



***Avoiding Unintended Tax Consequences When Toggling Grantor Trust Status***



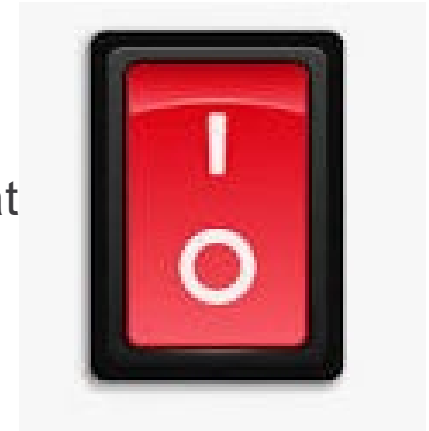
# Learning Objectives

- **Understand what a 'toggle' is and how it is achieved**
- **Understand mechanics of creating, maintaining, and terminating grantor trust status under Subpart E (IRC 671-679)**
- **Identify potential tax consequences of toggling from grantor to non-grantor status (and vice versa)**
- **Best drafting practices to ensure successful toggle and avoid inadvertent income tax status**
- **Practical tips, potential pitfalls, and alternative solutions**

# Toggle Basics

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- Trusts can be taxed in two ways, “grantor” or “non-grantor”
  - Grantor Trusts – Internal Revenue Code (IRC) 671-679
  - Non-Grantor Trusts – Own taxable entity, grantor has no beneficial interest or control
- Toggling = taking steps to convert or change the income taxation of a trust.
- This may involve release, or ‘switching off’ certain technical tax powers that trigger grantor trust status
- Any successful toggle has to be very deliberate
- Avoid traps and hidden grantor trust powers/triggers (and estate inclusion risks)



# Initial Considerations

- **Who is the Grantor?**

- IRC 678 – beneficiary or other person considered as Grantor
  - Withdrawal rights/beneficiary deemed owner trust

- **What if Husband and Wife are both Grantors?**

- Community Property states: both settlors considered the ‘owner’
  - Gifts reported as CP, not gift splits, on Form 709
  - *Example* – jointly created irrevocable life insurance trust, holds second to die policy
- Do the spouses file separate or joint income tax returns?
  - If separate, have to pro-rate and allocate the income based on contributions/ownership. See Treas. Reg. § 1.671-4(b)(8)
- On death of first Grantor, split reporting – based on pro rata share of contributions
- Divorce – also complicated in dual grantor trusts (and repeal of IRC 678 post-TCJA)

- **Practice tip:** Have each spouse be the sole settlor of a separate irrevocable trust (and transmute assets transferred to separate property)
- **Timing:** If possible, plan to toggle on the first day of the tax year (**January 1**) – for ‘clean’ calendar year reporting

# Decision Drivers for Your Toggle

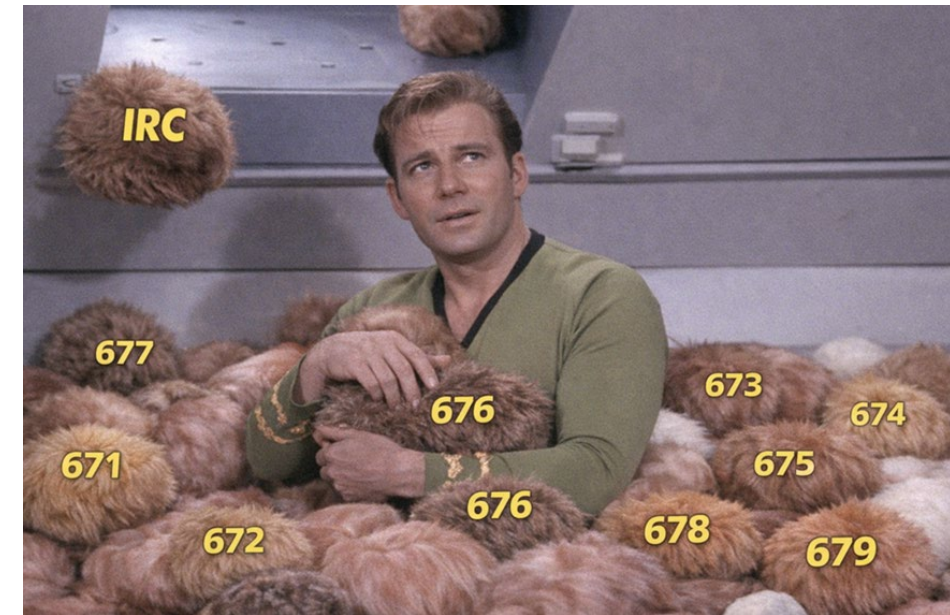
- **Grantor to Non-Grantor** (turning *off* grantor trust status)
  - Grantor not able to sustain tax burden / liquidity constraints
  - Avoid state and local income taxes. SALT deduction limitation (increased under OBBB, \$40,000 but 30% phaseout for modified AGI over \$500,000)
  - Separate taxpayer(s) desired (example, for QSBS) - but be careful about IRC 643
  - Shift income by distributing DNI to beneficiaries in lower tax brackets (and IRC 663, 65-d rule)
- **Non-Grantor to Grantor** (turning *on* grantor trust status)
  - Asset growth – faster compounding of trust assets when income taxes are paid by grantor rather than the trust
  - Additional (tax-free) gift to beneficiaries when grantor pays tax [Rev. Rule 2004-64]
  - Trust may be taxed at higher rate than grantor (trust has very compressed tax bracket)



# Grantor Trust Creation

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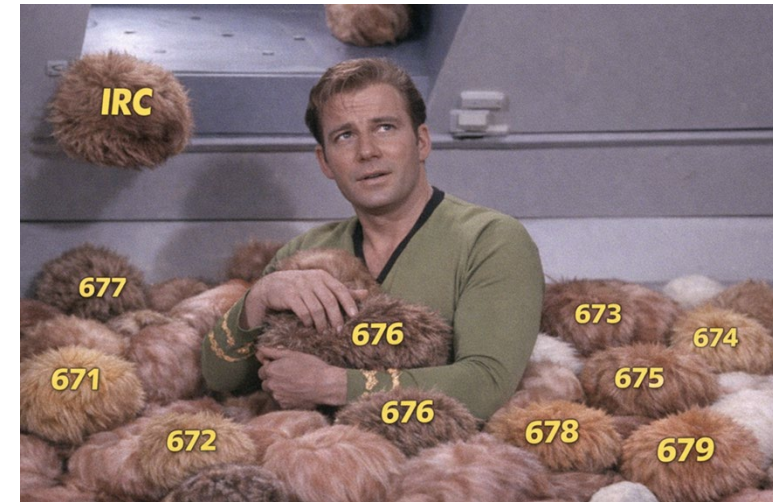
- Internal Revenue Code Sections 671-679 (Subpart E of Subchapter J)
- Settlor/Grantor (or other substantial owner) of the trust pays the income tax
- Transactions between grantor and trust are ignored for income tax purposes, including income, deductions, and credits
- Rev. Rul 85-13:
  - Grantor can sell an appreciated asset to the grantor trust and not recognize gain on the sale [Rev. Rul. 85-13]
  - If the sale is in exchange for a promissory note, the interest paid by the grantor trust to the grantor is not taxable income
- Rev. Rul. 2004-64
  - Grantor's payment of income tax is not a gift to beneficiaries
  - If tax reimbursement is in trustee's discretion, the existence of a tax reimbursement clause does not cause estate inclusion for the grantor under IRC 2036(a)(1)



# Grantor Trust Code Provisions

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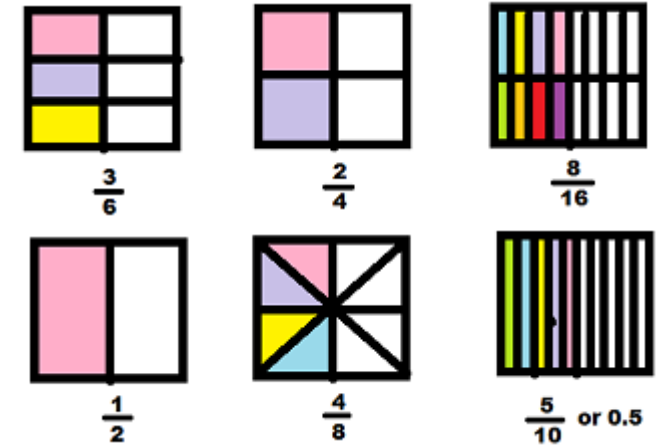
- Majority of cases: Goal is an “intentionally defective grantor trust” (IDGT)
- Typically, the trust will include one or more of these grantor trust powers (first three are most common):
  1. **“Substitution Power”** Grantor, in Non-fiduciary Capacity, Can Substitute Assets of Equivalent Value - IRC 675(4)(C)
  2. **“Borrowing Power”** - Power to Lend Income and/or Principal to Grantor Without Adequate Interest or Security – IRC 675(2)
  3. **“Add Beneficiaries”** - Power to Control Beneficial Enjoyment - IRC 674(a)
  4. Power to pay Life Insurance Premiums from Trust Income - IRC 677(a)(3)
- Some grantor trust powers have estate inclusion risk – we don’t like! **Reversions, voting controlled corporation stock, retained right to income, power to control distributions**



# Grantor Trust: Substitution Power

“**Substitution Power**” to Substitute Assets of Equivalent Value - IRC 675(4)(C) [aka “Swap Power”]

- A power **exercised by any person in a nonfiduciary capacity** (without approval or consent of any person acting in a fiduciary or non-fiduciary capacity) to “**reacquire the trust corpus by substituting other property of an equivalent value**” will cause grantor trust status
- Power needs to be held by the grantor or a non-fiduciary
- Allowing release of substitution power by the grantor is a common way to toggle

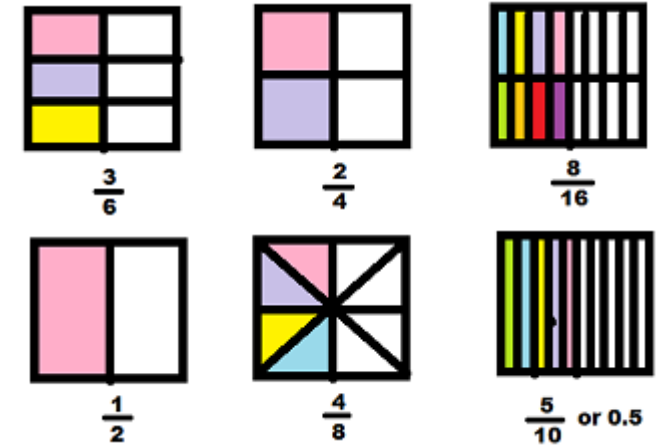


# Grantor Trust: Substitution Power

“**Substitution Power**” to Substitute Assets of Equivalent Value - IRC 675(4)(C) [aka “Swap Power”]

Requirements of Rev Rul. 2008-22:

- (1) Trustee has fiduciary obligation to ensure the assets being swapped have equal values
  - But – swap power must be exercisable without approval or consent of anyone in a fiduciary capacity
- (2) Power cannot be exercised to shift relative benefits of the beneficiaries.



# Grantor Trust: Borrowing Power

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“**Borrowing Power**” - Power to Lend Income and/or Principal to Grantor Without Adequate Interest or Security – IRC 675(2)

- Grantor trust is created where a “power exercisable by the **Grantor or a nonadverse party**, or both, enables the grantor to borrow the corpus or income, directly or indirectly, **without adequate interest or without adequate security**, **except** where a trustee (other than the grantor) is **authorized under a general lending power** to make loans to any person without regard to interest or security.”
- Should not cause estate inclusion
- Below-market loans should be avoided in any case because of IRC 7872
- If the Grantor (or nonadverse party) is expressly permitted to borrow from the trust on an unsecured basis, then the trust will be treated as a grantor trust
- Allowing release of borrowing power/requiring adequate interest and security by the grantor is a common way to toggle



# Grantor Trust: Add Beneficiaries

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“**Add Beneficiaries**” - Power to Control Beneficial Enjoyment - IRC 674(b)(5)-(7), 674(c), and 674(d)

- The power to add beneficiaries(beyond adding after-born children or after-adopted children) triggers grantor trust status
- If any person has a power to expand the class of potential beneficiaries to include charities, the trust will be a grantor trust
- Powerholder should be a nonadverse party.
- When toggling to non-grantor trust, make sure no one has the power to add beneficiaries



# Grantor Trust: Control Beneficial Enjoyment

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## Who Can Hold the Power?

- Power to add beneficiaries (other than charitable beneficiaries) may cause estate inclusion for the grantor under IRC 2036 and 2038, if held by the grantor or the grantor's spouse.
- If your trust includes the power to add beneficiaries, give this power to someone other than the grantor or anyone related or subordinate to the grantor

**Yes – Independent trustee, special trustee, independent protector**

**No – Grantor, Grantor's spouse, related or subordinate individuals**



# Grantor Trust Terms: Adverse Party

Definition in IRC 672(a):

*“Adverse party” means any person having a **substantial beneficial interest** in the trust which would be adversely affected by the exercise or nonexercise of the power which he possesses respecting the trust. A person having a general power of appointment over the trust property shall be deemed to have a beneficial interest in the trust.*

- **Income Beneficiaries**
- **Remainder Beneficiaries**
- **General Power Of Appointment Holders**
- **NOT: Trustee, Trust Protector**
- “Nonadverse party”: IRC 672(b) – *any person who is not an adverse party*



# Grantor Trust Terms: Adverse Party Consent

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- Certain toggles require **addition** of Adverse Party Consent into the trust agreements to ensure correct tax treatment
- Distributions of income for the benefit of Grantor or Grantor's spouse (i.e., SLAT trust), or to discharge a legal obligation of support of the grantor or spouse, will trigger grantor trust status **unless** there is Adverse Party Consent (IRC 677)



# Grantor Trust Terms: Related or Subordinate

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- IRC 672(c) – A related or subordinate person is defined as any nonadverse party who is (1) the grantor's **spouse**, or (2) the grantor's **mother, father, issue, brother, sister, employee, corporation controlled** by the trust or the grantor, or a **subordinate employee** of a corporation where the **grantor is an executive**
- IRC 672(e) – Grantor is treated as holding any power or interest held by the grantor's spouse



# Toggling: How do I do it?

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“Turn Off” power(s) that cause grantor trust status

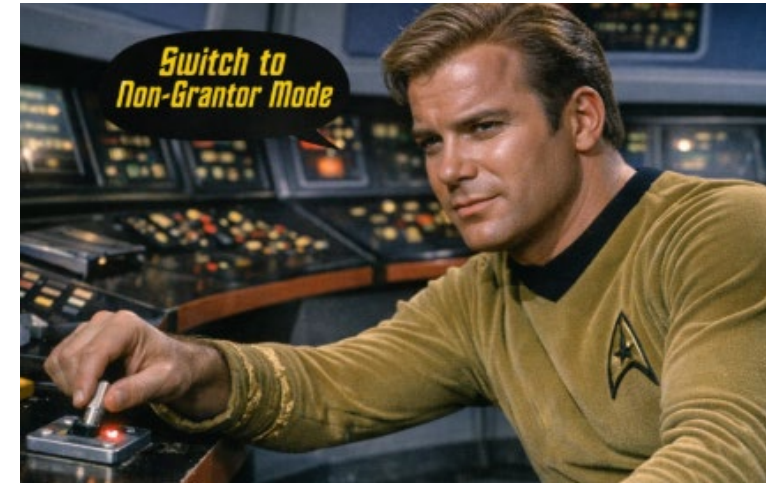
Easy, right?

Or is it...



# Making the switch – Grantor to Non-Grantor Trust

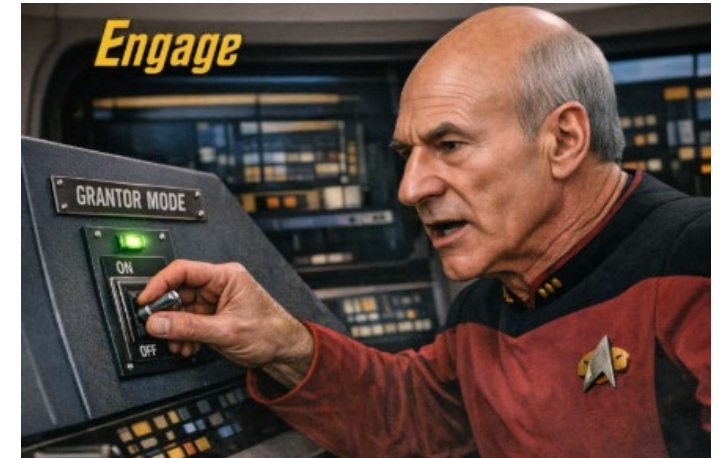
- Step 1: Identify and list ALL powers in the trust agreement that make it a grantor trust
- Step 2: Review distribution standards and income beneficiaries
- Step 3: Review identity of trust fiduciaries, **actual lending/borrowing**, life insurance provisions, and consider any spousal issues
- Step 4: Determine who can release grantor trust powers or amend trust instrument to exclude grantor trust powers
- Step 5: Consider partial decanting or creation of subtrusts
- Step 6: Prepare documents (decanting resolution, exercise of modification power, release of substitution power)
- Step 7: Re-read IRC 671-678 and make sure you haven't missed anything!
- *We don't want inadvertent tax status...consider a 'catch-all' or statement of intent when drafting*



# Making the Switch – Non-Grantor to Grantor Trust

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- Amend, modify, sever, or decant trust to add a grantor trust power
- Most commonly, substitution power
- Consider fiduciary duties – who is adding the grantor trust power?
- If a non-fiduciary can toggle, what are the criteria for them to decide to do so?
- CCA 200923024
  - Conversion from Non-Grantor to Grantor Trust was not a gain recognition event to the Grantors.
  - Several PLRs support this (but are not precedent)
  - Avoid multiple switches



# Example: IDGT to Non-Grantor Descendants Trust

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Wife created a defective grantor trust with an independent trustee

Grantor retained non-fiduciary power to substitute assets

Trustee could make loans to Grantor which could be secured or unsecured, with or without interest, as determined by the trustee

Trustee could guarantee Grantor's debts

- Grantor releases substitution power
- Grantor waives right to borrow from the trust without adequate interest and security
- Grantor waives right to have trustee guarantee indebtedness

Toggle complete! 

# Example: IDGT to Non-Grantor Descendants Trust

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## *Release of Grantor Trust Powers*

**NOW, THEREFORE, the undersigned, as Grantor, does hereby irrevocably release and waive any and all right she now has or ever had to:**

- (a) reacquire trust corpus (principal) under the Substitution Power,**
- (b) to borrow from the Trust without adequate interest and adequate security, and**
- (c) to have the Trustee guarantee the Grantor's indebtedness.**

**“In addition, the undersigned, as Grantor, does hereby completely and irrevocably renounce and waive any and all other powers which cause the Trust to be taxed as a “grantor trust” as to [insert grantor name] pursuant to the provisions of Subpart E of Part I of Subchapter J of the Code, and henceforth, the Trust shall be administered and distributed as if such powers had never been granted.”**



**‘Catch-all’ language is important to include!**

# Example: SLAT to SLANT

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Original trust for benefit of descendants only (descendants trust), but protector could add beneficiaries (grantor trust power)

A few years after formation, the protector added the spouse as a beneficiary, requiring that any distributions to the spouse or accumulations of income for the spouse's benefit required Adverse Party Consent

Then, the protector amended the trust to delete the power to add beneficiaries

Toggle complete! 

# Pitfalls and Risk Areas – Gain Recognition

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- If the IDGT holds ‘negative basis’ property, gain will be recognized when toggling from grantor to non-grantor taxation
- Madorin v. Commissioner 84 T.C. 667 (1985)
  - Deemed sale/disposition of assets upon termination of grantor trust status
  - When liabilities exceeded basis, gain is recognized on the ‘sale’
  - The gain was ordinary income [sale of partnership interest]
- Rev. Rul. 77-402
- Reg. 1.1001-2(c) Ex. 5



# Pitfalls and Risk Areas – S Corps

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- S Corporations
  - Make sure you consider S-corporation shareholder status if the trust is an S-corporation shareholder before toggling – otherwise, the trust may be a non-qualified shareholder
  - Make QSST or ESBT election



# Pitfalls and Risk Areas – Life Insurance

- Life Insurance Provisions
  - IRC 677(a)(3) power to use trust *income* for payment of premiums on policies insuring the grantor's life (or the grantor's spouse's life)
  - Grantor trust power!
  - Always review trust provisions regarding payment of life insurance premiums
  - Use of trust *principal* to pay premiums is not a grantor trust trigger
  - *Note – typically you will want ILITs to be grantor trusts*



# Pitfalls and Risk Areas – Lending and Borrowing

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- Lending/Borrowing Provisions
  - IRC 675(2) power for grantor to borrow without adequate interest or security, except as authorized under a general lending power
  - Always review trustee powers regarding loans to grantor or any others, and conditions on loans
  - Any outstanding interest-free and unsecured loan to the grantor may cause a grantor trust



# Pitfalls and Risk Areas – Control Issues

- **State Nexus**

- Know you know where your fiduciaries are and how state will tax the trust based on their residence

- **Grantor Control**

- Beware of indirect ways that grantor can direct beneficial enjoyment and estate inclusion risk areas
- Rev. Rul. 95-58 – grantor may replace trustee without estate inclusion risk

- **Fiduciary Capacity**

- When toggling, clearly show what action is taken in fiduciary vs. non-fiduciary capacity

- **Records**

- Have contemporaneous written record of toggle transactions



# Pitfalls and Risk Areas – Transaction of Interest

- One Bite at the Toggle Apple!
  - **IRS Notice 2007-73** -Transaction of Interest
  - Avoid toggling from grantor to non-grantor and back to grantor status repeatedly
  - In this notice, IRS flagged toggling grantor trust status off then on again, to create artificial tax losses or avoid gain recognition
  - Mandatory disclosure obligations for similar transactions



# Tax Reporting

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- Trustee chooses reporting method [unless there are foreign assets, foreign situs, or non US person grantor, or is a QSST – then, the traditional method must be used]
  - Grantor trusts can use the “**traditional method**” of reporting under Treas. Reg. § 1.671-4
    - File Form 1041 with an attachment with the grantor’s name, SSN, address, and income of the trust taxable to the grantor, and deductions and credits
  - Or, can use one of two **alternative methods**
    - (1) Single Owner. Treas. Reg. § 1.671-4(b)(2)(i)(A) – direct reporting on Grantor’s 1040, or attach forms 1099 to Grantor’s return, no separate TIN required (only use if Grantor is the trustee)
    - (2) Multiple Owners. Treas. Reg. § 1.671-4(b)(2)(i)(B) – Trustee files forms 1099.
- Changes in reporting method (from traditional to alternative) – pursuant to Treas. Reg. § 1.671-4(g)

# Tax Reporting

- If the toggle is effective mid-year, you may have split reporting (part of the year as grantor and part as non-grantor) on the same return
- Partial grantor trust – non-grantor portion reported on Form 1041 under normal reporting rules; grantor portion reported by attachment to Form 1041
- Coordinate with accountants before doing your toggle



# Toggle Alternative – Decanting

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Once alternative approach is to decant some of the trust assets instead of toggling whole trust

- State tax positioning – move decanted assets to new state, as non-grantor trust
- Qualified Small Business Stock under IRC 1202
  - Potential stacking opportunities
- In decanting, trustee is the one taking the action – make sure action is within fiduciary duties
- Make sure the distribution standard (discretionary) and trust agreement permit decanting



# Questions?

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# Thank you!

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Sara is a senior associate in the private client and tax team at the international law firm, Withers. Based in the San Diego office, she is a California and Nevada trusts and estates attorney who assists clients in all aspects of estate and tax planning, estate and trust administration, and charitable planning. She focuses on intra-family wealth transfers, estate and gift tax savings techniques, and complex trust administrations.

Sara has been recognized as a "One to Watch" by Best Lawyers for 2025. She is also recognized as a "Rising Star" by Super Lawyers for 2025.



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