this conversion of the trusts to grantor trusts did not cause recognition of gain by the grantors. Although this is a CCA, and not the authority of a full Revenue Ruling (such as Rev. Rul. 85-13) or court case establishing precedent, it is very helpful.

As stated, the use of grantor trust planning is now very common, both for situations where the trust is initially established as a grantor trust and where existing and funded non-grantor trusts are intentionally converted to grantor trusts. One would think that there would be substantially more authority confirming the conclusions made in Rev. Rul. 85-13 and CCA 200923024, such as a full Revenue Ruling or U.S. Tax Court case. However, perhaps this should be expected because of the long-standing presence of Rev. Rul. 85-13 and that any raising of the issue on audit was thus resolved.

In Ltr. Rul. 201730012, the IRS held that the conversion of a non-grantor trust to a grantor trust by adding a substitution-of-assets power "pursuant to [state] laws" (it was not stated whether there was court approval) does not cause recognition of gain on trust assets, although in that case the power was given to the Trustor's sibling and not reserved to the trustor. Although letter rulings are binding on the IRS only for the requesting taxpayer, as most all estate planners and CPAs know, they are nevertheless looked to for guidance on the IRS's likely position on tax issues.

Payment of the income tax liability of the grantor trust by the trustor is not a taxable gift transfer, even though it has the effect of bestowing a direct economic benefit to the trust and its beneficiaries.

Material modification. A related issue is whether modification of an irrevocable trust could cause recognition of gain because the beneficiary's interest is too substantially modified. The U.S. Supreme Court ruled, in *Cottage Savings Ass'n*, that an exchange of property might result in the realization of gain or loss under Section 1001 if the properties exchanged are materially different, and some commentators have referenced this in the context of trust decanting or modification.

Should this give us a concern the IRS might argue, despite the above authority and direction, that converting an existing irrevocable non-grantor trust to a grantor trust, such as by adding the Section 675(4)(C) substitution-of-assets provisions, along with other more administrative changes, would be such a "material modification" that causes there to be a taxable exchange of trust assets? Based on the analysis in this article, it appears the answer is no, and the author could find no authority that would support this adverse result. However, if changes to dispositive provisions are also included in the decanting or modification (if that is permissible under the process used), there needs to be further analysis of the situation.

In Ltr. Rul. 200231011, which analyzed the *Cottage Savings* issue and other court cases, the IRS ruled that the substantial modifications to a testamentary trust that occurred changed the economic nature and aspects of the grandson beneficiary's interest so drastically that there was deemed to be a taxable exchange, and the grandson beneficiary recognized capital gain on trust assets. However, that case is so different from the issue involving the conversion to a grantor trust that it would seem doubtful this would be a major concern in view of other above-referenced authority that is much more on point.

In this letter ruling, the trust provided that the grandson was to receive a stated dollar amount each year. First, the trust was modified by court order so that the beneficiary's annual payment was to be the lesser of net income or an amount under a "performance chart," but with a "minimum payment" amount also provided. Then, the trust was again modified by an agreement with the residual beneficiary charities, and the court order approving the modifications stated that (1) the charities received a current distribution in satisfaction of their interests (and they no longer were residuary beneficiaries), (2)

15 2004-27 IRB 7.

16 1985-1 CB 184.

17 See also, BNA Tax Management Portfolio, *Trust Decanting*, No. 871-1st, section D.3.(b), covering decanting a non-grantor trust into a grantor trust, which would be an alternative method of causing this conversion.

18 "IPO" is the abbreviation for an "initial public offering," and the taxpayer had filed with the Securities and Exchange Commission to qualify such offering.

grandson then received a 7% unitrust amount but the trustee also could make additional discretionary distributions for support, and (3) grandson also received a testamentary general power of appointment. Again, this is a totally different situation than, for example, adding Section 675(4)(C) substitution-of-assets provisions to convert an irrevocable trust to a grantor trust for income tax purposes, and the dispositive provisions for the beneficiary were substantially restructured.[19]

As a side note that may give some perspective on this matter, there are of course numerous other ways under Sections 671 to 678 that a non-grantor "complex" trust can become and be treated as a grantor trust in whole or in part by actions of the trustor or trustee. Examples are, pursuant to Section 677(a)(3) by the trustee paying life insurance premiums with trust income, or pursuant to Section 677(a)(1) by the trustor marrying a discretionary beneficiary, or pursuant to Section 672(e)(1)(B) by the trustor marrying an otherwise independent trustee of the trust. In view of the above authority, it is very doubtful that when an existing irrevocable non-grantor trust becomes a grantor trust because of these events, which might be inadvertent, that it would cause the recognition of gain on trust assets, not to mention the obvious unfairness of such a result.

It also seems very remote that the conversion of a non-grantor trust to a grantor trust would cause estate tax inclusion for the trustor.

Conversion to a grantor trust should not be considered a taxable gift

It seems the risk also is very small that the conversion of an existing non-grantor trust to a grantor trust for income tax purposes somehow creates a taxable gift by the trustor, especially in view of Rev. Rul. 2004-64 quoted above concluding that the actual payment of the income tax by the trustor is not a taxable gift. Yes, these are different issues, but it is difficult to see how to reconcile a difference in result. How could the IRS argue that creating the obligation of the trustor to pay future income tax for the trust, which benefits the trust beneficiaries, is somehow a taxable gift when the law is clear that the actual payment of the tax is not a taxable gift? Cleary, that would be illogical.

Where the trustor can terminate the Section 675(4)(C) power at anytime as always recommended, any argument that the conversion created a taxable gift is even more difficult to make. In such case, it seems there could be no gift until a tax is paid and Rev. Rul. 2004-64 has ruled payment of the tax is not a gift.

Of course, it strengthens the argument that conversion to a grantor trust does not create a taxable gift by the trustor/grantor if the trustor is not even a party to the process for modification of the trust. As discussed above, there are benefits to having court approval of the trust modification, and under the law of some states, this can be achieved without the trustor being a petitioner, or even specifically consenting to the conversion. In Arizona, the author's primary state of practice, as referenced above, the modification statutes intentionally exclude involvement by the trustor of noncharitable trusts.[20] And with respect to the IRS arguing there is a deemed gift by the trust beneficiaries if they are the petitioners, because they are the ones benefitting economically from adding the Section 675(4)(C) power and converting the trust to a grantor trust, it is difficult to see how they could be making a gift as a result of the conversion.

Where the facts of the case indicate support for the proposition that the trust modification agreement or court petition for conversion to a grantor trust also involves other modifications that relate to settlement of a trust dispute or controversy, coverage of this could be a helpful make weight argument. In such a situation and if plausible, the settlement agreement or petition could reflect that the modification is in settlement of such dispute. This may not only help to refute any argument that the conversion to a grantor trust creates a taxable exchange and recognition of gain, but also may help avoid an argu-

19 Even on these facts, one wonders if a court would find this would result in a deemed taxable exchange, but regardless, modification of a trust to add a substitution-of-assets power for the trustor does not involve a complete restructuring of the beneficiary's interest and economic structure.

20 See A.R.S. § 14-10410.B., and discussion at note 7, *supra*.

21 For example, see Ltr. Ruls. 201528024 and 201102004. These letter rulings also include positive determinations regarding income, estate, and GST exemption issues.

22 This article has been written primarily for readers who are estate planners and CPAs who have a reasonable level of understanding of income tax and wealth transfer tax rules, and thus general explanation of basic concepts is not included. However, because some readers may be familiar with tax planning in general but not GST tax, the following very brief information is provided. GST tax is designed to apply a wealth transfer tax to transfers made by (and distributions from trusts established by) the transferor of property to someone who is assigned to a generation that is two or more generations below the transferor (a "skip person"). Distributions to a skip person from a grandfathered trust or a trust to which GST exemption of the transferor is applied will not be a taxable distribution or termination under these rules and thus not subject to GST tax, which is currently 40%.

23 See also Ltr. Ruls. 201050005, 201049008, 200924018, 200919008, 200702013, 200743028, and 200417014, which do not limit the application of the trust modification safe harbor of Reg. 26.2601-1(b)(4) to grandfathered trusts, and all of which involved a petition for modification.

ment that the addition of the Section 675(4)(C) power gives rise to a taxable gift by the trustor or causes estate tax inclusion. Although Section 2512(b) provides that where a transfer of property is made for less than adequate consideration, the amount in excess of fair consideration will be treated as a gift, there is authority for the notion that a gift does not arise as a result of a trust modification pursuant to compromise and settlement, for it is considered to be a transfer for full and adequate consideration in money or money's worth and, thus, is not a gift for federal gift tax purposes.[21]

Conversion should not cause estate tax inclusion for the trustor

It also seems very remote that the conversion of a non-grantor trust to a grantor trust would cause estate tax inclusion for the trustor. It would be very difficult to reconcile that a court approved addition of a Section 675(4)(C) power, especially where the trustor is not a petitioner or consenting party to the petition for trust modification, would create a legitimate argument for estate tax inclusion, when the law is clear under the above-analyzed Rev. Rul. 2008-22 that the retention of this power *by the trustor* at the time the trust is established does not cause estate tax inclusion. Here too, as with the gift analysis, these are somewhat different issues but a different result would be irrational.

Stated differently, it is clear under Rev. Rul. 2008-22 that the trustor *retaining* the Section 675(4)(C) substitution-of-assets power does not cause estate tax inclusion—i.e., the trustor intentionally designing the trust to be able to swap out assets to continue tax and estate planning during the trustor's lifetime does not cause inclusion. It should logically follow that modification of the trust with court approval by petition of the beneficiaries, where the trustor is not involved, also does not cause this to occur. Of course, certain modifications to an irrevocable trust to convert a non-grantor trust to a grantor trust under the grantor trust rules of Sections 671 to 678 may cause estate tax inclusion if the powers of the trustor or a subservient party would so dictate under Sections 2036 to 2038, but that does not appear to be the situation here.

Conversion should not result in a loss of GST exemption

For many years Treasury Regulations have addressed the effect of a trust modification on the GST exemption[22] for a grandfathered trust, i.e., one that was irrevocable on or before 9/25/1985, and contain certain safe harbors. In particular, Reg. 26.2601-1(b)(4)(i)(D)(1) provides that a trust modification will not cause a trust to lose GST exempt status if the modification is "valid under applicable state law," and "does not shift a beneficial interest in the trust to any beneficiary who occupies a lower generation (as defined in section 2651)," and "the modification does not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust."

These Regulations also provide that changes to a grandfathered trust considered administrative in nature will not cause a loss of grandfathered status. It is very important to note that specifically included in this category are changes resulting in "lowering administrative costs or income taxes." Thus, the shifting of the income tax burden for trust income from the trust to the transferor/trustor by converting a grandfathered trust to a grantor trust would seem to be covered by this definition, and there should be no loss of GST exemption.

The IRS in recent years appears to have consistently taken the position that the trust modification safe harbor rules for grandfathered trusts also apply to other GST-exempt trusts. This is reasonable to expect when there does not seem to be any logical reason to differentiate. In recently issued Ltr. Rul. 201814005, the trustee filed a petition for modification of a GST-exempt trust (not grandfathered) which, among other things, made several changes to the timing and manner of making distributions to the beneficiaries, eliminated rights to withdraw principal at stated ages, and added "special needs" provisions for one beneficiary. In its analysis the IRS nevertheless applied the above-described modification safe harbor of Reg. 26.2601-1(b)(4), and concluded that there was no loss of GST exemption.[23] Combining this fact with the specific above-quoted statement in the Regulations that changes which reduce trust income taxes are considered "administrative" and thus do not affect the GST-exempt status, seems to provide substantial protection and support for the conclusion that the trust modification safe harbor provisions for grandfathered trusts will apply to modifications of non-grandfathered GST exempt trusts for which a Section 675(4)(C) substitution-of-assets power is added to convert a non-grantor trust to a grantor trust.

In Ltr. Rul. 201845006, the IRS again applied the safe harbor provisions of Reg. 26.2601-1(b)(4) to modification of an exempt, non-grandfathered trust which added provisions for appointment of a special trustee. Among other things, the special trustee was given the power to limit the appointees under a power of appointment for the trust's primary beneficiary. It is important to note that, similar to other recent letter rulings, this ruling specifically states that the modification "will not extend the time for vesting of any beneficial interest in the modified Trust beyond the period provided for in Trust," as required for this safe harbor to apply.

The analysis here relates to whether an additional generation was specifically added to the dispositive provisions, which appears appropriate, and not to whether limiting the power of appointment could nevertheless have the effect of retaining assets, which in turn could extend the duration of the trust and allow an additional generation to benefit from the discretionary distribution provisions.[24] This is analogous to the statement in the Reg. 26.2601-1(b)(4)(i)(D)(2) that modifications resulting in "lowering administrative costs or income taxes" will not be considered to be adding an additional generation, which is of course particularly relevant where the modification adds a Section 675(4)(C) substitution-of-assets power resulting in conversion to a grantor trust. The result of the grantor paying the tax on trust income will be an increase in principal, which in turn could extend the duration of a discretionary trust and allow an additional generation to benefit. If this safe harbor were inapplicable whenever a modification might increase principal, which in turn might allow some economic benefit (however small) to accrue to an additional generation, then availability of this safe harbor would be greatly diminished.

When these Regulations were first promulgated, the focus was more on the effect on grandfathered trusts, and not for trusts that are GST exempt because of application of GST exemption of the transferor. Although this may not be the top priority, and the opportunity was missed when they were updated in 2000, it is time the Regulations on this issue be clarified so planners do not have to rely on letter rulings and common-sense analysis, which would in turn avoid extra expenses for clients and the IRS. The Regulations on modifications to irrevocable trusts in Reg. 26.2601-1(b)(4) should be updated to specifically apply to all GST-exempt trusts.

The IRS in recent years appears to have consistently taken the position that the trust modification safe harbor rules for grandfathered trusts also apply to other GST-exempt trusts.

Nevertheless, the risk of a trust modification that converts a non-grantor trust to a grantor trust by adding a Section 675(4)(C) substitution-of-assets power causing a loss of GST exemption for a GST exempt, non-grandfathered trust would seem very remote where the changes fall within the safe harbor provision.

Conclusion

Using grantor trusts for tax and estate planning is very common, and as more supportive authority appears and knowledge of its benefits increase, barring a change in the tax law it will very likely continue and increase.[25] Some of the best authority for various aspects of this planning have appeared during the last 15 years, and thus the planning surrounding many previously established irrevocable non-grantor trusts could be significantly improved upon if some of these trusts could be modified to convert them to grantor trusts for income tax purposes. In addition, during the same period, there also has been an expansion of the methods for modification and decanting of irrevocable trusts to convert them to grantor trusts. This combination provides great planning opportunities.

Although some have raised possible tax issues and risks regarding conversion of existing non-grantor trusts to grantor trusts, and in particular where conversion is a result of adding a Section 675(4)(C) substitution-of-assets power, the risks appear to be very remote. Nevertheless, this has caused some corporate trustees to be cautious, although discussion and acceptance by beneficiaries seems to resolve things. And for planning purposes, even though there appears to be solid ground for modifying an irrevocable trust to add the Section 675(4)(C) power in order to convert a non-grantor to a grantor trust for income tax purposes without adverse tax consequences, explanation of these issues to clients and approval of the planning is of course proper and prudent in most situations in view of the current landscape, as clients must be made aware of tax risks.[26] This is true even though it appears that the tax issues analyzed in this article are somewhat academic and the risks seem to be minimal. Hopefully, even more supportive authority will appear in the near future. ■

24 Ltr. Rul. 201845006 also held that the addition of the bank special trustee provisions and reduction of the primary beneficiary's power of appointment did not constitute a release or exercise of a general power of appointment that would result in a taxable gift or estate tax inclusion.

25 During the prior administration, changes were advocated that would have curtailed grantor trust planning. The concept proposed was that if a trust is a grantor trust for income tax purposes then transfers to the trust would not be deemed completed for wealth transfer tax purposes. However, this proposal has not been raised since the last presidential election.

26 If available for the particular issues for which there is concern at the time, one may want to explore the possibility of applying for a private letter ruling from the IRS, and if available, the benefits and risks of such action.