Notre Dame Tax and Estate Planning Institute

Who Wins When?

An Analysis of the Techniques that Use Grantor Trusts to the Techniques that Use Non-Grantor Trusts

September 27, 2024

David A. Handler, Esq.
Kirkland & Ellis LLP

333 West Wolf Point Plaza
Chicago, Illinois 60654
312-862-2477
david.handler@kirkland.com

Tony Ray Meyer-Mangione
Kirkland & Ellis LLP

601 Lexington Avenue
New York, New York 10022
212-898-5304
tony.meyermangione@kirkland.com

The views, opinions, statements, analysis and information contained in these materials are those of the individual presenters and do not necessarily reflect the views of Kirkland & Ellis or any of its past, present and future clients. These materials (1) do not constitute legal advice; (2) do not form the basis for the creation of the attorney/client relationship; and (3) should not be relied upon without seeking specific legal advice with respect to the particular facts and current state of the law applicable to any situation requiring legal advice. These materials may only be reproduced with the prior written consent of Kirkland & Ellis. These materials are provided with the understanding that the individual presenters and Kirkland & Ellis are not rendering legal, accounting, or other professional advice or opinions on specific facts or matters, and, accordingly, such entities assume no liability whatsoever in connection with their use. Pursuant to applicable rules of professional conduct, this material may constitute Attorney Advertising. Prior results do not guarantee a similar outcome.

DAVID A. HANDLER is a partner in the Trusts and Estates Practice Group of Kirkland & Ellis LLP. Mr. Handler is a fellow of the American College of Trust and Estate Counsel (ACTEC), and a member of the NAEPC Estate Planning Hall of Fame as an Accredited Estate Planner (Distinguished), the Chicago Estate Planning Council (2015 Austin Fleming Distinguished Service Award recipient), and the professional advisory committees of several non-profit organizations. He is the author of numerous articles in estate planning and taxation journals, and has written the monthly "Tax Update" column for Trusts & Estates Magazine more than 20 years. He is among a small group of lawyers ranked in "Band 1" by Chambers USA in the Wealth Management category, is listed in The Best Lawyers in America©, (Trusts and Estates) and its 2015 and 2019 Trusts and Estates "Chicago Lawyer of the Year". David is a co-author of an e-book on estate planning, The Complete Estate Planning Sourcebook (published by Wolters Kluwer). He is a frequent lecturer at professional education seminars. David is a graduate of Northwestern University Pritzker School of Law and received a B.S. Degree in Finance with highest honors from the University of Illinois Gies College of Business.

TONY RAY MEYER-MANGIONE is an associate in the Trusts and Estates Practice Group in the New York office of Kirkland & Ellis LLP. Tony's practice focuses on wealth transfer and tax planning, structuring family offices, business succession planning, charitable giving, and the administration of high-net-worth trusts and estates. His clients include principals of private equity funds and venture capital firms, owners of closely-held businesses, high-net-worth families and public figures. Tony is a graduate of Harvard Law School and Harvard College.

TABLE OF CONTENTS

I. Introduction to Grantor Trusts and Non-Grantor Trusts 20-1

A. What is a Grantor Trust and Non-Grantor Trust? 20-1

B. What Makes a Grantor Trust? 20-1

C. Grantor and Non-Grantor Trusts: Who Pays the Tax? 20-2

D. State Income Taxation of Non-Grantor Trusts 20-3

E. Maximizing Wealth: Grantor vs Non-Grantor Trusts 20-5

II. Scenario Analysis: Which Maximizes the Most Wealth? 20-7

A. Introduction 20-7

B. Scenarios 20-7

C. Scenario Take-Aways 20-14

III. Other Benefits of Grantor and Non-Grantor Trusts 20-14

A. Other Factors that Supercharge the Benefits of Grantor Trusts 20-14

1. More GST Exempt Assets 20-14
2. Tax-Free Sales with Notes 20-15
3. The Substitution Power 20-15
4. Avoid the NIIT 20-16
5. Occasionally Subject to Less Tax 20-17

B. Non-Tax Practical Benefits of Grantor Trusts 20-17

1. Spouse as Beneficiary and as Trustee 20-17
2. Adding Beneficiaries 20-18
3. Hit Goals and Access Funds Sooner 20-18
4. Borrowing and Lending Assets 20-18
5. Use Income for Life Insurance Premiums 20-18
6. Holding S-Corp Stock 20-19

7. No Trust Income Tax Returns 20-19

8. Voting Certain Corporate Stock 20-19

C. Additional Tax Benefits Available to Non-Grantor Trusts 20-20

1. Save Money Today 20-20

2. No Mandatory Future Payments 20-20

3. Expanded Charitable Deductions 20-20

4. Qualified Small Business Stock 20-20

5. Section 199A Deductions 20-21

6. SALT Deductions 20-22

D. The Benefits of Using Both Grantor and Non-Grantor Trusts 20-22

IV. Conclusion 20-23

I. Introduction to Grantor Trusts and Non-Grantor Trusts

A. What is a Grantor Trust and Non-Grantor Trust?

When a settlor creates an irrevocable trust, the trust is generally treated as a separate tax entity for federal gift, estate, and generation skipping transfer ("GST") tax purposes. Whether the irrevocable trust is treated as a "grantor trust" or a "non-grantor trust" determines whether such trust is treated as a separate entity for federal income tax purposes.

A grantor trust is not a separate entity for income tax purposes – it has no independent existence from its grantor (e.g., the creator of the trust or a person who made a gratuitous transfer to the trust). Thus, the grantor must report on her personal income tax return all items of income, loss, deduction, and credit attributable to her grantor trust. An irrevocable trust is treated as a grantor trust based on certain powers or interests the grantor (or her spouse) has in the trust and on the identity and powers of the trustee, as described in Sections 671 – 679 of the Internal Revenue Code (the "Code") and as discussed below.

A non-grantor trust, on the other hand, is a separate entity for federal income tax purposes. A non-grantor trust is any irrevocable trust which is not treated as a grantor trust under Sections 671 – 679 of the Code. A non-grantor trust, as an independent tax entity, files its own tax return and is subject to its own income tax rules under Sections 641 – 668 of the Code. The income of a non-grantor trust is ultimately taxable either to the beneficiaries who receive distributions of such income or, if there are no such distributions, then to the trust itself.

B. What Makes a Grantor Trust?

Sections 671 – 679 of the Code contain the rules governing which trusts are treated as grantor trusts for federal income tax purposes. Generally, a trust will be a grantor trust if it falls into one of the following seven categories:

- The grantor or her spouse retained a reversionary interest worth more than five percent of the value of the trust upon its creation, within specified time limits (Section 673);
- The grantor, her spouse or nonadverse parties are serving as trustees and control beneficial enjoyment over the trust income and principal (Section 674);
- The grantor, her spouse, nonadverse parties, or persons who are not fiduciaries have certain administrative powers over the trust (Section 675);
- The grantor, her spouse or nonadverse parties have the power to revest the trust assets in the grantor or her spouse, within specified time limits (Section 676);
- Trust income can or does benefit the grantor or her spouse, or can be used to pay premiums on insurance on the life of the grantor or her spouse, without the approval of an adverse party (Section 677);

- A beneficiary of the trust has the power to withdraw trust income or principal for themselves, or released such power and retained control which would have caused the grantor of the trust to be treated as owner under Sections 671-677 (Section 678);[1] and
- The grantor or her spouse is a US person who transfers property to a foreign trust with a US beneficiary (Section 679).

Qualifying a trust as a grantor trust is beyond the scope of this material.

C. Grantor and Non-Grantor Trusts: Who Pays the Tax?

As noted above, a non-grantor trust pays its own tax bill. Paying the income taxes not only depletes the assets of the trust by the amount paid, but also reduces future appreciation in the trust.

> Ex. 1: A non-grantor trust has $10 million of assets and realizes $1 million of ordinary income ($11 million in total assets). If the federal income tax rate is 40.8%[2], then the federal income tax is $408,000 (40.8% x $1 million). After paying its own tax bill, the non-grantor trust is left with just under $10.6 million. If the trust continues to generate ordinary income at a 10% rate and pays tax each year, it will have $17.8 million after 10 years.

However, if the trust is a grantor trust, then the trust's taxable income is reported on the grantor's income tax return and she pays the tax bill from her own funds.

> Ex. 2: Same as in Ex. 1, but the trust is a grantor trust. After the grantor pays the $408,000 tax bill from her own pocket, the grantor trust still has $11 million. If the trust continues to generate ordinary income at a 10% rate, it will have $25.9 million after 10 years – $8.1 million more than the corresponding non-grantor trust.

While the IRS' position is clear that the payment by a grantor of the tax liability of a grantor trust is not a gift for federal gift tax purposes,[3] it is useful to think about such payments as a gift when evaluating the wealth-transfer benefits of grantor trusts. In Ex. 2, the grantor paid a total of $6.5 million in taxes on the grantor trust's income over 10 years, benefitting (effectively "gifting") the grantor trust that amount. Over those 10 years, the grantor trust was able to grow each of those "gifts" at the 10% rate of return. Thus, of the $8.1 million more that the grantor trust had after 10 years over the non-grantor trust, $1.6 million was due to appreciation on the yearly "gifts" of having its taxes paid by the grantor.

---

[1] If Section 678 applies to a trust, then the beneficiary with such power is treated as the grantor of the trust.

[2] E.g., 37% (the highest tax bracket) + 3.8% (the net investment income tax).

[3] In Rev. Rul. 2004-64, the IRS stated that the payment of a grantor trust's income tax liability by the grantor "does not constitute a gift…for federal gift tax purposes because [the grantor], not [the grantor trust], is liable for the taxes."

While the annual exclusion amount is currently $18,000 per person a year and the lifetime exemption amount is currently $13.61 million, there is no such limit on the amount of income tax that a settlor can pay on behalf of her grantor trust (indeed, she's actually obligated to do so). The grantor of a billion-dollar trust that generates $100 million of ordinary income will pay $40.8 million of federal income tax on the trust's income, benefitting the trust and reducing her estate dollar-for-dollar. Every year.

Grantor trusts for federal income tax purposes are grantor trusts for *state* income tax purposes as well.[4] Thus, the grantor also pays the state income taxes on a grantor trust's income and gains. State income tax rates range from zero (in no-tax states) to 14.776% (in New York City), with all states other than California settling out in the single digits (California is the second highest at 14.4%).

However, some non-grantor trusts can escape state income tax entirely, reducing the overall income tax for the family.

D. State Income Taxation of Non-Grantor Trusts

As a general rule, a state can only tax a non-grantor trust if it has sufficient connections to the state to justify imposing its tax on the non-grantor trust's income. States take various approaches to imposing tax on non-grantor trusts: some tax non-grantor trusts settled by persons who were residents of the state at the time the trust was created (e.g., Illinois), others tax non-grantor trusts that have state residents as trustees (e.g., Oregon), beneficiaries (e.g., North Carolina) or either (e.g., California), and others tax trusts "administered" in the state (e.g., Colorado), which have trust property located in the state (e.g., Georgia) or which derive certain income from the state (e.g., New Hampshire).[5] Other states have no state income tax at all (e.g., Alaska).[6] Some states combine these approaches (e.g., Idaho requires meeting three of five criteria), while others narrow them (e.g., New York).

> For example, in New York, "resident trusts" subject to state income tax are those created by a New York domiciliary or a New York decedent. However, resident trusts which do not have any trustees domiciled in New York, no New York situs assets, and no New York-source income are not taxed in New York.

Thus, to determine the state income tax applicable to a non-grantor trust, the nexus between a state and the trust's grantor, trustees, beneficiaries and assets must all be examined.

---

[4] Pennsylvania was the last holdout but changed its law this year. Some states use modified grantor trust rules (e.g., they define grantor trusts under state statutes which parallel but do not exactly mirror Sections 671-679 of the Code).

[5] See, e.g., the 10th Annual Non-Grantor Trust State Income Tax Chart, Steve Oshins (2024), for a comprehensive overview of the conditions under which each state taxes a non-grantor trust.

[6] Those states which only tax if a beneficiary is a state resident (or which limit the application of state income tax to those trusts which have an in-state beneficiary, like Delaware) effectively impose no state tax if beneficiaries live elsewhere.

> For example, if a trust that owns Georgia property was settled by an Illinois resident and is now administered by a trustee living in Colorado for the benefit of North Carolina beneficiaries, all four states could attempt to subject the trust to their own state income tax regimes.

However, the U.S. Supreme Court has held that not all nexuses are sufficient to merit a state taxing a non-grantor trust. The Supreme Court ruled in *Kaestner* that the residence of trust beneficiaries in North Carolina "does not supply the minimum connection necessary to sustain the State's tax" where such beneficiaries did not receive any income from the trust, had no right to demand income or otherwise control trust assets, and where they could not count on receiving trust assets in the future.[7] Thus, while North Carolina statutorily imposes state income tax on any non-grantor trust with a North Carolina beneficiary, there are constitutional limitations to the state's power to collect that tax.

Some state courts have also narrowed the application of the state's statutory definition of resident for state income tax purposes on constitutional grounds. For example, in *Linn v. Department of Revenue,* an Illinois appellate court held that Illinois requires a current nexus to the trust (and not merely a historical one) in order to tax the trust.[8] The Minnesota Supreme Court came to the same conclusion in *Fielding v. Commissioner of Revenue*, holding that a grantor's past contacts with the state, the beneficiaries' former residency in the state, and the fact the trust was settled in the state were all "irrelevant or too attenuated" to comply with the due process requirements for imposing Minnesota state income tax on the trust.[9] And in *McNeil*, the Pennsylvania Commonwealth Court held that despite a trust's beneficiaries living in Pennsylvania, because the trust had no Pennsylvania situs assets, did not conduct business in Pennsylvania, was not governed by Pennsylvania law and was administered in another state, there were not sufficient contacts with Pennsylvania for the trust to be subject to its state income tax.[10] These holdings all support the proposition that sufficient nexus must exist between a trust and a state in order for the state to impose its income tax on such trust.

Finally, though some non-grantor trusts may escape state income taxation, beneficiaries who receive distributions from such trusts can still be subject to state income tax. When a non-

---

[7] *North Carolina Dep't of Rev. v. Kimberley Rice Kaestner 1992 Family Trust*, No. 18-457 (U.S. 2019).

[8] In Illinois, the term "resident" is broadly defined for purposes of the state income tax to include trusts created by an Illinois resident or a decedent domiciled in Illinois. However, in *Linn v. Department of Revenue*, Il. App. 4th (2013), the Illinois Fourth District Appellate Court rejected on constitutional grounds the argument by the Illinois Department of Revenue that a trust with no Illinois trustees, beneficiaries, or assets, and which was no longer governed by Illinois law, was still subject to Illinois state tax.

[9] *Fielding v. Commissioner of Revenue*, 2018 WL 3447690 (Minn. 2018).

[10] *McNeil v. Commonwealth*, Pa. Comm. Court, Nos. 651 F.R. 2010, 173 F.R. 2011 (2013). Unlike in *Linn* and *Fielding*, there were in-state beneficiaries in *McNeil*. However, the Pennsylvania Commonwealth Court held that in-state beneficiaries with discretionary interests who had no current or future right to the trust's assets or income did not establish sufficient nexus to merit the state taxation of the trust (in part holding that while such beneficiaries benefited from the state's protections, opportunities and services, such benefit could not be attributed to a trust for their benefit with no physical connections to Pennsylvania).

grantor trust makes distributions of its income to its beneficiaries, distributed income which is included in calculating that year's distributable net income ("DNI") for the trust is included on the federal and state income tax returns of the beneficiaries receiving such distributions. Thus, beneficiaries may owe state income tax based on their domicile. Generally, distributions of income accumulated in prior years avoids state income tax.

Therefore, a non-grantor trust in a no-tax or low-tax jurisdiction may help escape state income tax and thus preserve more wealth for their families, particularly if the trust beneficiaries live in no-tax or low-tax states (or only receive distributions of accumulated income). However, the two states with the highest state income taxes (New York[11] and California[12]), in addition to Pennsylvania,[13] have enacted "throwback" taxes to decrease the benefit of accumulating income in non-grantor trusts. These throwback taxes impose state income tax on certain distributions of accumulated income (which normally would not be taxed). The purpose of throwback taxes is combat the use of non-grantor trusts that accumulate income tax-free and which later make distributions of such income to beneficiaries who are state residents (and who thus would have paid income tax if the distributions had been made in the year the income was earned).

E. Maximizing Wealth: Grantor vs Non-Grantor Trusts

For settlors living in high-income tax states, non-grantor trusts present a potential wealth-planning opportunity. Instead of settling a grantor trust for which the settlor would pay both federal and state income taxes on its income, the settlor could settle a non-grantor trust in a no-tax or low-tax jurisdiction. If the settlor's home state would not apply its state income tax to the out-of-state non-grantor trust, then the settlor and the trust could escape state income tax on the trust's income. Of course, the transfer by the settlor to the non-grantor trust is a gift which either consumes annual exclusion amounts, lifetime gift exemption, incurs gift tax or is the result of successful GRATs and other wealth-transfer strategies; moreover, the trust must sufficiently restrict the settlor's access to and control over the gifted assets to avoid the trust being treated as a grantor trust under Code Sections 671-679.[14]

---

[11] In New York, the throwback tax applies when an exempt resident trust (e.g., a trust settled by a New York resident which does not have any New York trustees, New York-situs assets or New York-source income) makes a distribution to a New York beneficiary of certain income (e.g., accumulated after January 1, 2014 during years in which a New York resident over twenty-one years of age was a beneficiary) that was not previously taxed by New York. See NY Tax Law Section 612(b)(40).

[12] In California, the throwback tax applies when (i) non-California source income was accumulated and not taxed because a California resident beneficiary's interest was contingent, and (ii) that income is later distributed to such beneficiary, so long as they are then a California resident. See California Revenue and Taxation Code Section 17745(b).

[13] In Pennsylvania, a Pennsylvania beneficiary who receives amounts not previously taxed by Pennsylvania from a nonresident trust also faces a throwback tax (with a credit for taxes paid on that income to another state). However, the state income tax is only 3.07%.

[14] It is possible to establish certain types of asset-protection trusts, known as incomplete gift non-grantor ("ING") trusts, which walk a fine line in avoiding a completed gift, avoiding grantor trust status (and thus state income tax), and allowing the grantor to remain a beneficiary of the trust. ING trusts are typically established in jurisdictions with self-settled asset protection statutes, such as Delaware (a "DING" trust) or Nevada (a "NING" trust), though

For example, a New York City resident who is otherwise subject to a 14.776% state income tax could settle a non-grantor trust in Wyoming, which has no state income tax. While New York typically taxes any trust which is settled by a New York resident, if the non-grantor trust in Wyoming has no New York trustees, no New York situs assets, and no New York source income, then the non-grantor trust will not be subject to New York state income tax.

However, is avoiding state income tax via a non-grantor trust actually better at maximizing the wealth of the settlor's family than a grantor trust? The total income tax paid by the family is reduced by such a trust, which *should* leave more wealth for the family. But does it? Remember, when using a grantor trust, (1) the trust grows undiminished by income tax, thus appreciating faster than a non-grantor trust would (which pays its own taxes), and (2) in comparison to a non-grantor trust paying its own taxes, a grantor trust is effectively reimbursed for its taxes by the grantor's estate, leaving a smaller taxable estate at death.

As an example of this trade-off, take the settlors from Ex. 1 and Ex. 2 above. Their trusts generated federal income tax bills of $408,000. The non-grantor trust paid this bill itself. In Ex. 2, the grantor paid this bill on behalf of the grantor trust – this tax payment is effectively a $408,000 "gift" from the grantor to her trust (such that it ends up with $11 million, while the non-grantor trust ended up with just under $10.6 million). Gifts, however, have costs. If the settlor of the non-grantor trust were to make the $408,000 tax payment on behalf of her trust, she would also need to make a gift tax payment of $163,200 (40% x $408,000).[15] The settlor of the grantor trust also makes two payments: one payment of the $408,000 federal income tax, and one payment of the *state* income tax (rather than the gift tax the non-grantor settlor paid). At its highest, this costs her $147,776 (if she lives in NYC) and costs less if she lives in a low-tax state (e.g., an Indiana settlor would only pay $30,500, while an Illinois settlor would pay $49,500). While the settlor must make this payment (because she's obligated to pay her grantor trust's taxes), it is in effect a bargain-rate gift tax (e.g., at the applicable state income tax rate). Even at the highest current state income tax rate, it would cost the settlor of a non-grantor trust more in gift tax to reimburse her trust for its taxes than it costs the settlor of a grantor trust (in paying the extra state tax) to cover her trust's tax bill.

Paying the state income tax as a "bargain" gift tax only benefits the grantor if there is more value in having assets in the grantor trust than in her estate. And there is: assets in the grantor trust avoid estate tax at the settlor's death, whereas assets in her estate are subject to such tax.

Therefore, the question then becomes: under which circumstances does a non-grantor trust or a grantor trust achieve the greatest wealth transfer?

Alaska and South Dakota permit them as well. While ING trusts may be appealing for settlors in high-tax states, the two highest tax states (California and New York) have both passed laws which treat ING trusts as grantor trusts for state income tax purposes (thereby shutting down the benefit of these trusts for their residents). The benefits and drawbacks of ING trusts are beyond the scope of this material.

[15] Or deplete her lifetime gift exemption by $408,000.

II. Scenario Analysis: Which Maximizes the Most Wealth?

A. Introduction

When maximizing total family wealth is the goal, is it better to settle a non-grantor trust that escapes state income tax, or a grantor trust that triggers state income tax for the settlor but avoids paying any tax itself? The answer depends on several factors, including:

- The federal income tax rate (for ordinary income and capital gains);
- The state income tax rate;
- The federal estate tax rate and the size of the settlor's taxable estate; and
- The realized investment rate of return for assets in the trust and in the estate.

In this section, we explore these factors in three scenarios to illustrate the circumstances in which a grantor trust preserves the most wealth and the times when a non-grantor trust wins out. The scenarios are as follows:

1. Scenario 1 demonstrates that, for a typical high-net worth settlor, a grantor trust produces significantly more wealth for her family due to the higher rate of growth in a grantor trust (compared to the non-grantor trust) and fewer overall assets being subject to estate tax.
2. Scenario 2 demonstrates the effects of rising state income tax rates, showing that grantor trusts continue to win until extremely high levels of state income tax.
3. Scenario 3 demonstrates that when the rate of return for trust assets is greater than the rate of return for assets in the settlor's estate, grantor trusts produce even more wealth compared to non-grantor trusts.

B. Scenarios

Scenario 1: ***Base Case***

This Scenario compares the wealth transfer outcomes for Jane and John. At the outset, Jane has $60 million in her estate and $10 million in an irrevocable grantor trust, while John has $60 million in his estate and $10 million in an irrevocable non-grantor trust.

We make the following assumptions for this Scenario: (1) Jane's estate and grantor trust, and John's estate and non-grantor trust, have full tax basis at the outset (e.g., there are no unrealized capital gains), (2) the assets in both their estates and their trusts appreciate at 5% per year and generate income at 2% per year, (3) the federal income tax rate for ordinary income is 40.8% (37% for the highest bracket, and 3.8% for the net investment income tax ("NIIT")) and for capital gains is 23.8% (20% for the highest bracket and 3.8% for the NIIT), (4) 50% of unrealized capital gains are realized each year during the lives of Jane and John, and their trusts

realize 100% of unrealized capital gains immediately after their deaths,[16] (5) the state income tax rate is 5% and does not apply to John's non-grantor trust, (6) the federal gift, estate and GST tax rates are each 40%, and neither Jane nor John have any remaining lifetime exemption, (7) there is no state gift, estate or inheritance tax, (8) Jane's grantor trust and John's non-grantor trust are each GST exempt, and (9) Jane and John each have $1 million in annual expenses per year (indexed to inflation at 3%), and they have other income of $500,000 per year.

The following tables show the net amounts passing to or in trust for heirs from the grantor trust, non-grantor trust and Jane's and John's estates over 30 years:

Table 1A: Jane's Grantor Trust

Year	Start of Year	Growth	Income	Realized Gains	Unrealized Gains	Tax Paid by Trust	End of Year	Cap. Gains Tax At Settlor's Death	Net Trust Value At Settlor's Death
1	$10,000,000	$500,000	$200,000	$250,000	$250,000	$0	$10,700,000	$59,500	$10,640,500
5	$13,107,960	$655,398	$262,159	$601,448	$601,448	$0	$14,025,517	$143,145	$13,882,373
10	$18,384,592	$919,230	$367,692	$862,357	$862,357	$0	$19,671,514	$205,241	$19,466,273
15	$25,785,342	$1,289,267	$515,707	$1,210,088	$1,210,088	$0	$27,590,315	$288,001	$27,302,314
20	$36,165,275	$1,808,264	$723,306	$1,697,230	$1,697,230	$0	$38,696,845	$403,941	$38,292,904
25	$50,723,670	$2,536,183	$1,014,473	$2,380,453	$2,380,453	$0	$54,274,326	$566,548	$53,707,779
30	$71,142,570	$3,557,129	$1,422,851	$3,338,708	$3,338,708	$0	$76,122,550	$794,613	$75,327,938

Table 1B: Jane's Estate (Grantor Trust)

Year	Start of Year	Growth	Income	Realized Gains	Unrealized Gains	Other Annual Income	Tax Paid for Self	Tax Paid for Trust	Annual Expenses	End of Year	Estate Tax	Net from Estate
1	$60,000,000	$3,000,000	$1,200,000	$1,500,000	$1,500,000	$500,000	$1,210,600	$163,600	$1,000,000	$62,325,800	$24,930,320	$37,395,480
5	$68,656,842	$3,432,842	$1,373,137	$3,240,153	$3,240,153	$500,000	$1,791,061	$293,286	$1,125,509	$70,752,965	$28,301,186	$42,451,779
10	$79,466,349	$3,973,317	$1,589,327	$3,860,582	$3,860,582	$500,000	$2,068,759	$416,762	$1,304,773	$81,738,699	$32,695,479	$49,043,219
15	$91,186,491	$4,559,325	$1,823,730	$4,440,310	$4,440,310	$500,000	$2,343,078	$584,699	$1,512,590	$93,629,179	$37,451,671	$56,177,507
20	$103,644,039	$5,182,202	$2,072,881	$5,056,562	$5,056,562	$500,000	$2,634,669	$820,076	$1,753,506	$106,190,871	$42,476,348	$63,714,522
25	116407713.4	$5,820,386	$2,328,154	$5,692,880	$5,692,880	$500,000	$2,934,844	$1,150,199	$2,032,794	$118,938,416	$47,575,366	$71,363,049
30	$128,728,830	$6,436,442	$2,574,577	$6,315,351	$6,315,351	$500,000	$3,226,977	$1,613,214	$2,356,566	$131,043,092	$52,417,237	$78,625,855

Table 1C: John's Non-Grantor Trust

Year	Start of Year	Growth	Income	Realized Gains	Unrealized Gains	Tax Paid by Trust	End of Year	Cap. Gains Tax At Settlor's Death	Net Trust Value At Settlor's Death
1	$10,000,000	$500,000	$200,000	$250,000	$250,000	$141,100	$10,558,900	$59,500	$10,499,400
5	$12,291,836	$614,592	$245,837	$571,594	$571,594	$236,341	$12,915,923	$136,039	$12,779,884
10	$15,732,221	$786,611	$314,644	$750,052	$750,052	$306,887	$16,526,589	$178,512	$16,348,077
15	$20,125,490	$1,006,274	$402,510	$960,115	$960,115	$392,731	$21,141,543	$228,507	$20,913,035
20	$25,745,261	$1,287,263	$514,905	$1,228,234	$1,228,234	$502,401	$27,045,028	$292,320	$26,752,708
25	$32,934,266	$1,646,713	$658,685	$1,571,202	$1,571,202	$642,690	$34,596,975	$373,946	$34,223,028
30	$42,130,700	$2,106,535	$842,614	$2,009,939	$2,009,939	$822,152	$44,257,697	$478,365	$43,779,331

Table 1D: John's Estate (Non-Grantor Trust)

Year	Start of Year	Growth	Income	Realized Gains	Unrealized Gains	Other Annual Income	Tax Paid for Self	Tax Paid for Trust	Annual Expenses	End of Year	Estate Tax	Net from Estate
1	$60,000,000	$3,000,000	$1,200,000	$1,500,000	$1,500,000	$500,000	$1,210,600	$0	$1,000,000	$62,489,400	$24,995,760	$37,493,640
5	$69,607,009	$3,480,350	$1,392,140	$3,274,905	$3,274,905	$500,000	$1,809,773	$0	$1,125,509	$72,044,218	$28,817,687	$43,226,531
10	$82,540,419	$4,127,021	$1,650,808	$3,990,842	$3,990,842	$500,000	$2,134,433	$0	$1,304,773	$85,379,042	$34,151,617	$51,227,425
15	$97,703,066	$4,885,153	$1,954,061	$4,728,416	$4,728,416	$500,000	$2,485,744	$0	$1,512,590	$101,043,947	$40,417,579	$60,626,368
20	$115,559,377	$5,777,969	$2,311,188	$5,593,446	$5,593,446	$500,000	$2,898,436	$0	$1,753,506	$119,496,591	$47,798,636	$71,697,955
25	$136,612,604	$6,830,630	$2,732,252	$6,613,027	$6,613,027	$500,000	$3,384,923	$0	$2,032,794	$141,257,769	$56,503,108	$84,754,662
30	$161,463,226	$8,073,161	$3,229,265	$7,816,249	$7,816,249	$500,000	$3,959,083	$0	$2,356,566	$166,950,004	$66,780,001	$100,170,002

[16] Note that gain recognition in a grantor trust or non-grantor trust is not required upon a settlor's death – we make this assumption so as to compare the relative benefits of grantor trusts and non-grantor trusts.

Table 1E: Grantor vs Non-Grantor Trust Summary of Total Wealth

Year	Jane's Trust (Grantor)	Jane's Estate	Jane's Total Passed Wealth	John's Trust (Non-Grantor)	John's Estate	John's Total Passed Wealth	Additional Wealth (Grantor Trust)
5	$13,882,373	$42,451,779	$56,334,152	$12,779,884	$43,226,531	$56,006,415	**$327,737**
10	$19,466,273	$49,043,219	$68,509,492	$16,348,077	$51,227,425	$67,575,502	**$933,990**
15	$27,302,314	$56,177,507	$83,479,822	$20,913,035	$60,626,368	$81,539,404	**$1,940,418**
20	$38,292,904	$63,714,522	$102,007,426	$26,752,708	$71,697,955	$98,450,663	**$3,556,764**
25	$53,707,779	$71,363,049	$125,070,828	$34,223,028	$84,754,662	$118,977,690	**$6,093,138**
30	$75,327,938	$78,625,855	**$153,953,793**	$43,779,331	$100,170,002	**$143,949,334**	**$10,004,460**

Winner: *The grantor trust (Jane).*

Commentary: Here, Jane maximizes more wealth for her family in each year over 30 years by using a grantor trust over a non-grantor trust. The two key drivers of this wealth maximization are (1) the higher net rate of return in the grantor trust vs. the non-grantor trust (because the non-grantor trust pays tax on its appreciation and income) and (2) that the grantor trust shielded more wealth from the estate tax.

Higher Net Rate of Return. In the non-grantor trust, the effective net rate of appreciation for capital assets held by the trust is 3.8% (5%, reduced by a tax rate of 23.8%); for income-generating assets in the trust, the effective net rate is 1.2% (2%, reduced by a tax rate of 40.8%). The grantor trust's returns are not reduced by tax (because the taxes come out of the grantor's estate) – thus, the grantor trust has an additional 1.2% growth rate on capital assets and 0.8% growth rate on income. Thus, over 30 years, the grantor trust has 72.1% more assets than the non-grantor trust.

Avoiding Estate Tax. One way of looking at the difference in the estate tax paid is that Jane pays 5% (the state income tax) on the trust's realized gains to transfer 23.8% (the federal capital gains rate) of the realized gains from her estate to the grantor trust (thus avoiding estate tax); she also pays 5% of the trust's taxable income to transfer 40.8% (the federal income tax rate) of the trust's income from her estate to her grantor trust (also avoiding estate tax). Meanwhile, John pays 40% (the federal estate tax) on the amounts he retained in his estate compared to Jane (e.g., 28.8% of the amount of the trust's realized gains and 45.8% of the trust's income). This ultimately results in maximizing more family wealth for Jane by avoiding more estate tax.

Importantly, Jane's grantor trust not only wins each year, but the longer the grantor trust structure is operating, the greater its margin of win. In Year 5, Jane's Total Passed Wealth is only 0.59% more than John's, and by Year 15, still only 2.4% greater. Yet by Year 25, she's 5.1% ahead; and finally, in Year 30, she has 7.0% more Total Passed

Wealth than John (e.g., $10 million more), simply by virtue of using a grantor trust over a non-grantor trust.

GST Savings: Moreover, the use of a GST exempt grantor trust also shields more overall wealth from the GST tax, as shown below:

Table 1F: Benefit Including GST Tax Savings

Year	Jane's Total Passed Wealth	John's Total Passed Wealth	Additional Wealth (Grantor Trust)	GST Tax Saved (Grantor Trust)	Total Benefit (Grantor Trust)
5	$56,334,152	$56,006,415	$327,737	$309,901	**$637,638**
10	$68,509,492	$67,575,502	$933,990	$873,682	**$1,807,672**
15	$83,479,822	$81,539,404	$1,940,418	$1,779,544	**$3,719,962**
20	$102,007,426	$98,450,663	$3,556,764	$3,193,373	**$6,750,136**
25	$125,070,828	$118,977,690	$6,093,138	$5,356,645	**$11,449,783**
30	$153,953,793	$143,949,334	$10,004,460	$8,617,659	**$18,622,118**

In each year, Jane maximizes even greater wealth for her family because her grantor trust is GST exempt – not only does it shelter from the estate tax, but from the GST tax as well. By Year 30, she pays $8.6 million less in GST tax when transferring her estate to her grandchildren. Fully factored in, that puts Jane's total net wealth transfer at 17.9% more than John – all due to the power of paying the grantor trust's taxes and allowing that trust to grow tax-free.

Take-Away: Grantor trusts can preserve significantly more wealth for one's family, driven in particular by higher rates of returns in the grantor trust over the non-grantor trust, long time horizons for compounding to occur, subjecting less wealth to the estate tax, and the benefits of growing GST exempt assets tax-free.

Scenario 2: ***Higher state income tax***

While very few states have double-digit state income tax rates, persons in those states (e.g., California, New York) are the most motivated to avoid state income taxes by using a non-grantor trust. Thus, how does a grantor trust compare to a non-grantor trust when the state income tax rate is the highest in the country?

This scenario is the same as Scenario 1, with the following modification:

- The state income tax rate is increased from 5% to 14.776% (e.g., a NYC resident).

Table 2: Grantor vs Non-Grantor Trust Summary of Total Wealth

Year	Jane's Trust (Grantor)	Jane's Estate	Jane's Total Passed Wealth	John's Trust (Non-Grantor)	John's Estate	John's Total Passed Wealth	Additional Wealth (Grantor Trust)
5	$13,882,373	$40,846,385	$54,728,757	$12,779,884	$41,831,323	$54,611,207	**$117,551**
10	$19,466,273	$44,925,330	$64,391,603	$16,348,077	$47,670,220	$64,018,297	**$373,306**
15	$27,302,314	$48,596,985	$75,899,300	$20,913,035	$54,113,797	$75,026,832	**$872,467**
20	$38,292,904	$51,445,493	$89,738,397	$26,752,708	$61,214,498	$87,967,207	**$1,771,191**
25	$53,707,779	$52,820,450	$106,528,228	$34,223,028	$68,997,251	$103,220,280	**$3,307,949**
30	$75,327,938	$51,767,707	**$127,095,645**	$43,779,331	$77,472,632	**$121,251,963**	**$5,843,681**

Winner: *The grantor trust (Jane).*

Commentary: While the state income tax rate in Scenario 2 nearly tripled the state income tax rate in Scenario 1 (14.776% from 5%), not only do Jane and her grantor trust still win, but there is only a marginal impact on the percentage differences by which she wins. In Year 25, she passes 3.2% more wealth than John (compared to 5.1% in Scenario 1), and in Year 30, she passes 4.8% more than John (compared to 7.0% in Scenario 1).

Across all 30 years, the amounts in both the grantor trust and the non-grantor trust remain the same in Scenario 2 as in Scenario 1 (because neither trust is depleted by the state income tax). However, John's estate grows more slowly on account of his paying the state income tax on his estate assets. Jane's estate also grows more slowly – moreover, because the amount of state income tax continues to climb as the trust assets grow, her estate actually begins to deplete after Year 25. In fact, between Year 25 and Year 30, while Jane's estate is reduced by $1.1 million, her grantor trust grows by $21.6 million and the total additional wealth she transfers increases from $3.3 million to $5.8 million.

So, even in the later years when the higher state income tax is affecting her most (indeed, the cost of the trust appreciation overcame the growth in her own estate, causing it to reduce), she still increased by 77% the advantage of the grantor trust over the non-grantor trust. Again, as in Scenario 1, this is due to (1) the grantor trust growing at greater rates than the non-grantor trust and (2) Jane's grantor trust reducing the overall family wealth subject to the estate tax.

Finally, when factoring in the GST benefits, Jane saves $10.3 million in GST tax in Year 30 in Scenario 2, compared to $8.6 million in Scenario 1 – the GST benefit to the grantor trust actually grew as the state tax rate increased. This is because Jane's estate was reduced due to the higher taxes, exposing less overall family wealth to the GST tax.

Could Increasing the State Tax Rate Even More Make the Non-Grantor Trust Win?

The threshold state income tax rate at which the non-grantor trust outperforms the grantor trust depends on the time horizon. This is due in part to the fact that while the state income tax depletes Jane's estate, it also slows the growth in John's estate. At the same time, the state income tax has no impact on the growth in either of the trusts (neither of which pay the state income tax). Because the grantor trust compounds at a higher rate of return than the non-grantor trust, this threshold for the state income tax rate continues to increase over time.

For example, the non-grantor trust wins at the following state income tax rates for certain time periods, based on the numbers for Scenario 2:

- At 21.0%, the non-grantor trust wins in Year 1, but the grantor trust wins each year thereafter.
- At 21.6%, the non-grantor trust wins through Year 10, but the grantor trust wins each year thereafter.
- At 25.7%, the non-grantor trust wins through Year 20, but the grantor trust wins each year thereafter.

Take-Away: Because paying the state income tax allows more wealth to escape federal estate tax and exposes more wealth to the higher rate of return in the grantor trust, a grantor trust can preserve more overall wealth compared to a non-grantor trust even at very high state income tax rates.

Scenario 3: ***Greater rate of return for trust assets than estate assets***

Generally, there may be a greater appetite for risk when investing assets in an irrevocable trust than assets held in a settlor's estate. This is especially true when the investment horizon is long because beneficiaries are young or the assets are not intended to be used in the near term (e.g., less current need for access to the funds), and when the initial funding amount is greater than $10-15 million (e.g., when fees are reasonably low and the trust can qualify for higher-returning financial products). Thus, how does a grantor trust compare to a non-grantor trust when the trust's rate of return for appreciating assets is higher than those held in the settlor's estate?

This scenario is the same as Scenario 1, with the following modification:

- The trust assets have higher appreciation rates (8%) than estate assets (5%). There is no change in the income rate (2% for both trusts and estates).

Table 3: Grantor vs Non-Grantor Trust Summary of Total Wealth

Year	Jane's Trust (Grantor)	Jane's Estate	Jane's Total Passed Wealth	John's Trust (Non-Grantor)	John's Estate	John's Total Passed Wealth	Additional Wealth (Grantor Trust)
5	$15,854,524	$42,140,285	$57,994,809	$14,261,210	$43,226,531	$57,487,741	**$507,068**
10	$25,526,039	$47,897,838	$73,423,877	$20,380,364	$51,227,425	$71,607,789	**$1,816,089**
15	$41,109,696	$53,268,257	$94,377,954	$29,126,537	$60,626,368	$89,752,905	**$4,625,048**
20	$66,207,570	$57,335,701	$123,543,270	$41,626,154	$71,697,955	$113,324,109	**$10,219,161**
25	$106,627,953	$58,462,796	$165,090,749	$59,489,968	$84,754,662	$144,244,630	**$20,846,119**
30	$171,725,384	$53,848,149	**$225,573,533**	$85,020,016	$100,170,002	**$185,190,018**	**$40,383,515**

Winner: *The grantor trust (Jane).*

Commentary: Unsurprisingly, when the gross rate of return increases (e.g., to 8% from 5%), the grantor trust wins by even greater margins. In Year 20, Jane passes 9.0% more wealth than John (compared to 3.6% in Scenario 1) – in fact, by Year 20, she's already surpassed the win rate she achieved after 30 years in Scenario 1 (7.0%). Then, in Year 25, she passes 14.5% more than John (compared to 5.1% in Scenario 1), and finally in Year 30, she passes 21.8% more than John (compared to 7.0% in Scenario 1).

Why is there such a difference when the appreciation rate only increased 3% (from 5% to 8%)? First, the effective rate of return in the grantor trust is even greater in Scenario 3 than in Scenario 1. In Scenario 1, the grantor trust had 1.2% additional growth rate (5% to 3.8% for the non-grantor trust). In Scenario 3, the grantor trust has 1.9% additional growth rate (8% to 6.1% for the grantor trust).

Second is the additional wealth transfer in Scenario 3 from Jane's estate to her grantor trust. John's estate is the same between Scenario 1 and Scenario 3 ($100.2 million). But Jane's estate decreases from $78.6 million to $53.8 million (thus, she paid less in overall estate tax). Some of this was due to the state tax that John's non-grantor trust avoided but which Jane paid for her trust (e.g., 5%) – but the rest was due to Jane paying the 23.8% capital gains tax for the trust from her estate (which John's non-grantor trust paid itself). Given the higher rate of return in the trusts in Scenario 3, the benefit of transferring estate assets to the trust was even more pronounced than in Scenario 1.

GST Tax Saved. Finally, the GST benefit to the grantor trust only further reinforces its advantage over the non-grantor trust. In Year 30, Jane's estate will save $18.5 million in GST tax to which John's estate is subject – when added to the other wealth transfer benefits, the use of a grantor trust will have maximized Jane's wealth 40.6% over John.

Take-Away: The wealth maximization benefits of the grantor trust are significantly compounded when the trust assets have a higher rate of return than the estate assets, allowing the grantor trust to take further advantage of its ability to grow gross of income tax and shield more overall family wealth from the estate tax.

C. Scenario Take-Aways

The following are some key take-aways from the above scenarios:

- The two key drivers of wealth maximization that benefit a grantor trust over a non-grantor trust are (1) the higher net rate of return in a grantor trust on account of not paying its own income taxes, which reduces the net rate of return in a non-grantor trust, and (2) the ability for a grantor trust to shift more overall assets out of the settlor's estate, thereby escaping the estate tax.

- The higher the state income tax rate, the more muted the benefit of a grantor trust over a non-grantor trust. The state income tax must be very high (generally higher than any current state or local income tax rates) for the non-grantor trust to ultimately transfer more wealth than the grantor trust, and even then, it's only at shorter time horizons.

- When trust assets have higher rates of return than estate assets, the wealth maximization effect of a grantor trust is significantly magnified.

- When a settlor's irrevocable trust is GST exempt, there is typically a very significant GST tax savings by using a grantor trust that further compounds its advantages over a non-grantor trust.

III. Other Benefits of Grantor and Non-Grantor Trusts

There are other key differences between grantor trusts and non-grantor trusts that further tip the scale in favor of grantor trusts. Some are factors that super-charge the wealth preservation benefits of a grantor trust (Section A); some are are practical benefits that, while not directly impacting the total amount of wealth preserved, provide valuable features or flexibility when using grantor trusts (Section B); and others are tax benefits only available to non-grantor trusts, allowing non-grantor trusts to win in certain circumstances (Section C).

A. Other Factors that Supercharge the Benefits of Grantor Trusts

1. More GST Exempt Assets

As discussed above, there are significant GST tax advantages to using a grantor trust. A grantor trust will always have more assets than a corresponding non-grantor trust under the same circumstances (because the grantor trust does not pay taxes). Therefore, when the grantor trust and non-grantor trust are GST exempt, more total family assets will be GST exempt and thus shielded from that additional 40% tax when assets are distributed to a grandchild or more remote descendant of the settlor.

2. Tax-Free Sales with Notes

A common estate planning technique available to grantor trusts is an income tax-free sale between the grantor and her grantor trust. In a third-party sale (including a sale between a non-grantor trust and its settlor), a sale is a taxable event that causes gain recognition, and if done for a note by buyer to seller, the interest paid on the note is taxable income to the seller.

However, a grantor trust is disregarded as a separate income tax entity, and the assets of the grantor trust are treated as owned by the grantor for federal income tax purposes.[17] Thus, when a grantor makes a sale to a grantor trust, the sale itself is ignored for federal income tax purposes (e.g., it is not a taxable event and there is no gain recognition). Moreover, if the grantor trust pays with a note, the interest paid on the note is tax-free income to the grantor.

This technique allows a grantor to effect an estate tax freeze – by selling an appreciating asset to her grantor trust, the grantor is transferring future appreciation on that asset (less the interest on any promissory note used to pay for it) out of her estate, tax-free.

> Ex. 3: A grantor sells stock $1 million of marketable securities to her grantor trust for a 9-year promissory note at the applicable federal rate (4.34% as of August 2024).[18] The stock appreciates to $10 million five years later. The $9 million of appreciation (less the interest payments on the note) were transferred out of her estate and to her grantor trust without incurring any gift tax.

The technique is even more powerful if the asset sold to the grantor trust receives the benefits of any market discounts for lack of control or lack of marketability. While this can be done with a non-grantor trust, gains are triggered upon the sale and the interest is taxable to the settlor.

Finally, the technique is particularly useful when a grantor has run out of GST exemption but wants to transfer additional wealth to a GST exempt trust. By selling appreciating assets to the trust, the grantor can effectuate a wealth transfer to a GST exempt trust.

3. The Substitution Power

Another powerful tool available to grantor trusts is the ability to substitute assets in the trust for those of equivalent fair market value from the estate. The substitution power allows grantors to eliminate capital gains via basis step-up at death, utilize capital losses against other parts of their portfolio, and solve for cash flow and liquidity issues in the trust and in their own estates.

First, the grantor of a grantor trust can exercise her substitution power to swap out a low basis appreciated asset in the grantor trust with a high basis asset (such as cash) from the grantor's estate. Under Code Section 1014, all assets included in the grantor's gross estate at death receive a step-up in basis to their fair market value – transmuting that low basis asset into a high basis

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

[18] The applicable federal rate is a safe harbor which safeguards against the note being issued at too low an interest rate and thus a deemed gift.

one. By exercising the substitution power, the grantor eliminates all capital gains tax on that appreciated asset – both federal and state. This boosts the benefit of the grantor trust over the non-grantor trust.

> For example, in Scenario 3 above, Jane's grantor trust in Year 30 has $11.6 million of unrealized capital gains. If realized, the trust would owe $2.8 million in capital gains tax. However, if Jane engages in a tax-free asset swap with her grantor trust and exchanges the grantor trust's appreciated assets with full basis assets (e.g., cash), she can completely eliminate this $2.8 million capital gains tax and further improve her wealth maximization compared to John.

If a settlor does not have enough high basis assets to swap into the grantor trust, she can still benefit by selling the trust's appreciated assets before her death. Because it's a grantor trust, she will pay all of the taxes, depleting her estate (and thus avoiding estate tax on these amounts) while eliminating the appreciated gains from her grantor trust's assets.

Second, a grantor trust is more flexible with respect to built-in loss property. During a grantor's life, she can sell assets with built-in losses held by her trust and use those losses against gains from assets held by either her trust or her estate. Moreover, before the grantor dies, she can use the substitution power to move assets with built-in loss out of her estate and into her grantor trust. If a settlor dies with built-in loss property in her estate, the economic value of such built-in loss is lost when the basis is adjusted to fair market value under Code Section 1014. However, if those assets are held in her grantor trust, the trust will continue to hold such built-in loss property and can benefit from the value of such losses upon liquidation.

Finally, the substitution power can be used to reconfigure the portfolio of the grantor trust and the grantor's estate without triggering any recognition events. The substitution power can be used to diversify assets, to shift income-producing assets into or out of the grantor trust, and to access liquid assets in either the trust or the grantor's estate, all without triggering income taxes.

4. Avoid the NIIT

The NIIT is a 3.8% tax that applies to the net investment income[19] of individuals, estates and trusts. If the grantor of a grantor trust materially participates in a business activity, the income from such activity is exempt from the NIIT (effectively attributing the grantor's activities to the grantor trust). However, the IRS has held that for non-grantor trusts, the trust may only be attributed the activities of a trustee acting in their fiduciary capacity.[20] Many settlors who are transferring interests in a business in which he or she would be treated as materially participating

---

[19] Generally, net investment income includes interest, dividends, annuities, royalties and rents not derived from a trade or business; income in a trade or business which is a passive activity or trading in financial instruments or commodities; net gains from the disposition of stocks, bonds, mutual funds, and real estate (if not held in a trade or business); and net gain from the sale of passive partnership interests.

[20] See, e.g., TAM 201317010.

want other grantor trust features (such as the substitution power) with respect to their business interests, making this exemption more readily applicable in grantor trusts.

5. Occasionally Subject to Less Tax

Since grantor trusts are disregarded entities from their grantors, they use the individual tax brackets when calculating their tax liabilities. However, non-grantor trusts use the brackets for estates and trusts, which reach the highest tax rate much more quickly than the individual tax brackets do. It is thus possible for the taxes paid on account of a grantor trust to be less than the taxes paid by a non-grantor trust.

> Ex. 4: The settlor of an irrevocable trust has no personal income – her trust alone is the only source of taxable income. If the trust generates $750,000 in taxable income a year, then if the trust is (i) a non-grantor trust, the trust would pay $275,535.50 in federal income tax, and (ii) a grantor trust, the grantor would pay only $235,687.75 in federal income tax, a difference of almost $40,000.

In this example, if the settlor lives in a no-tax state or low-tax state, she'll pay less tax using a grantor trust than a non-grantor trust.[21]

B. Non-Tax Practical Benefits of Grantor Trusts

1. Spouse as Beneficiary and as Trustee

First, a grantor trust can more easily accommodate a grantor's spouse as a beneficiary. Code Section 677 provides that if income can be distributed or accumulated for future distribution to a grantor or the grantor's spouse without the approval or consent of an adverse party, such trust is a grantor trust. Such trusts are sometimes referred to as spousal lifetime access trusts ("SLATs").

When structured as a non-grantor trust, a spousal lifetime access non-grantor trust ("SLANT") requires that distributions to the spouse have the approval of an adverse party (e.g., another beneficiary of the trust, such as the grantor's child). These are obviously more difficult to administer and structure: the spouse cannot serve as trustee to make any distributions to herself, beneficiary consent is required for all distributions to the spouse, and consent of a distribution to the spouse by a beneficiary might be treated as a gift by the beneficiary.

Second, a grantor's spouse can serve as trustee of a grantor trust but cannot be a trustee of a non-grantor trust – Code Section 674(d) provides that if a spouse can distribute, apportion or accumulate income to or for a beneficiary or beneficiaries, the trust is treated as a grantor trust.

[21] If she lives in a high tax jurisdiction (like New York City), she would pay an additional $77,921.10 in tax, then making the grantor trust less tax-efficient than the non-grantor trust.

2. Adding Beneficiaries

The power to add beneficiaries after the creation of the trust is flexible tool, particularly when designing trusts to avoid the reciprocal trust doctrine.[22] This can be used to add a spouse, parent, sibling or even charities as a beneficiary of the trust.

In practice, non-grantor trusts generally will not include this power. Under Code Section 674, unless a settlor structures the trust to provide that all distribution decisions are approved or consented to by a beneficiary of the trust, a non-grantor trust cannot include powers to add beneficiaries without running afoul of the grantor trust rules.

3. Hit Goals and Access Funds Sooner

Because the grantor trust appreciates faster than a non-grantor trust (because it doesn't bear income taxes), wealth goals are hit sooner and funds in the trust are available at an earlier date to the grantor's descendants. If the goal for family wealth is met, the grantor can revise their estate plan to meet their philanthropic goals, leaving their estate to charity without paying the estate tax and thus maximizing the overall wealth transfer.

4. Borrowing and Lending Assets

Grantor trusts also provide the flexibility of allowing grantors to borrow assets from and lend assets to their own grantor trusts without triggering income tax on the interest. The ability to borrow and lend tax-free means that a grantor can provide needed cash flow to a grantor trust (such as to fund insurance premiums, capital commitments for the trust's private equity investments or to meet other obligations without liquidating existing assets) and can use a trust to ease personal liquidity issues without incurring a tax cost.

5. Use Income for Life Insurance Premiums

A grantor trust can use trust income to pay for the premiums on insurance on the life of the grantor or the grantor's spouse. Code Section 677 provides that a trust "whose income without the approval or consent of any adverse party is, or in the discretion of the grantor or a nonadverse party, may be…applied to the payment of premiums on policies of insurance on the life of the grantor or the grantor's spouse" is a grantor trust. While it's possible to structure a non-grantor trust to avoid the application of Section 677 (e.g., have a current income beneficiary who is not a beneficiary for purposes of the insurance proceeds consent to the use of the trust's income to pay insurance premiums), most practitioners will structure trusts intended to hold life insurance as grantor trusts.

[22] The reciprocal trust doctrine provides that where interrelated trusts are created by two or more settlors and the arrangement leaves the settlors in approximately the same economic position as they would have been had they created trusts naming themselves as beneficiaries, a court can unwind the trusts (resulting in inclusion in the settlors' gross estates of the property they sought to leave in trust). See *United States v. Grace*, 395 U.S. 316 (1969); see also *Lehman v. Commissioner*, 109 F.2d 99 (2d Cir. 1940).

6. Holding S-Corp Stock

It is generally more advantageous to hold S-corporation stock in a grantor trust than in a non-grantor trust. Grantor trusts are permitted shareholders under Code Section 1361, so long as the grantor is an eligible shareholder. However, non-grantor trusts need to qualify as qualified subchapter S trusts ("QSSTs") or electing small business trusts ("ESBTs") in order to qualify as a permitted shareholder. Both of these options have practical limitations: QSSTs can only have one beneficiary, have mandatory income distributions, and require the beneficiary to be treated as owner of the portion of the trust holding the S-corporation stock (negating the benefit of a non-grantor trust), and ESBTs typically have higher taxes on their income due to complex rules for how its income is to be treated as compared to a grantor trust. Given these limitations (and the negation of non-grantor trust status in some respects), S-corporation stock is typically more easily managed in a grantor trust.

7. No Trust Income Tax Returns

As the items of income, deduction and credit for a grantor trust are reported on the grantor's federal income tax return, a grantor trust does not file a separate tax return on its behalf. Since a non-grantor trust is its own taxpayer, it files its own tax return (both a federal return and state returns for each state which imposes a return filing obligation on the non-grantor trust). This results in more administrative cost and burden for a non-grantor trust as opposed to a grantor trust.

8. Voting Certain Corporate Stock

A further benefit to grantor trusts is the ability for the grantor to contribute the stock of a closely held corporation whose stock the grantor intends to continue to vote. Code Section 675 provides that a grantor is treated as owner of any portion of a trust in which a power of administration is exercisable in a nonfiduciary capacity without the consent or approval of a person in a fiduciary capacity, and a power of administration includes the power to vote or direct voting of stock of a corporation (or to sell or invest such stock) in which the holdings of the grantor and the trust are significant from the viewpoint of voting control. Treas. Regs. Section 1.675-1(b)(4)(iii) specifies that while a power exercised by a trustee is presumed to be exercisable in a fiduciary capacity primarily in the interests of the beneficiaries, the presumption can be rebutted; furthermore, the determination of whether a power is exercisable in a fiduciary or nonfiduciary capacity is based on the terms of the trust and the circumstances surrounding its creation and administration. A settlor serving as the investment trustee should typically be considered a fiduciary with respect to the exercise of such voting and investment powers, but it is not definitive; moreover, the Court has previously held that a non-fiduciary grantor was controlling the trust's investment decisions when the grantor's advice on hiring and firing advisers was always followed.[23]

Thus, whenever a grantor intends to gift stock which represents significant voting control in a corporation, there is a risk such trust may be treated as a grantor trust based on the actual administration of the trust with respect to such stock. While controlling 20% or more of the vote

[23] See, e.g., *Stern v. Commissioner*, 747 F.2d 555 (9th Cir. 1984).

in a company can result in inclusion of such stock in the settlor's gross estate,[24] less than 20% could still represent significant voting control for purposes of the grantor trust rules.

C. Additional Tax Benefits Available to Non-Grantor Trusts

1. Save Money Today

Some settlors prefer to save money today by avoiding the state income tax than potentially saving money down the line on estate taxes. The tax rules that benefit grantor trusts may change in the future – the estate tax and GST tax could be repealed, or their exemptions could be greatly increased. Furthermore, many settlors prefer the comfort of knowing they have access to the wealth they've generated rather than potentially giving way more than they could afford to part with.

2. No Mandatory Future Payments

A settlor is obligated to pay the federal and state income taxes on behalf of her grantor trust. Some settlors know the amount they want to give away and do not want to be obligated to pay future taxes on behalf of their irrevocable trust. Such settlors feel that the amount in their irrevocable trust is the "right" amount (either currently or accounting for future appreciation), and they have other wealth planning goals, such as giving to other beneficiaries or to charity, that they would rather meet. For these settlors, a non-grantor trust is preferable.

3. Expanded Charitable Deductions

While the charitable deductions for an individual taxpayer (such as the grantor of a grantor trust) are governed by Code Section 170, the charitable deductions for a non-grantor trust are governed by Section 642. Under Section 170, the deduction for charitable contributions is limited to certain percentages of a taxpayer's adjusted gross income depending on the type of charitable recipient and the type of property contributed (e.g., cash contributions are generally at 60% of AGI, while contributing appreciated assets is limited to 30% of AGI). However, under Section 642, a non-grantor trust is allowed an unlimited deduction against its taxable income for charitable contributions made during the year. Furthermore, while Section 170 disallows the deduction if a taxpayer contributes to a non-US charity, Section 642 permits deductions for contributions to non-US charities. Therefore, to the extent a settlor wants no limit on the amount of charitable deductions which can reduce taxable income or desires to contribute to non-US charities, a non-grantor trust can be more favorable than a grantor trust.

4. Qualified Small Business Stock

A non-grantor trust is its ability to make use of the $10 million exclusion with respect to qualified small business stock ("QSBS"). Generally, Code Section 1202 provides that if a taxpayer holds stock that is (1) directly issued from a domestic C-corporation, (2) issued after

[24] If the grantor votes stock in a controlled corporation (e.g., grantor had the right to vote stock possessing at least 20% of the total combined voting power of all classes of stock), such stock held by her irrevocable trust will be included in her gross estate under Code Section 2036(b).

August 10, 1993, (3) issued when the business was a qualified small business, (4) issued when the gross assets of the corporation did not exceed $50 million, and (5) held for 5 years, then such taxpayer can exclude 100% of the gain (up to the greater of $10 million or 10 times the basis of the stock). The five-year holding period for QSBS includes the time such stock was held by a prior owner if the stock was transferred by gift or upon death, which makes QSBS an attractive asset for gifting to an irrevocable trust.

A non-grantor trust is treated as its own taxpayer, permitting a settlor to create multiple non-grantor trusts for different beneficiaries, each of which can benefit from up to $10 million in gain exclusion with respect to QSBS that the trusts own.

> Ex. 5: Jane owns $1 million of stock in Acme Corp, a startup she founded whose stock qualifies as QSBS. Jane anticipates the stock will highly appreciate in the future (e.g., up to $50 million). If Jane were to sell such stock herself at that time, she would be able to exempt $10 million of the $50 million from gain, but she would incur capital gains taxes on the remaining $40 million. Instead, Jane creates separate non-grantor trusts for the benefit of each of her four children, and she contributes 20% of her stock to each non-grantor trust. When the stock later appreciates to $50 million ($10 million in Jane's estate and $10 million in each non-grantor trust), they all can sell their stock and benefit from individual $10 million exemptions, resulting in no capital gains being paid on the full $50 million of QSBS.

The primary risk is whether the trusts run afoul of the multiple trust rule in Code Section 643. Treas. Regs. Section 1.643-1(f)(1) provides that "two or more trusts will be aggregated and treated as a single trust if such trusts have substantially the same grantor or grantors and substantially the same primary beneficiary or beneficiaries, and if a principal purpose for establishing one or more of such trusts or for contributing additional cash or other property to such trusts is the avoidance of Federal income tax." If care is taken to avoid the application of the multiple trust rule, a settlor can take advantage of multiple exemptions and transfer significantly more wealth to her family. In the example above, so long as the non-grantor trusts were created for purposes other than avoidance of income tax (e.g., one non-grantor trust per family line to facilitate generational wealth transfers and equally distribute wealth among Jane's four children), they may be able to individually take advantage of the QSBS exemption and completely eliminate the capital gains on the stock.

5. <u>Section 199A Deductions</u>

Under Code Section 199A, individual taxpayers (including non-grantor trusts) receive a deduction equal to the lesser of the taxpayer's combined qualified business income amount[25] or 20% of the excess of their taxable income over their net capital gain. The combined qualified business income amount is the sum of certain amounts from each qualified trade or business and 20% of the amount of qualified real estate investment trust dividends and qualified publicly traded partnership income. The amounts with respect to qualified trades or businesses is the

---

[25] The qualified business income amount is the sum of 20% of the taxpayer's qualified business income from each qualified trade or business and 20% of the amount of qualified real estate investment trust dividends and qualified publicly traded partnership income.

lessor of (i) 20% of the qualified business income and (ii) the greater of 50% of the W-2 wages and 25% of the W-2 wages plus 2.5% of the unadjusted basis of qualified property used in the trade or business; however, if a taxpayer's income does not exceed the threshold amount under Section 199A, then prong (ii) is ignored and such amounts are always 20% of the qualified business income.

Thus, if a settlor's income (or a single non-grantor trust's income) exceeds the threshold amount, and if the qualified trade or business does not pay sufficiently high W-2 wages, then the settlor can achieve a greater tax benefit from the Section 199A deduction by dividing the income subject to the Section 199A deduction between multiple non-grantor trusts. In doing so, the settlor can lower the threshold income of each trust such that the trust can benefit from the better Section 199A deduction formula and achieve greater tax savings than a single trust could have alone. However, the same Section 643 multiple trust rules apply – if the trusts are formed solely for the purpose of making use of the Section 199A deduction, the settlor risks the IRS not respecting the multiple trusts as separate taxpayers for these purposes.

6. SALT Deductions

Under Code Section 164, state and local real property taxes, personal property taxes, and income taxes paid by a taxpayer can be deducted from such taxpayer's taxable income for federal income tax purposes (the "SALT deduction"). However, the Tax Cuts and Jobs Act of 2017 limited the SALT deduction to $10,000 per taxpayer per year through December 31, 2025. Thus, much like the exemption for QSBS and the Section 199A deduction, there is an opportunity for a settlor to divide income-generating assets between multiple non-grantor trusts such that each can take advantage of the $10,000 SALT deduction with respect to the state and local taxes paid by the non-grantor trust (e.g., property taxes on rent-producing real estate).

However, given the limit on the SALT deduction expires at the end of 2025, and given the potential tax ramifications of transferring property out of a non-grantor trust (e.g., by taxable sale to the settlor), settlors may prefer to see how Congress approaches the sunset of the TCJA before structuring multiple non-grantor trusts to take advantage of this particular deduction. (And as noted above, if the primary purpose of the multiple non-grantor trusts is to avoid federal income tax, the IRS can ignore such trusts under the Section 643 multiple trusts rule.)

D. The Benefits of Using Both Grantor and Non-Grantor Trusts

Settling an irrevocable trust does not set in stone the choice of grantor trust or non-grantor trust. Grantor trusts can often be converted into non-grantor trusts by eliminating the powers or features which trigged grantor trust status under Code Sections 671 – 679 (e.g., releasing the swap power, removing a spouse as a beneficiary, changing trustees). Non-grantor trusts can likewise often be converted into grantor trusts with respect to the settlor or with respect to one of its beneficiaries (e.g., by granting withdrawal powers which trigger Section 678).[26] Decanting a

[26] Non-grantor trusts in which a beneficiary has a Section 678 withdrawal power (causing the beneficiary to be treated as the grantor of the trust) are known as beneficiary deemed owner trusts, or "BDOTs." BDOTs allow a

trust can also toggle grantor or non-grantor status, depending on the trust instrument and the relevant decanting statute. These various conversion techniques, and the federal income tax, gift tax, estate tax and GST tax implications of such conversions, are beyond the scope of these materials.

However, we include mention of such conversions to underscore that settlors may benefit from using grantor trust status for certain periods of the trust's life and non-grantor trust status at other times. For example, a settlor may initially establish a grantor trust and continue to pay its income taxes until sufficient wealth has been generated for her family inside the trust, at which point she releases the powers which cause it to be treated as a grantor trust and thereafter allows the trust (now a non-grantor trust) to pay its own taxes.

Finally, grantor trusts may also include tax reimbursement provisions whereby such trusts can reimburse the grantor for some or all of the income taxes paid by the grantor on the trust's behalf. While the grantor may still be paying more tax overall on account of the state income tax, reimbursement for taxes from her grantor trust can ease cash flow or liquidity issues, especially in years with unexpectedly high tax bills (e.g., on account of a liquidation event in the grantor trust). In practice, trustees should avoid frequent or regular exercise of such power to avoid potential challenge by the IRS – while the discretionary exercise of a tax reimbursement power does not result in gross estate inclusion of such trust's assets, inclusion is caused by an express or implied understanding that they will do so.[27]

IV. Conclusion

In most scenarios, a grantor trust will maximize the most total wealth for most high-net-worth families. However, specific preferences, goals, and portfolios can all shift the equation in favor of non-grantor trusts, either at the time a trust is settled or over time as a settlor's circumstances evolve.

Whether a grantor or non-grantor trust is more appropriate for a particular client depends on the myriad of factors discussed above, including:

The amount of the assets in the settlor's estate and in her trust;

The federal income tax and state income tax rates applicable to the settlor and her trust;

The estate tax and GST tax rates and the availability of exemption from such taxes;

The rate of return for capital and income, both in the trust and in the estate;

beneficiary to pay the trust's income taxes and thus grow the trust for future generations, which is useful in the context of dynasty trusts.

[27] See, e.g., Rev. Rul. 2004-64. A power which is always exercised to reimburse the grantor for income taxes paid may not be treated as a discretionary power.

The applicability of the NIIT (for trust assets) and throwback taxes (for trust beneficiaries);

The existing and future appreciated gains for trust assets and the techniques available for avoiding realization;

The non-tax practical considerations (e.g., spouse as beneficiary or trustee, ability to add beneficiaries, access to and use of funds, trust tax returns, and dispositive and investment powers);

The settlor's preferences for current savings and maximizing wealth for family beneficiaries versus others (such as charity); and

The availability of specific tax exclusions or deductions, such as for QSBS, Section 199A, SALT, or expanded charitable contributions.

© 2024 Kirkland & Ellis LLP. All rights reserved.