

GRANTOR TRUSTS PLUS! (AGAIN?!)

October 2025

I. INTRODUCTION TO GRANTOR TRUSTS

- A. Brief background: The concept of a “grantor trust” is one that is derived from the federal tax code, although you will not find the term “grantor trust” anywhere in the Internal Revenue Code (“IRC” or “Code”) or the income tax regulations issued under the Code.
- B. A “grantor trust” is a trust in which the grantor (or some other person) retains control over the trust to such an extent that the grantor (or such other person), rather than the fiduciary or beneficiary, is treated as the “owner” of all or part of the trust, and is therefore taxed directly on all or part of the income and/or other tax attributes of the trust.
1. Pennsylvania now recognizes Grantor Trusts – Pennsylvania Senate Bill 815 aligned PA with federal treatment of grantor trusts. Starting in this 2025 tax year, grantor trust income can be taxed to the owner for both State and Federal purposes.

<https://www.palegis.us/legislation/bills/2023/sb815>
- C. Ownership of the trust can be by percentage, by specific asset, or by type of income (ordinary income or capital gains). More to come on this later.
- D. In the case of a grantor trust, the trust’s separate legal existence is disregarded altogether. The trust’s income, deductions and other tax items are imputed directly to the grantor as if the trust did not even exist.
- E. A “grantor trust” can be either revocable or irrevocable. All revocable trusts are grantor trusts, but not all grantor trusts are revocable trusts. With irrevocable trusts, it can be challenging to determine whether the trust is a grantor trust, a non-grantor trust, or partially both. Irrevocable trusts can be created so they are recognized for federal estate tax and other purposes, but not for federal income tax purposes.

- F. History of Grantor Trusts. The grantor trust rules were first developed in the late 1960s in order to thwart taxpayers' use of trusts to shift income into lower tax brackets. At the time the grantor trust rules were first developed, trust income tax rates graduated at the same rate as individual income tax rates, and so it made sense for wealthy grantors to fund trusts that benefited their descendants solely for the purpose of utilizing the lower income tax rates that applied to the trusts. It was also possible to transfer assets to a trust for a number of years and have those assets revert back to the grantor after that time had passed.
- G. The combination of those circumstances made it possible for wealthy individuals to establish multiple trusts to benefit other family members (such as children or grandchildren), who were taxed at a lower tax rates during that time, and then ultimately have the trust assets revert back to the grantor afterward. That was perceived by some as an abuse of the tax rules then in existence, and so the grantor rules were developed to combat that perceived abuse by tracing the income generated by the trust assets back to the grantor in those circumstances where the grantor retained too much control over or rights to the property or income of the trust.
- H. As part of the Tax Reform Act of 1986, the income tax rates applicable to trust were revised. Under the law in effect today, the trust income tax rates graduate much more quickly than individual income tax rates. A trust therefore does not have to have very much taxable income before it reaches the top marginal tax rates (37% for income over \$15,650). Because of this fact, trusts are not a useful tool for shifting income into lower tax brackets. Therefore, the original rationale for the grantor trust rules for the most part no longer applies; but the grantor trust rules nevertheless remain a part of the Internal Revenue Code today largely for historical reasons.
- I. Key concepts: this is a type of "look-through" trust which is (generally) not taxed as its own entity. The individual (usually, the grantor, but sometimes someone else) is treated as the owner of the income of the trust.
- J. Where we commonly use grantor trusts – asset protection planning where grantor wants to retain control and ownership and the tax treatment is just the result of the plan; estate and gift tax planning where the grantor can pay the income tax liability of assets gifted to others without incurring gift tax; or income tax planning where we don't want to incur the higher trust rates, but don't want to distribute income to the beneficiary.
1. **ASSET PROTECTION PURPOSES:** Often a wealthy individual may wish to make gifts to children or other family members, but they may not want to give cash or other valuable assets directly to those family members, perhaps because of their age and immaturity, perhaps because they're not good at handling money, or possibly for other reasons. The donor may therefore decide to instead give the funds to a trustee to

manage for the benefit of the intended beneficiary as a means of protecting the assets from the *beneficiary*.

Alternatively, families might use Grantor Trusts for asset protection from *creditors*, such as Medicaid. Placing assets into a Grantor Trust allows the grantor to maintain significant control and flexibility over the trust, while excluding the assets from Medicaid estate recovery.

2. ESTATE / GIFT PLANNING: Grantor trusts are often used as means to enhance the value of a gift to a beneficiary even beyond the value of the item given. This is sometimes referred to as “leveraging” the gift. If a donor creates a trust to benefit an individual (the beneficiary) and if the trust never has to pay tax on the income earned on the entrusted funds, then the gift to the trust has a value to the beneficiary that is even greater than its dollar value at the time of the gift. The grantor is treated as the owner of the entrusted assets, and he/she therefore has to pay the tax on any income generated on the trust assets. The grantor is in effect making “an additional gift” each year to the beneficiary in the amount of the taxes paid by the grantor on the trust income. The accumulated trust income will ultimately be distributable to the beneficiary free of tax, even though the beneficiary never had to pay tax on that income. However, the payment of the tax is not treated as a gift for gift tax purposes
3. INCOME TAX PURPOSES: If the trust is recognized for tax purposes as a separate taxpaying entity, it will often prove to be disadvantageous from a tax standpoint because of the compressed tax bracket structure applicable to trusts for federal income tax purposes. For that reason, the donor may wish to structure the trust as a grantor trust for federal tax purposes, so that the trust’s income can be taxed to the grantor (or possibly to the beneficiary) if the marginal tax rate applicable to the grantor is lower than that of the trust, as it often will be.

In conclusion, although the purpose of grantor trusts has shifted over time, they are extremely useful and applicable in many situations, depending on the goals, assets, and family situation of the clients.

II. SPOTTING A GRANTOR TRUST / REVIEW OF GRANTOR TRUST RULES AND TRIGGERS

- A. Basic rule = §671 sets forth the basic rule that if the grantor (or another person) is treated as the owner of any part of a trust under the rules set forth in §§673 through 678, then the grantor (or such other person) shall be required to take into account the income, deductions, credits, etc. of that part of the trust he is deemed to own in computing his own tax obligations.

1. This necessitates identifying who is the Grantor – more to come.
2. In most types of grantor trusts, the person who creates and funds the trust (the grantor) has retained some “strings” that cause that person (the grantor) to be treated as owning the trust assets and taxed accordingly. So, in those types of grantor trusts, it is the grantor (also sometimes called the “settlor” or “trustor”) who is subject to tax on any taxable income earned by the trust. However, if a person other than the grantor retains certain powers over the trust assets, then that person can be treated as the owner of the trust and taxed on the trust income.

B. Definitions - §672

1. Key Terms

- (a) Adverse Party – Any person who has a substantial, beneficial interest in the trust that would be adversely affected by the exercise or nonexercised of the power held by the grantor or nonadverse party.
- (b) Nonadverse Party – Any person who is not an adverse party.
- (c) Related or Subordinate – A nonadverse party who is the Grantor’s:
 - (i) Spouse
 - (ii) Parent
 - (iii) Issue
 - (iv) Sibling (including half-sibling)
 - (v) Employee (of Grantor of company of which Grantor is significant owner or executive)
- (d) Grantor’s Spouse = Grantor. The Grantor is treated as holding any power or interest held by the Grantor’s spouse at the time of creating such power at such time the person became the Grantor’s spouse.

C. Reversionary interests = §673

1. Under IRC §673(a), a grantor is treated as the owner of trust assets if:
 - (a) The grantor (or the grantor’s spouse) retains a reversionary interest in those assets; and if

- (b) The value of the reversionary interest exceeds five percent (5%) of the value of those assets over which the reversionary interest is held.
2. The value of the reversionary interest is measured on the date that the property subject to the reversionary interest is transferred to the trust.
 3. Under IRC §7520, the reversionary interest is valued under tables issued by the IRS, based on the federal midterm interest rate in effect for the month in which the transfer is made.
 - (a) One must first determine the applicable interest rate, which is published monthly by the IRS.
 - (b) Once the interest rate is determined, you must go to the applicable IRS table, which will set forth a valuation factor, based on the prevailing interest rate and the number of years (in the case of a reversion following a term interest) or the life expectancy (in the case of a reversion following a life interest).
 - (c) The IRS has issued Table B for valuing a reversionary interest that takes effect following a term of years.
 - (d) The IRS has issued Table S for valuing a reversionary interest that takes effect on the death of some person (such as the beneficiary).
 - (e) EXAMPLE: G creates a trust that benefits his son, S, for 25 years. Under the terms of the trust, S receives income from the trust for 25 years after which the corpus reverts back to G. The transfer to the trust is made in April 2017. In April 2017, the midterm rate is 2.6%. So, one must go to Table B to value the grantor's reversionary interest because it follows a term interest. Table B reveals that, at an interest rate of 2.6%, the valuation factor for a remainder/reversionary interest following a 25-year term is 0.526400. G's reversionary interest is 52.64% of the value of the interest conveyed to the trust. So, the trust is a grantor trust as to G, based on IRC §673(a).
 4. Exception to interests following a minor child: a grantor will not be taxed as the owner of a trust solely on the basis of a reversionary interest that takes effect upon the death of a lineal descendant (child or grandchild) before that beneficiary reaches 21 years of age.
 5. Capital gains: If a grantor retains a reversionary interest in property transferred to a trust, then he is taxed on the capital gains attributable to the reversionary interest. The capital gains are taxed to the grantor because they are deemed to be accumulated as part of the trust corpus for future distribution to the grantor.

D. Power to control beneficial enjoyment = §674

1. IRC §674(a) sets forth the general rule that “[T]he grantor shall be treated as the owner of **any portion** of a trust in respect of which the beneficial enjoyment of the corpus or the income therefrom is subject to a **power of disposition**, exercisable by the grantor or a nonadverse party, or both, **without the approval or consent of any adverse party.**”

(a) *Any Portion* – Grantor allocated income, deductions and credits only that portion of the trust of which the Grantor holds a covered power or interest. The remaining portion of the trust is taxed under the normal rules of subchapter J.

- (i) Ownership can be of either Ordinary Income (trust income = e.g. interest and dividends) or Principal Portions (trust principal = e.g. capital gains, depreciation, operating losses). Generally, the Grantor’s deductions of expenses are limited to Grantor’s income interest. However, depreciation expenses can be allocated to the income owner in excess of income interest¹.

a. For example: the grantor’s right to remain in their home causes the Grantor to be the owner of the trust asset (i.e. the home).

- (ii) Ownership of a fractional or pecuniary share of all trust income and principal: a party owns a fractional share of the trust is allocated a fractional share of income, deduction, and credit of the trust. The fraction is either expressed in the document (i.e. the right to distribute 50% of the income) or as a pecuniary amount (i.e. the right to withdraw \$5000). The fractional interest is then computed by dividing the pecuniary amount by the value of the trust corpus. The fractional ownership changes over time as the value of the trust corpus changes. Guidance on this computation is unclear.

- (iii) Ownership of all items of a specific asset: Grantor allocated all income, deductions, and credits related to specific assets of which the Grantor has ownership powers.

a. Example: Grantor contributes stock in Last Mango Stables and stock in Paradise Key Teas. Dividends of Last Mango Stables must be distributed to his children. Grantor has the discretion to distribute dividends of Paradise Key Teas to his

¹ This is the conclusion drawn from the opinion *Edgar v. Commissioner*, 56 T.C. 717 (1971).

grandchildren. Income, deductions, and credits related to Paradise Key Teas allocated is to Grantor.

- (b) *Power of disposition* – Grantor or nonadverse party has power, beyond specified limits, to dispose of the beneficial enjoyment of the income or corpus, whether the power is a fiduciary power, a power of appointment, or any other power. Tres. Reg. §1.674(a)-1.
 - (i) Grantor retained power to veto distributions: Grantor = Owner. PLR 201507008.
 - (ii) Majority of distribution committee are adverse parties: Grantor ≠ Owner. PLR 201925005.
 - (iii) Right to use trust property without adequate consideration (e.g. right to live rent free in house): Grantor = Owner. *Wesenberg v. Commissioner*, 69 T.C. 1005.
- (c) *Without adverse party approval/consent* – PLR 200247013 suggests that the addition of an adverse party's approval/consent to all 671-678 powers negates grantor trust treatment period.

2. **Exceptions** = specific powers are allowed without triggering grantor trust status. The following powers can be held by anyone, including the grantor, without causing them to be treated as the owner of the trust:

- (a) Power to Apply Income to Support a Dependent. A power to distribute trust income to support a beneficiary whom the grantor is legally obligated to support does not cause the trust to be treated as a grantor trust, except to the extent that the income is in fact used for such purpose. This exception applies even if the power is held by the grantor or the grantor's spouse. [IRC §674(b)(1).]
- (b) Power affecting Beneficial Enjoyment only after the Occurrence of an Event. A grantor will not be treated as the owner of a trust based on a power to affect beneficial enjoyment of the trust if that power is not exercisable for a long enough time period such that, had the postponed power been a reversionary interest, it would not have triggered grantor trust status under IRC §673. Thus, a power to control beneficial enjoyment does not trigger grantor trust status if it cannot be exercised by the grantor (or a non-adverse party) for a period of time that, if the power had been a reversionary interest, it would have a value of less than five percent (5%) of the trust. To determine whether this criterion is met, it is necessary to determine the prevailing interest rate, and then go to the applicable IRS Tables under the regulations. However, after the stated event has occurred (e.g. expiration of a stated time) and the power

becomes immediately exercisable, the grantor will be treated as the owner unless he relinquishes the power earlier. [IRC §674(B)(2).]

- (c) Power Exercisable only by Will. A grantor will not be treated as the owner of a trust income based on a power to affect beneficial enjoyment if the power is exercisable only by Will, except for a power to appoint accumulated trust income by Will if the trust provides for the mandatory or discretionary accumulation of trust income by the grantor or a non-adverse party. [IRC §674(b)(3).]
- (d) Power to Allocate Among Charitable Beneficiaries. A grantor will not be treated as the owner of a trust based on a power to determine the beneficial enjoyment of the trust corpus or income if the corpus or income is irrevocably payable for a charitable purpose as defined in IRC §170(c). [IRC §674(b)(4).]
- (e) Power to Distribute Corpus Limited by a Standard. A grantor will not be treated as the owner of a trust based on a power to distribute corpus to beneficiaries if the grantor's power to distribute the corpus is subject to a *reasonably definite standard* which is set forth in the trust instrument. [IRC §674(b)(5).]
 - (i) Example: power to distribute corpus for the "health, education, maintenance or support" of the beneficiary is subject to a reasonably definite standard. So is "reasonable support and comfort" and maintain an accustomed standard of living".
 - (ii) However, power to distribute corpus for the "pleasure", "desire" or "happiness" of the beneficiary is not limited by a reasonable definite standard.
 - (iii) Sometimes referred to as HEMS powers, these terms are very common in trust agreements. The primary purpose is usually to maintain a beneficiary's standard of living and the reasonably definite standard is very similar to the ascertainable standard found in the gift and estate tax sections of the Code (IRC §§2041 and 2514). However:
 - a. An additional qualifier is found in the regulations that requires that "the entire context of a provision of a trust instrument granting a power must be considered in determining whether the power is limited to a reasonably definite standard" and that it must be a "clearly measurable standard under which the holder of a power is legally accountable". If the trust agreement states that the trustee has the sole

and absolute discretion to exercise or not exercise the power, the power is not limited to a reasonably definite standard.

- b. Unlike the ascertainable standard for estate and gift taxes, the standard cannot be implied by state law, it must be set forth in the trust agreement.
- (f) Power to Distribute as an Advancement. The Power to distribute corpus from a Trust that reduces the beneficiaries share of the corpus (i.e. treated as an advancement), does not trigger grantor trust status. [IRC §674(b)(5).]
- (g) Power to Withhold Income Temporarily, or during Minority or Disability.
- (i) A grantor will not be treated as the owner of a trust based on a power to distribute or apply income to any current beneficiary or to accumulate the income if the accumulated income must ultimately be paid to one of the following: The beneficiary from whom the income was withheld; The beneficiary's estate; The beneficiary's appointees; or The current income beneficiaries in shares fixed by the trust instrument. [IRC §674(b)(6).]
 - (ii) A grantor will not be treated as the owner of a trust merely because the grantor (or a non-adverse party) holds a power to distribute income or to accumulate income and add it to principal during a time when the income beneficiary is under 21 years of age or is under a legal disability. Income withheld during such periods need not ultimately be payable to the income beneficiary or his or her estate.
- (h) Power to allocate between Corpus and Income. This gives the grantor significant ability to alter beneficial interest of the income and principal beneficiaries. Care should be given to allowing the Grantor to exercise this power in a nonfiduciary capacity.
- (i) Powers exempt ONLY for an Independent Trustee: IRC §674(c) enumerates powers that will not trigger grantor trust status if they are held by an independent trustee. An independent trustee may be given fairly broad powers over beneficial enjoyment without causing the grantor to be treated as the owner. Examples:
- (i) Power to distribute, apportion, or accumulate income to or for a beneficiary or beneficiaries;
 - (ii) Power to invade corpus for specified beneficiaries;

- (iii) Power to allocate income limited by a standard: a trustee who is not the Grantor or Grantor's spouse can distribute, apportion, or accumulate income without causing the Grantor to be taxable as the trust's owner, provided that trust document provides a reasonably definite external standard of doing so.
 - a. This is different than the exception in 674(c), because neither the Grantor nor the Grantor's spouse can possess this power. A nonadverse, related or subordinate person can possess this power.
- (iv) For determining grantor trust status, the Grantor is deemed to have the powers of a Trustee the Grantor or Grantor's spouse can appoint: §1.674(d)-2

E. Administrative Powers = §675

1. General rule: The grantor is treated as the owner of a trust if he possesses certain administrative powers which are exercisable for his benefit rather than the beneficiaries. The existence of such powers may be determined either from the wording of the trust instrument or from the way in which the trust is actually operated.
2. There are four main categories of such administrative powers:
 - (a) Power to deal with trust property for less than adequate consideration = IRC §675(1)
 - (b) Power to borrow from the trust without adequate interest or security = IRC 675(2)
 - (c) Actual borrowing by the Grantor - The grantor will be treated as the owner of a trust in which the grantor (or the grantor's spouse) has borrowed from the trust and has not repaid the loan in full (including interest) prior to the beginning of the year
 - (d) Certain other powers that may be exercised in a non-fiduciary capacity, including:
 - (i) The power to vote stock of a corporation over which the grantor (and/or the trust) has significant voting control;
 - (ii) The power to control the investment of trust corpus to the extent it involves stocks of a corporation over which the grantor (and/or the trust) have significant voting control;
OR

- (iii) The power to re-acquire corpus by substituting property of equivalent value

F. Power to revoke = §676

1. General Rule = The grantor will be treated as the owner of any part of a trust in which the grantor (or a non-adverse) party has the power to re-vest title to trust assets in the grantor. In other words, if the grantor (or a non-adverse party) has the power to revoke any part of a trust and reclaim the trust assets, then the grantor will be taxed on the trust income. [IRC §676(a).]
2. This is true even if the power of revocation is held by a person other than the grantor, UNLESS that person's interest is adverse to that of the grantor.
3. Conversely, if the grantor's power to revoke is conditioned on the consent of an adverse party, then the power will not cause the grantor to be treated as owning the trust assets. [See Reg. §1.676(a)-1.]
4. Unlimited power to "alter" or "amend" or "modify" the trust, or a power to "terminate" the trust, would likewise be viewed as effectively a power of revocation over the trust assets even if not described as such.

G. Income for the benefit of the grantor = §677

1. The grantor will be treated as the owner of any portion of a trust if the income from the trust is or may, in the discretion of the grantor (or a non-adverse party) be:
 - (a) distributed to the grantor/grantor's spouse
 - (b) accumulated for future distribution to the grantor/grantor's spouse,
 - (c) or applied to the payment of insurance policies on the life of the grantor/grantor's spouse.
2. Exception = power to distribute is conditioned on the approval of an adverse party
3. NOTE - A grantor is not treated as the owner of a trust merely because the trust income, at the discretion of the grantor (as trustee) or another person, may be used for the support of a beneficiary (other than the grantor's spouse) whom the grantor is legally obligated to support. The grantor is only taxed on the trust's income if the income is actually distributed for such purposes. [IRC §677(b).] The "support" exception does not apply if trust income is required (without any discretionary determination) to be applied to support a beneficiary whom the grantor is obligated to support.

H. Non-Grantor Owned Trusts = §678

1. Under IRC §678, a person other than the grantor of a trust (such as, for example, a trust beneficiary) will be treated as owning the trust assets if that person holds one or more of the following powers:
 - (a) The right to *unilaterally* withdraw the trust corpus or income;
 - (b) Retention of a grantor trust-type power (under IRC §§673-677) over trust assets after having released a power to withdraw trust corpus or income; OR
 - (c) The actual use of trust income to discharge the holder's legal support obligation.
2. NOTE - A beneficiary will not be treated as owning the trust under IRC §678 merely because she has the power to apply trust income to support or maintain a person whom she is already legally obligated to support, provided that the beneficiary holds that power in a fiduciary capacity. (Example: as a guardian of a ward/minor). However, if trust funds are actually used to discharge the beneficiary's legal support obligation, then the application of the trust funds for that purpose will be treated as a trust distribution to the beneficiary holding the power.
3. This is easy to understand if you view person's right to withdraw or use income as "constructive ownership" of the income or principal. In which case they are the "grantor". In other words, the IRS views a person as the owner if they own the asset or have the unrestricted right to acquire the asset. So, the IRS understands this person to have exercised their power to obtain the income/principal and then contributed the property back to the trust.
4. Where do we see this happen?
 - (a) Trusts that allow beneficiary to withdraw income or principal (e.g. 5 and 5 powers).
 - (b) Non-grantor trusts with Crummey withdrawal powers with residual grantor powers of the powerholder. *Crummey withdrawal powers give beneficiaries a temporary right to withdraw contributions made to a trust (for example, within 30-60 days). Because the beneficiary has the right to withdraw that principal, the gift is a "present interest" which allows the gift to qualify under the annual gift tax exclusion.*

5. Beneficiary Defective Inheritor's Trust (BDIT)
 - (a) The beneficiary has the power to withdraw all contributions (principal) to the Trust [678(a)(1)]
 - (b) As a practical matter, the trust is usually funded with only \$5,000 initially, because of this power to withdraw the principal
 - (c) However, the withdrawal power lapses if not exercised within a specific period
 - (d) After this period lapses, the trust has other terms which satisfy the release of power requirement [678(a)(2)]
 - (e) These can be used for "asset freezing". For example, once the BDIT is properly set up, the beneficiary can sell assets to the Trust in exchange for a promissory note. The assets can appreciate in the BDIT outside of the beneficiary's estate, but the beneficiary can still benefit from the assets.

6. Beneficiary Deemed Owner Trust (BDOT)
 - (a) The beneficiary has the power to withdraw all taxable income (including capital gains) of the Trust. Beneficiary is owner of income, deductions, and credits related to trust income and principal. IRC 678(a)(1). Some commentators argue that "income" §678 means **taxable** income.
 - (b) The initial funding is typically not limited to \$5,000 because there is no principal access for the beneficiary.
 - (c) If the beneficiary fails to withdraw the taxable income in any year, the withdrawal power lapses partially or fully.
 - (d) BDOT's have significant tax planning opportunities and, in many cases, can provide the same asset protection.

III. INCOME TAX PLANNING VERSUS ASSET PROTECTION PLANNING

- A. Why income tax mitigation frustrates asset protection, and vice versa.
 1. Income Tax Planning = the goal is often to "pass out" the taxable income to an individual rather than keep it in the trust.
 2. Asset Protection = the goal of asset protection is to keep assets in a trust and not accessible by others (sometimes including the beneficiary).

3. In order to get the best of both worlds, you need to keep the assets and income in the trust, but have the income taxed at individual income tax rates.

B. Pennsylvania Spendthrift Statute

1. *“Rights of beneficiary's creditor or assignee.* A judgment creditor or assignee of the beneficiary may reach the beneficiary's interest by attachment of present or future distributions to or for the benefit of the beneficiary or other means to the extent the beneficiary's interest is not subject to a spendthrift provision.” 20 Pa. C.S 7741.
2. *“Spendthrift Provision.*
 - (a) **Validity.** A spendthrift provision is valid only if it restrains both voluntary and involuntary transfer of a beneficiary's interest.
 - (b) **Creation.** A trust instrument providing that the interest of a beneficiary is held subject to a “spendthrift trust,” or words of similar import, is sufficient to restrain both voluntary and involuntary transfer of the beneficiary's interest.
 - (c) **Effect.** A beneficiary may not transfer an interest in a trust in violation of a valid spendthrift provision. Except as otherwise provided in this subchapter, a creditor or assignee of the beneficiary of a spendthrift trust may not reach the interest or a distribution by the trustee before its receipt by the beneficiary.” 20 Pa. C.S.A. 7742
3. *“Property subject to power of withdrawal.* Trust property that is subject to a power of withdrawal, during the period the power may be exercised and after its lapse, release or waiver, may be reached by a creditor or an assignee of the holder of the power whether or not the interest of the holder in the trust is subject to a spendthrift provision.” 20 Pa. C.S 7748.
4. *“Power of withdrawal.* The unrestricted power of a beneficiary, acting as a beneficiary and not as a trustee, to transfer to himself or herself the entire legal and beneficial interest in all or a portion of trust property. *However, a power to withdraw the greater of the amount specified in section 2041(b)(2), 2503(b) or 2514(e) of the Internal Revenue Code of 1986 (Public Law 99-514, 26 U.S.C. § 2041(b)(2), 2503(b) or 2514(e)), or any lesser amount determined by reference to one or more of these provisions, may not be treated as a power of withdrawal.*” 20 Pa. C.S 7703

5. In other words, the power of withdrawal for spendthrift exclusion does not apply to amounts that are equal to or less than the greater of:
 - (a) \$5,000
 - (b) 5% of the aggregate value of assets out of which the withdrawal could be satisfied (this includes all assets of the trust, not just the assets subject to withdrawal).
 - (c) The annual exclusion for federal gift tax (\$19,000 – 2025).
6. Case Study
 - (a) Jimmy creates a trust the gives his daughter, Delaney, the right to withdraw all trust income.
 - (i) Delaney is the owner of the trust income, but not the principal. So, interest and dividends are allocated to Delaney, but capital gains are not.
 - (b) Jimmy creates a trust and grants Savanna, Sarah, and Cameron power to withdraw trust contributions in equal amount within sixty days of the contribution. In the initial year, Jimmy contributes \$30,000. The trust provides that the Trustee can distribute to Savanna, Sarah, and Cameron for their best interest.
 - (i) Not enough information.
 - (ii) If Trustee is independent = complex trust; except income earned during the sixty days is owned equally by Savanna, Sarah, and Cameron.
 - (iii) If Trustee is Savannah's spouse = Savannah is the owner of 1/3 of the income and principal, 2/3rds of the income earned during the year and 2/3rds of the trust is a complex trust
 - (iv) Same scenario, but the power to withdraw only lapses after sixty days to the extent of \$5000 or 5% of the trust property. Savannah is still 1/3 owner of income and principal; Sarah and Cameron each own 1/6 of the income and principal and 1/3 of the trust is a complex trust.
 - (v) Same scenario, but Sarah and Cameron have 671-677 powers. Each Savanna, Sarah, and Cameron own 1/3 of the trust (income and principal).

- (c) If the beneficiary must have the power to distribute income or principal to themselves in order to have the taxable income allocated to them and if creditors can get assets and income that a beneficiary has the power to acquire, can you get the benefit of both worlds?
- (i) Jane creates two testamentary trusts: one for each of her two children: Savannah and Sarah.
 - (ii) Savannah's Trust gives her the ability to withdraw all taxable income. The right to withdraw will lapse to the extent of the greater of \$5000 and 5% of the trust balance each year.
 - (iii) Sarah's Trust requires the trustee to distribute all income to Sarah.
 - (iv) Jane dies and leaves real property (\$1,000,000), non-qualified investments (\$1,500,000) and Roth IRA (\$500,000) and Traditional IRA (\$1,000,000) to her daughter's trusts.
 - (v) Each Trust has \$1,500,000 of principal comprised of \$750,000 of inherited traditional IRA and \$750,000 of other assets. In the first year each trust receives \$75,000 IRA distribution and earns \$25,000 of interest, dividends, and capital gains.
 - (vi) Savannah is taxable on \$100,000 of income and gains. Savannah's trust has no taxable income.
 - (vii) Sarah is taxable on \$25,000. Sarah's trust is taxable on the \$75,000 IRA distribution². All of Sarah's trust assets remain protected by her trust but is reduced by \$52,750 (the \$25,000 distributed and \$27,500 tax on the trust's income).
 - (viii) Assuming Savannah is in the 25% tax bracket and exercises her withdrawal power to withdraw enough funds (\$25,000) to pay the income tax on the income she did not receive, the remaining \$75,000 remains in her trust. The amount that can lapse without being considered a taxable gift is \$76,250 (5% of the value of the trust assets: \$1,500,000 initial principal plus \$25,000 of income). Further, this amount is not considered an amount subject to withdraw

² Assumes no appreciation of the inherited traditional IRA and no allocation of the inherited traditional IRA was made from principal to income.

under Pennsylvania's spendthrift statute, so it is protected from her creditors.

- C. **Non-UTC state trust.** Several states did not adopt the Uniform Trust Code or a variation of it and have a provision that protects from creditors, the assets subject to the right to withdraw and/or the lapse of the right to withdraw.
1. Alaska, Colorado, Delaware, Indiana, Kentucky, Maryland, Oklahoma, Rhode Island, South Carolina, South Dakota, Tennessee.
 2. Must establish nexus in order to have state's trust laws apply.
 3. Nexus can be created if:
 - (a) The trustee resides in the state
 - (b) The trust assets are located in the state
 - (c) One or more beneficiaries reside in the state
 4. Clients may be hesitant to use or find trustees in other states, however, consider that some states allow the settlor or beneficiary to be an investment trustee and other involvement. Further, the settlor or a beneficiary can have the power to remove and appoint independent trustee and bring the trust back to Pennsylvania.
 5. Practical Planning:
 - (a) If the beneficiary is mature, trustworthy, not in financial jeopardy, create a BDOT with withdraw rights lapse annually to the extent of 5% of the trust. Thus, over time the entire trust is protected from creditors
 - (b) If the beneficiary is not mature or trustworthy have an independent trustee that has the power to eliminate and reinstate the power to withdraw; with the understanding that the independent trustee will eliminate the withdrawal power if the beneficiary uses the withdrawn amounts for expenses other than those related to income tax or HEMS.
 - (c) If the beneficiary is in financial jeopardy, create a trust in a more friendly jurisdiction and give the beneficiary the right to direct investments and move the trust to other jurisdictions.

IV. GRANTOR TRUST REPORTING

- A. General rule – The owner of the income is taxed on that income. How do you report this for tax purposes?

- B. Traditional reporting method = Under the traditional method of reporting, the trustee files a fiduciary income tax return (IRS Form 1041) BUT that return looks different from a normal fiduciary return.
1. The top of the return is filled out, but the lines where the income, deductions, credits, etc. would normally be reported are left blank.
 2. The items of income, deduction, and credit are shown on a separate statement attached to the tax return that:
 - (a) States that the trust is a grantor trust;
 - (b) Identifies the grantor (by name and SSN); and
 - (c) States that the various tax items are being furnished to the grantor and will be reported on the grantor's personal income return.
- C. First Alternative reporting method = The Trustee does not file a fiduciary return reporting the tax items, but instead facilitates the grantor's tax reporting by providing information to the grantor and to parties who are payors (to the trust)
1. Permitted where there is one owner of the trust; common for reporting revocable trusts; no TIN is necessary.
 2. No requirement to file a return with the IRS.
 3. First, the trustee provides the grantor's name and other identifying information (address and SSN) to all "payors" (parties that made payments to the trust during the year.
 4. Second, the trustee furnishes the grantor with a statement that:
 - (a) Informs the grantor that the information on the statement must be included in computing the grantor's taxable income and credits;
 - (b) Sets out all items of income, deduction, and credit for the trust for the taxable year;
 - (c) Identifies the payor of each item of income; and
 - (d) Provides all information that the grantor needs to compute his taxable income with respect to the trust.
 5. The Owner(s) takes this data and use it to calculate their taxable income.
- D. Second Alternative reporting method = the trustee assumes the 1099 reporting obligations of all of the various parties making payments to the trust. Trustee is required to obtain a TIN.

1. The trustee provides all payors (parties who made payments to the trust during the tax year) with the name and other identifying information (address and EIN) for the trust.
2. The trustee then files Form 1099s (showing the trust as payor and the grantor as payee) with the IRS to report each of the payments with the IRS. (Under this method, the trustee has similar obligations for filing the appropriate 1099 forms as a payor making reportable payments.)
3. The trustee must also furnish the grantor with a statement similar to the one described in Alternate Method #1.

Note – there are special requirements for tax reporting in the year of the grantor’s death, and in the year after the grantor’s death.