

## SPECIAL ALERT: Grantor Trusts

Big News! The IRS has finally agreed that a grantor's payment of income taxes due on trust income of a type of irrevocable trust known as a "Grantor Trust" does not result in an additional gift by the grantor. This allows tax-free shifting of greater wealth to future generations.

The ruling is contained in Revenue ruling 2004-64, 2004-27IRB, page 7.

The ruling validates the technique of creating intentionally "defective" trusts, which can successfully remove assets from Federal Estate Tax inclusion while being "defectively" designed for income tax purposes. The intentional "defect" results in the grantor being taxed on the income personally, instead of the trust paying taxes in the trust's highly compressed (and higher) tax brackets. The "intentional defect" technique is accomplished by carefully drafting the trust to fail certain tests of Code sections 673-677, which then causes the trust income to be taxed to the grantor, but does not trigger inclusion of the assets in the grantor's taxable estate under provisions reaching transfers with retained powers: IRC Section 2036 (which includes within the taxable estate any transfers with retained possession or enjoyment); or IRC Section 2038 (which includes within the taxable estate any revocable transfers).

The most common grantor trust powers are the power to add charitable beneficiaries, the power to re-acquire assets by substituting assets of reasonably equivalent value, and the power of the grantor to borrow from the trust on favorable terms.

The Revenue Ruling contains a serious caution: for trust's created after October 3, 2004, if the trust **requires** the trustee to reimburse the grantor for income taxes (or if applicable state law so requires), the entire trust assets will be includible within the taxable estate of the grantor.

Because of the significant wealth transfer advantages of placing assets in an intentionally "defective" grantor trust, this IRS acquiescence has enormous planning potential for taxpayers with Federal Estate Tax liability.

Please feel free to call me regarding your clients who can benefit from the use of this now IRS-sanctioned technique.