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Nothing is Ever What it Seems: An Overview of Disregarded Entities

Presented By:

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Presentation Outline

I. Business Entities
  1. Creation, choice of entity, and default classifications
  2. Tax elections including check-the-box[1]
  3. Reporting
  4. Classification changes and termination
  5. Planning matters

II. Grantor Trusts
  1. Trust taxation
  2. Creation of grantor trusts
  3. Reporting
  4. Planning considerations

[1] NOTE: We will not cover foreign rules, which differ from those applicable to domestic entities.

Choice of Entity Considerations

- Legal entity formation
  - Creation under state law
  - Liability protection
  - Federal law considerations
    - Corporate transparency act
    - Permissible entity types for specific business endeavors
- Income tax
  - Federal
  - State – franchise (*i.e.*, business income) tax in Texas
- Corporate governance and strategy such as business management, succession, and maintenance.

Types of Business Entities

- State Law
  - Most common business entity types
    - Limited liability company (“LLC”)
    - Partnership – including general partnership, limited partnership, limited liability partnership, etc.
    - Corporation
- Federal Income Tax
  - Considerations include initial/default classification, changes/elections, and termination/exit
  - Common income tax classifications
    - Disregarded entity (“DRE”) – including single member LLC (“SMLLC”), multi member LLC with synonymous owners, qualified subchapter S subsidiaries (“QSub”)
    - Partnership
    - C corporation
    - S corporation
    - Also, sole proprietorship (which is not an income tax classification)

What is a Disregarded Entity?

- There is no single statutory definition, but a disregarded entity is recognized for state law purposes and ignored for federal income tax purposes.
- More specifically:
  - ❖ A disregarded entity is an entity with a single underlying owner that the IRS disregards for federal income tax purposes and, therefore, the owner pays the entity's income tax liability as part of his or her personal income tax return (Form 1040, Schedule C, E, or F).
  - ❖ For state law purposes, however, a disregarded entity is a legal entity, distinct from its owner and, therefore, has separate and limited business liability and creditor exposure from its owner.

What is a Disregarded Entity?

- Features
  - ❖ Assets and liabilities treated as those of the owner for federal income tax purposes.
  - ❖ No separate tax attributes from owner, including no separate taxable year.
  - ❖ “Sale” of assets to disregarded entity is disregarded for federal income tax purposes.
  - ❖ Owner does not have a separate basis in the disregarded entity or its assets.
- Common types of disregarded entities for federal tax purposes:
  - ❖ Single-owner eligible entities (most often, LLCs) that have not elected corporate treatment,
  - ❖ QSubs,
  - ❖ Qualified real estate investment trust subsidiaries, and
  - ❖ Grantor trusts (not business entities but treated as disregarded for income tax purposes).

Check-the-Box

- "Check-the-Box" ("CTB") refers to how an eligible entity elects to be classified/taxed for federal income tax purposes.
- Initial Domestic Entity Classification under CTB Regulations (Treas. Reg. §§ 301.7701-1, -2, -3):
  - ❖ Elections available for eligible entities (generally, an LLC or partnership) to be taxed as a corporation, partnership, or a disregarded entity, depending on number of owners.
  - ❖ If an entity is using its default classification, no election should be filed.

Check-the-Box

- What is an "eligible entity" that can CTB?
  - ❖ Generally, one that is not automatically classified as a corporation; more specifically, it is (i) not an individual, (ii) a business entity under § 301.7701-2(a), and (iii) not a "per se" corporation (*i.e.*, automatically classified as a corporation) under §§ 301.7701-2(b), -3(a).
    - ➢ A business entity is any entity recognized for federal tax (including a DRE) not properly classified as a trust or subject to special treatment under the I.R.C. (Treas. Reg. § 301.7701-4(b))
    - ➢ A business entity is a "per se" corporation if, for example: (1) it is organized under a federal or state statute, (2) it is an insurance company, (3) it constitutes one of the foreign business entities enumerated in the regulations, and (4) it satisfies certain other requirements listed in the regulations. (Treas. Reg. § 301.7701-2(b)(8))

S Corporation

- <u>Definition</u>: Corporations that elect to pass corporate income, losses, deductions, and credits through to their shareholders for federal tax purposes. (I.R.C. § 1361)
- Avoids C corporation double taxation. Shareholders of S corporations report the flow-through of income and losses on their personal tax returns and are assessed tax at their individual income tax rates.
- S corporations are responsible for tax on certain built-in gains and passive income at the entity level.
- Requirements to qualify for S corporation status:
  - ❖ Be a **domestic** corporation,
  - ❖ Have only **allowable shareholders**
    - ➢ May be individuals, certain trusts, and estates, and
    - ➢ May not be partnerships, corporations or non-resident alien shareholders,
  - ❖ Have **no more than 100 shareholders**,
  - ❖ Have only **one class of stock**, and
  - ❖ Not be an ineligible corporation (*i.e*. certain financial institutions, insurance companies, and domestic international sales corporations).

S Corporation

- Electing to be taxed as an S corporation? (I.R.C. §§ 1361, 1362, and 1378)
  - ❖ A domestic entity eligible under I.R.C. § 1361.
  - ❖ Tax year requirements: It has or will adopt one of the following: (i) a tax year ending December 31; (ii) a natural business year; (iii) an ownership tax year; (iv) a tax year elected under I.R.C. § 444; (v) a 52-53-week tax year ending with reference to one of the forgoing listed years; or (vi) any other tax year (including a 52-53-week tax year) for which the corporation (entity) establishes a business purpose.
  - ❖ Ineligible corporations include certain financial institutions, insurance companies, and domestic international sales corporations.

Tax Classifications

The default classification (in the absence of an election or a change in the number of owners) depends on the number of owners and the type of state law entity.

Number Owners / State Law Entity Type	**Default Tax Classification**	**CTB (& S election) Alternate Classification Options**
One unique owner (including SMLLC)	DRE	C Corporation (S corporation)
More than one unique owner (partnership, multimember LLC)	Partnership	C Corporation (S corporation)
Corporation	C corporation	(S corporation)

Making the Election
CTB

- Three general requirements to CTB (Treas. Reg. § 301.7701-3(c)):
  - ❖ Properly filed Form 8832 (attaching a copy of the executed Form 8832 to the entity's federal tax or information return (or, if none, then that of the direct or indirect owner) for the tax year of the election) which is signed by each owner-member or other authorized officer, manager, or member, and
  - ❖ The entity is not electing a change of classification within 60 months of the effective date of the prior election to change classification (an election by a newly formed entity is not considered a change for these purposes). (Treas. Reg. § 301.7701-3(c)(2))
    - ➢ The election is effective as of the date specified on the relevant Form 8832.
    - ➢ Timely filed means effective not more than 75 days prior to the date of the election nor later than 12 months after the date of the election, but Rev. Proc. 2009-41 provides for automatic remediation for late elections under certain circumstances within 3 years and 75 days of the desire effective date. Otherwise, 9100 relief may be available. (Treas. Reg. § 301.9100-1 through -3).

Making the Election
S corporation

- The corporation must timely elect using Form 2553, signed by all shareholders. (Treas. Reg. § 1.1362) Timely filed means:
  - ❖ No more than 2 months and 15 days after the beginning of the tax year the election is to take effect, or
  - ❖ At any time during the tax year preceding the tax year it is to take effect.
  - ❖ Relief for late elections under Rev. Proc. 2013-30.
    - ➢ A late election is generally effective for the tax year following the tax year beginning on the date entered on line E of Form 2553 within 3 years and 75 days.
- Form 8832 not necessary.
- A parent S corporation can elect to treat an eligible wholly owned subsidiary as a Qsub using Form 8869, Qualified Subchapter S Subsidiary Election. If the election is made, the subsidiary's assets, liabilities, and items of income, deduction, and credit generally are treated as those of the parent.
- Once made, the election remains effective until terminated or revoked.

Classification Constraints

- Classification change when change in number of owners (§ 301.7701-3(f)):
  - ❖ Corporations
    - ➢ Are not affected by a change in the number of stockholders of the entity,
    - ➢ Can only be taxed as C corporation or S corporation, and
    - ➢ Cannot be taxed as DRE nor partnership.
  - ❖ Entity taxed as a Partnership
    - ➢ Becomes default DRE when membership reduced to one unique owner,
    - ➢ State law partnership or multimember LLC can only be taxed as partnership, C Corporation, S Corporation.
  - ❖ Single Owner Entity
    - ➢ Cannot be (taxed as) a partnership.
  - ❖ Changes resulting from a change in number of owners do not count toward the 60-month limitation rule.

Entity Change Consequences

- When a tax classification changes (Treas. Reg. § 301.7701-3(g)):
  - Partnership Elects to Change to Corporation: The partnership is deemed to contribute all of its assets and liabilities to a corporation in exchange for stock of the corporation, and immediately thereafter, the partnership **liquidates** by distributing the stock to its partners.
  - Corporation Elects to Change to Partnership: The corporation is deemed to distribute all of its assets and liabilities to its shareholders in **liquidation**. The shareholders immediately contribute the assets and liabilities to a new partnership.
  - Corporation Elects to Change to DRE: The corporation is deemed to distribute all of its assets and liabilities to its single owner in **liquidation**.
  - DRE Elects to Change to a Corporation: The owner of the DRE is deemed to contribute all of the assets and liabilities of the DRE to the corporation in exchange for stock of the corporation.

Considerations for Electing

- [*Vastly*] Different tax regimes apply to the four general types of income tax entity classifications.
- For example:
  - ❖ Single (flow-through) v. double taxation,
  - ❖ Applicable income tax rates, employment taxes, net investment income tax,
  - ❖ Available deductions,
  - ❖ Treatment of allocations of debt and transfers of property, and
  - ❖ Business termination implications.

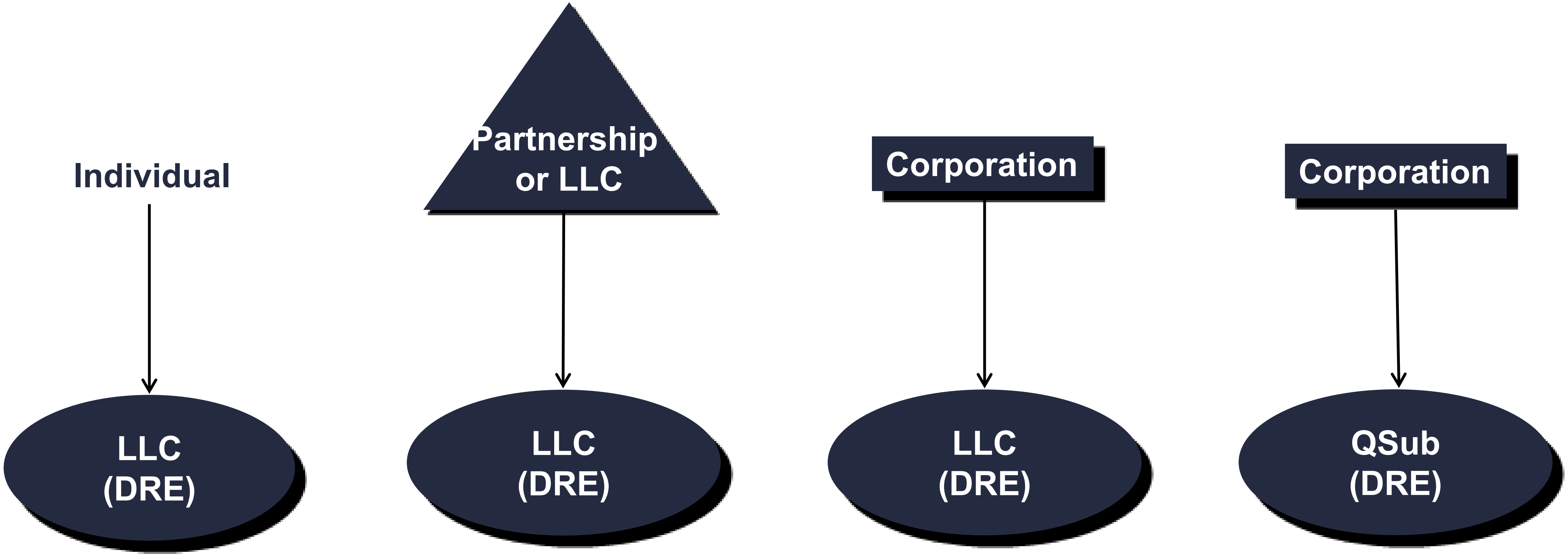
Considerations for Electing

- DRE may remain regarded in certain situations such as:
  - ❖ Employment Taxes. Owners are subject to tax on net earnings from self employment in the same manner as sole proprietorship and, as a statutory employer, certain DREs liable for employment taxes from the DRE. (Treas. Reg. § 301.7701-2(c)(2)(iv))
  - ❖ Excise Taxes. (Treas. Reg. § 301.7701-2(c)(2)(v))
  - ❖ FBAR Reporting Requirements. (Treas. Reg. § 301.7701-2(c)(2)(ii))
  - ❖ Gift, estate, and GST tax valuation.
- Non-tax considerations:
  - ❖ Liability/creditor protection and anonymity.
  - ❖ Ease of management and administration (and incapacity planning).
  - ❖ Separate (allocable) opportunities.
  - ❖ Estate planning and succession considerations.

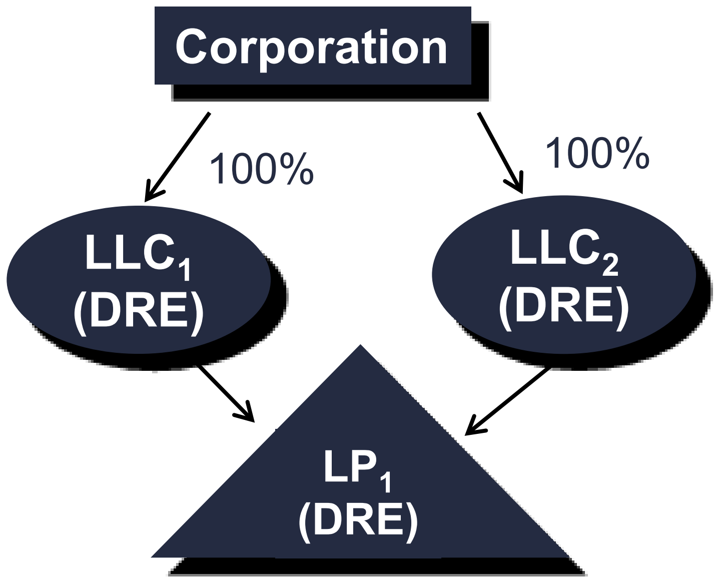
Reporting

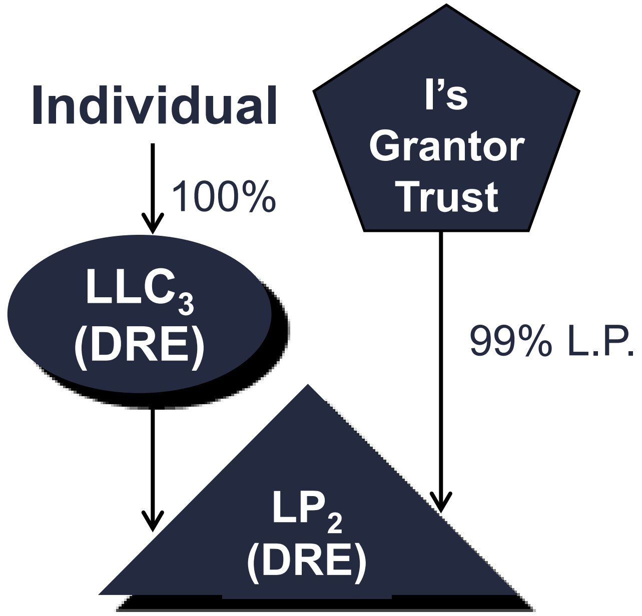
- DRE filing and reporting
  - Activities of DRE owned by:
    - Individual should be reported on Schedule C, E, or F of owner's Form 1040.
    - Corporation should be treated as branch or division of the owner-corporation's income tax return.
    - Partnership should be reflected on its as operations of the owner-partnership's income tax return.
      - When a partner is a disregarded entity, the partnership will need to provide the beneficial owner's entity type for reporting purposes.
      - Similarly, the partnership interest is owned by tiered disregarded entities, the partnership must report the information pertaining to the disregarded entity which is the legal owner of the partnership interest.

Common DRE Ownership



Common Disregarded Entities Structures

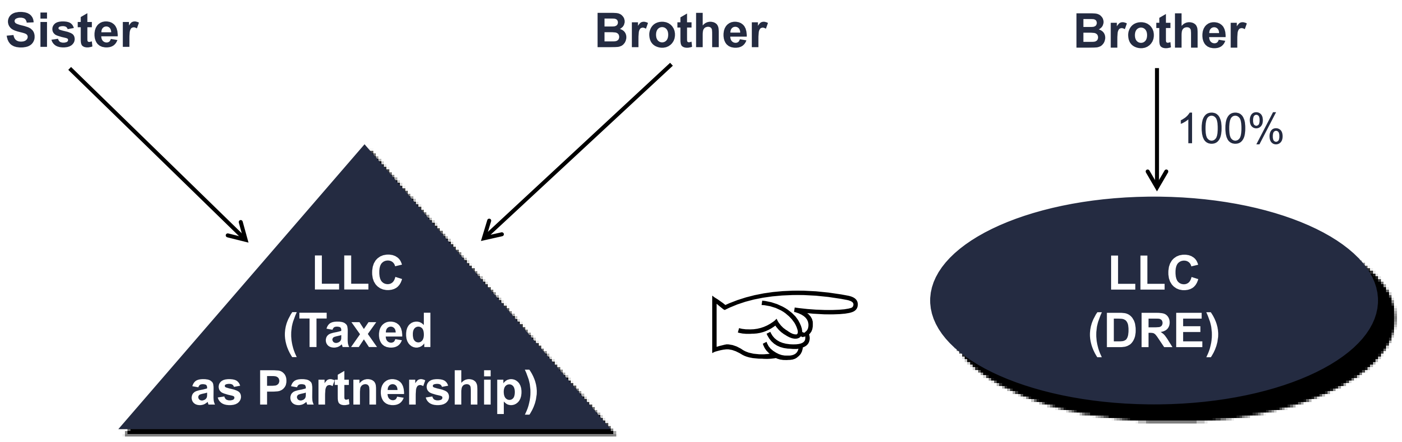




LLC_1 is disregarded
LLC_2 is disregarded
LP_1 is disregarded

LLC_3 and LP_2 can both be treated as disregarded

Transaction Involving Disregarded Entities



- When Sister sells her 50% interest in the Partnership to Brother, the entity defaults to disregarded for income tax purposes. Brother can elect to be taxed as a corporation but can no longer be taxed as a partnership.
- Tax consequences of this transaction follow.
- Treas. Reg. § 301.7701-3(f)(2)

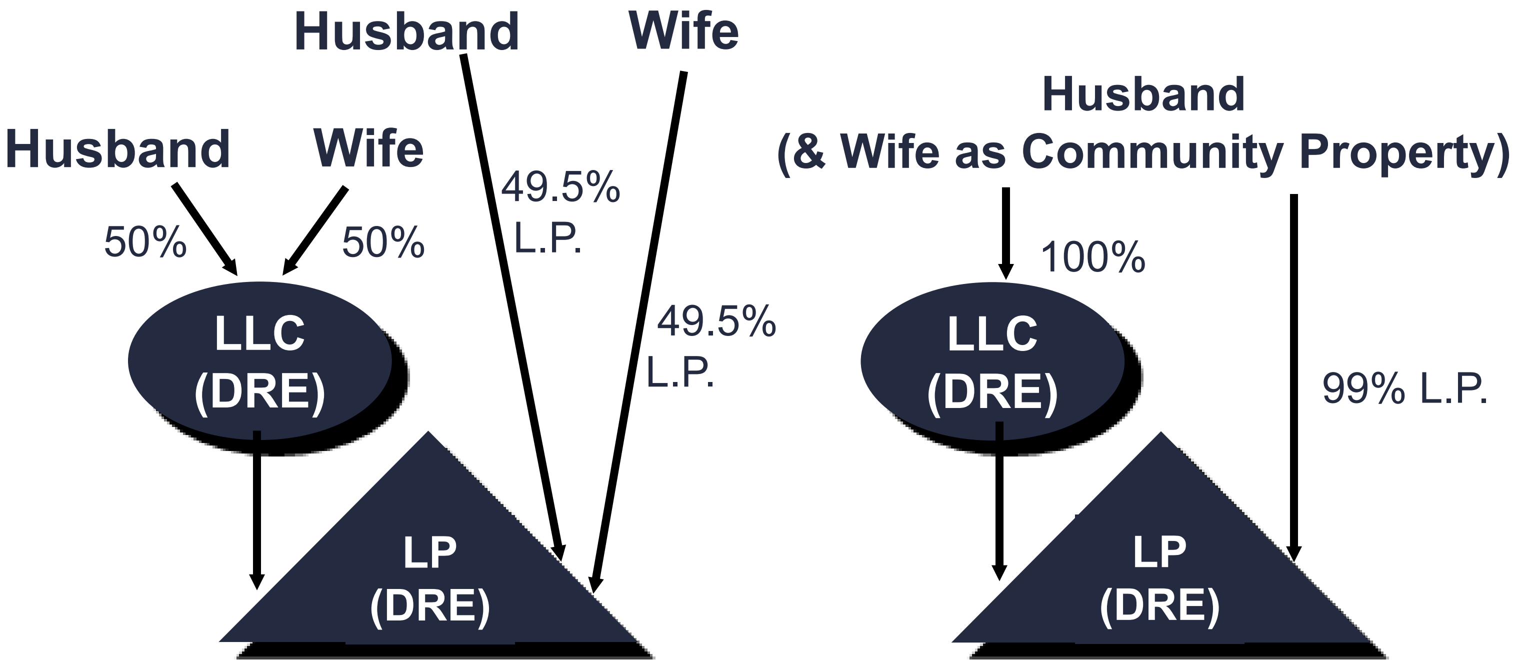
Entities Owned by Spouses in Community Property Jurisdictions

H & W can treat a "Qualified Entity" as <u>either</u>: (i) a disregarded entity, <u>or</u> (ii) a partnership, for federal income tax purposes.

A business entity is a <u>qualified entity</u> if:

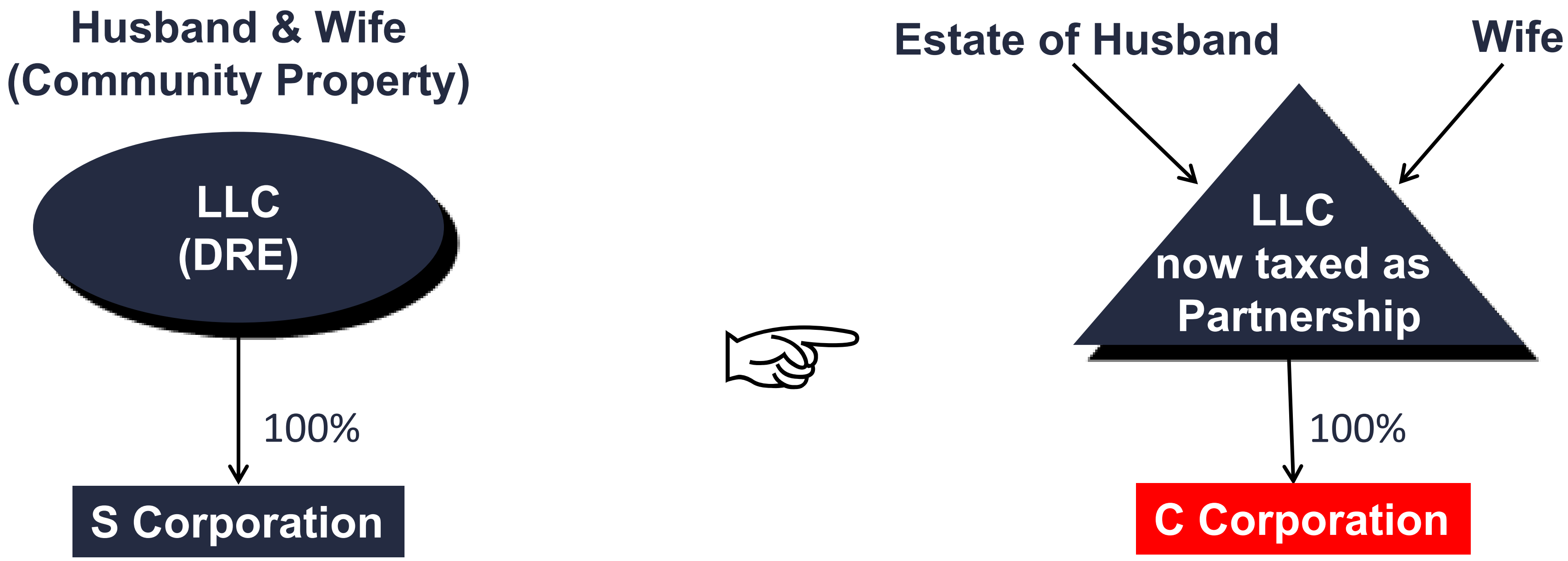
1. The business entity is ***wholly owned*** by a husband and wife as community property under the laws of a state, a foreign country, or a possession of the United States;
2. No person other than one or both spouses would be considered an owner for federal tax purposes; and
3. The business entity is not treated as a corporation under Treas. Reg. § 301.7701-2.

Entities Owned by Spouses in Community Property Jurisdictions



- LLC and LP can both be treated as disregarded entities under Rev. Proc. 2002-69.
- By filing a Form 1065 for one or more of these entities previously treated as DREs, the IRS will respect the position and treat it a as a conversion of the entity.

Transactions Involving Disregarded Entities



- Husband and Wife own all interests in LLC, which is disregarded for income tax purposes (but IRS will also respect reporting if taxed as partnership under Rev. Proc. 2002-69).
- When Husband dies, the LLC ceases to qualify as a DRE, and consequences follow.
- If, as in this hypothetical, the LLC owns interests in an entity taxed as a S corporation, the S election will immediately involuntarily terminate.
- Treas. Reg. § 301.7701-3(f)(3)

DREs and EINs

- DREs must use the SSN or EIN of the owner, except, an EIN is or may be required when:
  - ❖ Necessary for normal business operations such as to open bank account, obtain insurance, etc., or as provided by state law (respecting corporate formalities favors obtaining an EIN),
  - ❖ The entity has employees, or
  - ❖ The entity has excise or employment tax liabilities accruing after 1/1/2008 and 1/1/2009, respectively.
- Regardless of obtaining EIN, for W-9 (identification for payment as an independent contractor), use the SSN or EIN of the owner, rather than the LLC's EIN.

Tax Classifications of Trusts

1. Non-Grantor Trusts
    A. Simple
    B. Complex
2. Grantor Trusts
    A. As to Grantor
    B. As to Another Person
3. Subchapter S Trust (QSST or ESBT)
4. Charitable Trusts

Income Taxation of Trusts

- General Rules
  - ❖ Trust is generally a separate taxable entity.
  - ❖ Taxation is generally determined under Subchapter J of Code.
  - ❖ Neither double taxation nor flow-through. Rather, somewhat of a mix of individual and entity tax concepts depending on type and classification of trust and distributions from trust.
- Trusts as disregarded for income tax purposes:
  - ❖ Irrevocable grantor trusts
  - ❖ Revocable trusts (I.R.C. § 676)
    - ➢ Generally, becomes regarded upon the death of grantor

Principles of Trust Taxation

- Taxable Income. Taxable income of a trust is gross income (under I.R.C. § 61) less deductions determined in the same manner as an individual with certain exceptions. I.R.C. § 642(b).
- Fiduciary Accounting Income ("FAI"). The term "income," when not preceded by the terms "taxable," "distributable net" or "gross," is known as fiduciary accounting income. I.R.C. § 643(b).
- Distributable Net Income ("DNI"). DNI bridges the gap between Taxable Income and FAI in order to determine amount deductible by trust and includible by beneficiary.
- Basic Rules:
  - ❖ DNI determines the maximum amount that can be taken as a Distribution Deduction.
  - ❖ Beneficiary will be taxed on the lesser of FAI required to be distributed or DNI, but not to exceed Taxable Income.

Trust Income Not Over	Individual (MFJ) Income Not Over	Tax Rate
3,100	23,200	10%
	94,300	12%
	201,050	22%
11,150	383,900	24%
	487,450	32%
15,200	731,200	35%
15,201+	731,201+	37%

Trust Cap Gain Not Over	Individual (MFJ) Cap Gain Not Over	Tax Rate
3,150	94,050	0%
15,450	583,750	15%
15,451+	583,751+	20%

What is a Grantor Trust?

- Subpart E of Subchapter J of the I.R.C. contains the "grantor trust" rules.
- If any of the requirements of this part (*i.e.*, I.R.C. §§ 671–79) apply, then **<u>the grantor (or possibly another person) is treated as the owner of all or a portion of a trust</u>**.
- In other words, **<u>the grantor trust is not a separate taxpayer</u>** with respect to the various items of income, deductions and credits which the trust itself may generate. Instead, those items must be taxed directly to the grantor or some other person with a grantor-like power over the trust.
- As a result, all items of income, deductions, and credits are attributable to the grantor (or other person). I.R.C. § 671.
- A trust can be a grantor trust as to all or a portion of the trust.
- Depending on the power retained by the grantor (or provided to someone other than the grantor), the trust can be a grantor trust as (i) only the income, (ii) only the principal, (iii) both income and principal, (iv) specific property of the trust, or (v) a fractional, or pecuniary, portion of the trust.

Grantor Trust History

- Federal income tax enacted in 1913 with no requirement that the grantor of a trust to be taxed on income generated by the trust assets even if the grantor retained control of those assets.
- Changes made to the I.R.C. in 1924 required the income of a revocable trust to be taxed to the grantor.
- Throughout the 1930s, ‘40s, and ‘50s, taxpayer planning techniques attempted to shift income to taxpayers in lower tax brackets using a variety of trust arrangements. Several Supreme Court cases led to grantor trust rules.
  - ❖ Tax rates under I.R.C. of 1939 included 20 brackets from 19.2% on first $2,000 to **89%** on taxable income in excess of $200,000!
  - ❖ To shift income, multiple trusts were created for taxpayers with the intent that each trust would be recognized as an independent taxpayer to be taxed beginning at the lower end of the progressive rate structure while the grantors of these trusts tried to maintain as much control over them as they possibly could.
- Enter the grantor trust rules, wherein Congress forced trust grantors to chose retained control or taxation shift.
- Tax rates for trusts and estates compressed as of the Tax Reform Act of 1986, which are often avoided with use of the grantor trust rules.

Grantor Trust Powers

- Generally, a grantor creates a trust and contributes property thereto and the trust agreement provides for one of the "grantor trust powers."
- Grantor trust powers set forth in I.R.C. §§ 671–79:
  - ❖ § 673. Reversionary interests (greater than 5% of the value of the relevant portion of the trust has a reversionary interest in either the corpus or the income therefrom.
  - ❖ § 674. Power to control beneficial enjoyment.
  - ❖ § 675. Administrative powers (sell, borrow, or loan trust property without commercially reasonable terms).
    - ➢ Most common: *NON-FIDUCIARY Administrative Powers*. The grantor is treated as owning any part of a trust in which the grantor (or a non-adverse party) retains the power to reacquire corpus by substituting property of equivalent value.
  - ❖ § 676. Power to revoke.
  - ❖ § 677. Income for benefit of grantor.
  - ❖ § 678. Person other than grantor treated as substantial owner.
  - ❖ § 679. Foreign trusts having one or more United States beneficiaries.

Identifying the Grantor(s)

- Settlor of the Trust is often referred to as the grantor.
  - ❖ The individual who establishes the trust is sometimes called the grantor, settlor, trustor, etc.
- Deemed Owner for income tax purposes is also referred to as the grantor.
  - ❖ Treas. Reg. 1.672-2(e)(1) indicates that a grantor will include a person who creates a trust; and/or a person who, directly or indirectly, makes a ***gratuitous transfer*** to a trust.
  - ❖ A gratuitous transfer typically includes where a transfer is made to a trust for less than the full fair market value of the transferred property.
    - ➢ Notably, then, someone who creates a trust but makes no transfer thereto cannot be the deemed owner under the grantor trust rules.
    - ➢ Gratuitous transfer can be direct (*e.g.*, a gift of $5MM) or indirect (the lapse or release of a withdrawal right). Meaning, a grantor trust could be deemed owned by the contributor of property to the trust or a person other than the contributor, such as a beneficiary.

Identifying the Grantor(s)

- Multiple grantors.
  - ❖ More than one individual can be a deemed owner of a portion of the trusts trust and, therefore, taxed on some, but not all, of the trust income.
  - ❖ If the trust has more than one contributor, each as deemed owners in proportion to the value of property such individual(s) contributed to fund the trust.
    - ➢ Often the case with a trust created by spouses.
    - ➢ NOTE: The grantor of a trust is treated as holding the powers/interests held by his or her spouse. (I.R.C. §672(e))
  - ❖ At the death of a grantor spouse, it may be necessary to divide a joint grantor trust along grantor lines resulting in a portion taxed as a grantor trust to the surviving spouse and the other portion taxed as a complex trust post-death.
- Wholly Owned or Partial Grantor Trust.
  - ❖ A wholly owned grantor trust is a trust where the entire trust is deemed to be owned by one person. Conversely an individual can be the deemed owner of only some, but not all, of the trust. (*See* Treas. Reg. 1.671-3)

Grantor Trust EIN

- Reporting requirements generally depend on the existence and number of deemed owner(s). (Treas. Reg. 301.6109-1(a)(2))
- The method of reporting selected or required informs EIN requirements.
  - ❖ Treas. Reg. § 301.6109-1(a)(1)(ii)(C) states that generally a trust must use an employer identification number as its TIN. Treas. Reg. § 301.6109-1(a)(2), however, provides an exception to the general rule for grantor trusts.
    - ➢ If there is more than one deemed owner/grantor (unless grantors are married filing jointly), an EIN is required.
    - ➢ When only one deemed owner, the need to obtain an EIN depends on the reporting method utilized. (Treas. Reg. 1.671-4(b)(2))
  - ❖ But, don't overlook the other reasons one might obtain an EIN such as opening a trust bank account or to separate trust assets from the grantor.

Reporting Methods
Wholly Owned Grantor Trust

- Traditional Method: A Form 1041 (fiduciary income tax return) is filed for the trust reporting only the entity information.
    - ❖ The activity of the trust is shown on a statement/attachment providing (i) the deemed owner/grantor's name, Social Security number, and address; (ii) that the income of the trust that is taxable to the grantor; and (iii) any deductions or credits that apply to the income. Treas. Reg. § 1.671-4(a)
    - ❖ A trust EIN is required.
    - ❖ Required method for QSST and non-U.S. grantors

Reporting Methods
Wholly Owned Grantor Trust

- Alternative Method #1 (Treas. Reg. 1.671-4(b)(2)(i)(A)): The Trustee does not file a Form 1041 but, instead, takes steps to facilitate the grantor's tax reporting.
  - ❖ The trustee provides the grantor's name and other identifying information (address and SSN) to all payors (Treas. Reg. § 1.671-4(b)(4) defines "payor" as any person required to make any type of information return to the trust in the taxable year) and provides to the grantor (assuming the grantor is not the trustee) a statement (under Treas. Reg. § 1.671-4(b)(2)(ii)) that:
    - ➢ Informs the grantor that the information on the statement must be included in computing the grantor's taxable income and credits;
    - ➢ Sets out all items of income, deduction, and credit for the trust for the taxable year;
    - ➢ Identifies the payor of each item of income; and
    - ➢ Provides all information that the grantor needs to compute his taxable income with respect to the trust.
  - ❖ Along with the statement, the trustee must also (i) obtain a W-9 from grantor, and (ii) provide trust's Forms 1099 to grantor to attach to his individual income tax return.
  - ❖ No EIN required.

Reporting Method for Wholly Owned or Multiple Grantor Trust

- Alternate Reporting Method #2. (Treas. Reg. §§ 1.671-4(b)(2)(i)(B), (b)(3))
  - ❖ Trustee receives Forms 1099 from payors listing the trust as payee.
  - ❖ Trustee must file Forms 1099 with the IRS showing the income or proceeds received by the trust during the year and showing the trust as the payor and the grantor as the payee. (Treas. Reg. § 1.671-4(b)(2)(iii))
  - ❖ If income is reported to the trust through a form other than Form 1099 such as a K-1, the trustee must furnish an informational statement to the grantor similar to that discussed in Alternative Method #1.
  - ❖ Trust EIN required.
- Change in filing method governed by Treas. Reg. § 1.671-4(g).
- Trusts must adopt a calendar year; thus, the filing deadline is effectively the April 15th following the end of the trust's tax year, except in certain circumstances or in the year of the grantor's death (Treas. Reg. § 1.671-4(h)).

When Grantor Trust Becomes Complex

- Generally:
  - ❖ Irrevocable grantor trusts become regarded when grantor relinquishes grantor trust powers, and
  - ❖ Revocable trusts:
    - ➢ Upon the death of grantor.
    - ➢ Upon affirmative action to terminate grantor trust status, as provide in the relevant trust agreement.
  - ❖ When regarded (becomes a simple or complex trust for income tax purposes), an EIN and complete Form 1041 is required.

When Grantor Trust Becomes Complex

- Issues involving termination of grantor trust status.
  - S elections.
    - Qualified S corporation shareholders include grantor trusts and testamentary trust (only for a two-year period following grantor's death) but, not complex. For all complex trusts, a timely filed election to be treated as a qualified shareholder trust is required:
      - Electing Small Business Trust (ESBT). Generally, can be any trust that makes the election. If ESBT status is elected, **all** income is taxed at trust level at highest tax bracket.
      - Qualified Subchapter S Trust (QSST). A QSST is a trust which has only one beneficiary and **all** of the income is distributed (or required to be distributed) to such beneficiary, and for which an election is made. If elected, the trust is treated as being deemed owned by such beneficiary.
  - Basis Adjustment at death.
    - IRS No Ruling List since 2005 and removed from Treasury's 2021–22 Primary Guidance Plan
    - Rev. Rul. 2023-2: assets of an IDGT, not included in the grantor's gross estate upon his or her death, receive no basis adjustment at death. But is there an alternate argument?
  - IRS CCA 202352018. Gift tax consequences of modifying a grantor trust to add a tax reimbursement clause. (I.R.C. § 2511)

Uses of Grantor Trusts

- As a means of avoiding probate (in the case of a revocable trust).
- As a technique to avoid the compressed tax bracket structure applicable to trusts (in the context of intra-family planning–but be cognizant of relevant individuals' income tax brackets).
- As a "leveraging" tool to increase the impact of gift and sales (in the context of federal estate/gift tax planning) including sales and exchanges of interests between grantor and grantor trust (*e.g.*, selling assets to a grantor trust with no income tax consequence).
- As an asset protection structure to protect business interests from potential creditors or claimants.
- Business succession planning.
- Typical irrevocable grantor trusts include SLATs, QPRTs, GRATs, ILITs, etc.

Illustration of Common Grantor Trust and DRE Structure

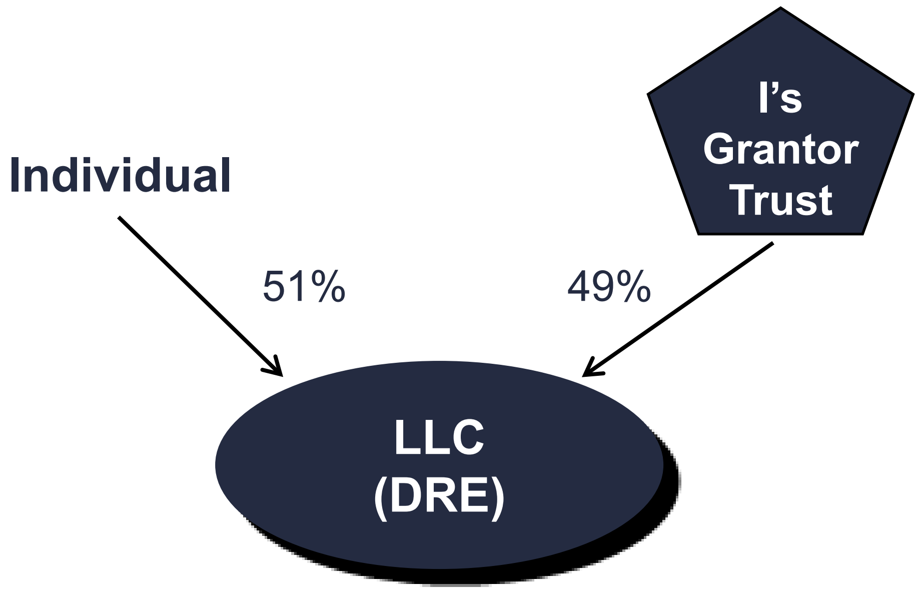
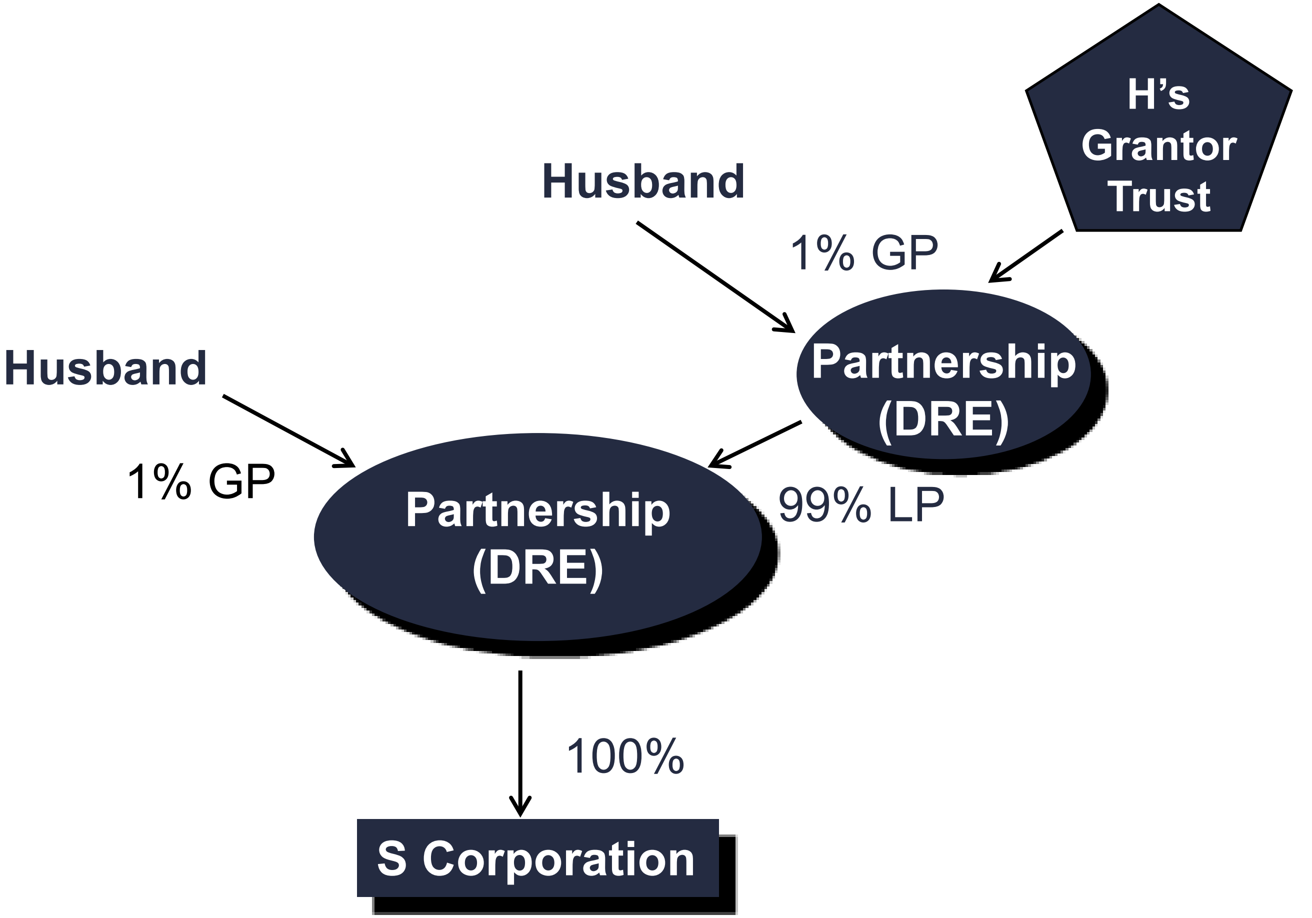


Illustration Involving Grantor Trust and Multiple DREs



- H's Grantor Trust income is taxed to Husband.
- This is a more complicated structure but has little bearing on the disregarded nature of taxation.
- Significant issues arise, however, upon death (or divorce) of Husband including the involuntary termination of S Corporation's S election.

Power of Grantor Trust Status

- Payment of income tax liability of the assets of a grantor trust is not a taxable gift.
- Illustration of wealth transfer power of grantor trust.
  - ❖ Grantor profile:
    - ➢ Single, 80 years old
    - ➢ Hypothetical expected taxable estate = $20MM with no remaining unified credit available [approx. $2.8MM estate tax liability in 2024]
  - ❖ Assume:
    - ➢ Previously funded grantor trust with a current trust corpus net asset value of $15MM, having an annual income tax liability $300,000 when taxed to Grantor (ignore applicable marginal tax rates for purposes of this example).
    - ➢ Over a 5-year period, the satisfaction of the trust's income tax obligation equals the transfer of $1.5MM untaxed.

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Jana represents individuals and multi-generational families. She primarily focuses on tax planning, drafting complex wills and trusts, implementing wealth preservation strategies, and charitable giving. Jana emphasizes helping clients achieve their objectives by designing creative and functional solutions tailored to their specific goals—whether it involves business establishment or reorganization, or facilitating the administration of a trust or estate.

Jana draws from a vast breadth of experience in her law practice. Prior to joining the firm, she managed a large horse ranch and cultivated successful real estate and insurance practices. Jana's business-focused background allows her to understand her clients' concerns and employ a practical approach to tax, estate, and business planning issues.

She holds an LL.M. in Taxation from Georgetown University Law Center with an academic concentration in Estate Planning. During her time at Georgetown, Jana served as an extern for the United States Department of Justice, Tax Division. While working on her J.D., Jana completed her Master's degree in Personal Financial Planning, represented pro bono clients in tax controversy matters with the IRS, served as a Peer Financial Counselor, and clerked for the Honorable Robert L. Jones, United States Bankruptcy Court, Northern District of Texas.

Jana is admitted to practice law in Texas, is Board Certified in Estate Planning and Probate by the Texas Board of Legal Specialization, and is a Certified Financial Planner, CFP®.

DISCLAIMER

The information included in these slides is for discussion purposes only, is not legal advice, and should not be relied on without seeking individual legal advice.