When is a Liquidating Trust a Grantor Trust, and Why Does it Matter?

Due to the economic fallout from the coronavirus pandemic, many businesses are facing the grim possibility of closing down permanently. When winding up a business, liquidating trusts can serve as a useful tool to manage contingent liabilities or difficult-to-sell assets. However, when creating a liquidating trust, the so-called "grantor trust rules" must be carefully considered because they can spoil an otherwise well-planned exit strategy.

First, this article will briefly describe grantor trusts and liquidating trusts. Next, applicable Treasury Regulations and a Revenue Procedure will shed light on how liquidating trusts are taxed. Finally, a recent Tax Court opinion will highlight the dangers the grantor trust rules present to a liquidating trust.

Grantor Trusts

A so-called "grantor trust" is a trust in which the grantor retains so much control, that for income tax purposes, the trust is disregarded. Consequently, the tax law "looks through" the trust and deems the grantor to be the owner of the corpus and/or income.[1] The requisite control can be manifested in a number of various powers and rights held by the grantor, which powers and rights are prescribed by very complex rules. Generally, some of the powers held by the grantor of a grantor trust include, but are not limited to:

1. *Power to revoke*. A trust is a grantor trust if the grantor retains the power to revoke the trust agreement and/or return the trust corpus to the grantor.[2]

2. *Power to distribute income.* A trust is a grantor trust if the trust income may be (i) distributed to the grantor[3]; (ii) held or accumulated for future distribution to the grantor[4]; or (iii) applied to the payment of life insurance premiums for the grantor[5].

3. *Power to dispose of a beneficial interest.* A trust is a grantor trust if the grantor holds a power of disposition of beneficial enjoyment of corpus or income.[6]

4. *Right to a reversionary interest.* A trust is a grantor trust if the grantor retains the right to a reversionary interest in either corpus or income if, at the inception of such portion of the trust, such reversionary interest is valued at more than five percent of the value of such portion.[7]

Liquidating Trusts

Liquidating trusts are a tool that business organizations can use for at least two purposes. One purpose of a liquidating trust (a/k/a litigation trust) arises in the context of Chapter 11 Bankruptcy, where a debtor-in-possession transfers to the liquidating trust certain causes of action – which can take years to fully investigate and prosecute to final judgment – so that the debtor can emerge from bankruptcy quicker than if it had to wait for the causes of action to be fully adjudicated.[8] Another purpose of liquidating trusts arises in the context of a complete liquidation of a corporate subsidiary. Where the assets of a corporate subsidiary are difficult to sell and cannot be liquidated and distributed within the statutory three-year period, the subsidiary transfers the assets to a liquidating trust, allowing the subsidiary's distribution to qualify for tax-free treatment.[9]

Taxation of Liquidating Trusts

Somewhat surprisingly, the Internal Revenue Code and Treasury Regulations make only one express reference to liquidating trusts.[10] Treas. Reg. §301.7702-4(d) describes the conditions under which a trust will be considered a liquidating trust. It states:

> An organization will be considered a liquidating trust if it is organized for the primary purpose of liquidating and distributing the assets transferred to it, and if its activities are all reasonably necessary to, and consistent with, the accomplishment of that purpose. A liquidating trust is treated as a trust for the purposes of the Internal Revenue Code because it is formed with the objective of liquidating particular assets and not as an organization having as its purpose the carrying on of a profit-making business which normally would be conducted through business organizations classified as corporations or partnerships. However, if the liquidation is unreasonably prolonged or if the liquidation purpose becomes so obscured by business activities that the declared purpose of liquidation can be said to be lost or abandoned, the status of the organization will no longer be that of a liquidating trust.

Because liquidating trusts are designed specifically for business organizations it is worth noting Treasury Regulation §1.671-2(e)(4), which states that if a partnership or corporation transfers assets to a trust, the corporation or partnership is treated as the grantor of the trust.[11] Although §1.671-2(e)(4) would appear to always cause the transferring partnership or corporation to be treated as the grantor of a liquidating trust, Revenue Procedure 94-45 can change this result.

Revenue Procedure 94-45 prescribes the method by which a taxpayer can request a letter ruling wherein the Internal Revenue Service (Service) makes the determination that a particular trust qualifies as a liquidating trust. If the conditions in Rev. Proc. 94-45 are met, the taxpayer can effectively escape the grantor trust rules by deeming the transfer as a two-step transaction: (1) the corporation or partnership is deemed to transfer its assets to the liquidating trust's beneficiary; and (2) the beneficiary is deemed to transfer the assets to the liquidating trust.[12] The result is that the liquidating trust is still a grantor trust, but the grantor is deemed to be the beneficiary, not the transferor.[13]

Grantor Trust Rules Applied to a Liquidating Trust

In Sage v. Commissioner, 154 T.C. 12 (2020), the United States Tax Court opined on the income tax consequences of a transaction between an S-corporation and a liquidating trust. In Sage, the Tax Court agreed with the Service that, because a liquidating trust is a grantor trust, a transfer of assets to the liquidating trust is not a "closed and completed transaction"; therefore, a loss cannot be claimed on the transfer of assets to the liquidating trust.[14]

In Sage, the taxpayer was a real estate development company which filed as an S corporation (Taxpayer). In 2009, the Taxpayer and its disregarded entities owned three parcels of real estate located in Oregon. All three parcels secured outstanding loans held by the Taxpayer's lenders. Due to the Great Recession, each parcel was worth less than the loans they secured.

In an attempt to stay solvent, the Taxpayer engaged in several transactions akin to a deed in lieu of foreclosure. On December 31, 2009, at 4:52 p.m., the Taxpayer transferred each of the parcels to three separate liquidating trusts and named the lenders as beneficiaries under the trusts. Simultaneous with the transfer, the Taxpayer sent an email and a letter to each of the lenders notifying them of the transfer and requesting a meeting to "go over these transactions so the bank understands what we did and how we are going to proceed from here." The Taxpayer claimed a loss for 2009, the year in which the parcels were transferred to the liquidating trusts.

For several years after the 2009 transfer, the Taxpayer managed and marketed the parcels. In 2010 and 2012, two of the three parcels were sold and the proceeds applied to the outstanding loans. The third parcel generated some rental income for a time. But, in 2011, in exchange for settlement of the outstanding loan, the Taxpayer transferred the parcel to the lender by deed in lieu of foreclosure.

The Service disallowed the 2009 claimed loss, reasoning that because the liquidating trusts were grantor trusts, the loss was not "evidenced by closed and completed transactions.[1]" The Taxpayer unsuccessfully argued that the lenders were grantors of the liquidating trusts by virtue of the two-step transaction described earlier in Rev. Proc. 94-45. However, because the opinion fails to mention Rev. Proc. 94-45, apparently the parties and the court were unaware of it.

Nevertheless, even if the Taxpayer had requested the letter ruling, it is not clear the Service would have granted it. Section 3 of Revenue Procedure 94-45 requires that a liquidating trust be formed pursuant to a confirmed plan under Chapter 11 of the Bankruptcy Code, and the Taxpayer in Sage apparently did not satisfy this condition. The Tax Court emphasized that the Treasury Regulations under I.R.C. § 677 considers a grantor the owner of any trust "whose income without the approval or consent of an adverse party is, or in the discretion of the grantor or a nonadverse party, or both, may be applied in discharge of a legal obligation of the grantor."[15] Because the liquidating trusts in Sage were in fact used to discharge the legal obligations of the Taxpayer, the Court concluded that the liquidating trusts were grantor trusts.

Because the Tax Court concluded that the liquidating trusts were grantor trusts, the Tax Court agreed with the Service that the 2009 loss was not evidenced by closed and completed transactions.

[1] At first, in the notices of deficiency, the Service disallowed the loss on the grounds that it was "attributable solely to nonbusiness expenses." In briefs to the Tax Court and at trial, however, the Service changed its theory. Because the Service raised a new issue by changing its theory, pursuant to Tax Court Rule 142(a)(1), the Court properly shifted the burden to the Service.

Conclusion

Liquidating trusts are grantor trusts. The identity of the grantor depends on whether a letter ruling is obtained from the Service pursuant to Rev. Proc. 94-45. If the Service determines in a letter ruling that the trust is a liquidating trust, the beneficiary is deemed to be the grantor due to a deemed two-step transaction. If the Service does not determine in a letter ruling that a trust is a liquidating trust, the transferor may be deemed to be the grantor, which may result in a trust that is disregarded for income tax purposes.

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[1] I.R.C. § 671
[2] I.R.C. § 676(a)
[3] I.R.C. § 677(a)(1)
[4] I.R.C. § 677(a)(2)
[5] I.R.C. § 677(a)(3)
[6] I.R.C. § 674(a)
[7] I.R.C. § 673(a)
[8] Chief Counsel Advisory 200149006, 2001 WL 1559018 (Dec. 7 2001)
[9] I.R.C. § 332
[10] Sage v. Commissioner, 154 T.C. 12, 26-27 (2020)
[11] Treas. Reg. § 1.671-2(e)(4)
[12] Rev. Proc. 94-45
[13] Section 3.03, Rev. Proc. 94-45
[14] Treas. Reg. § 1.165-1(b)
[15] Treas. Reg. §1.677(a)-1(d)