Burning Questions (and Even Hotter Answers) About Grantor Trusts

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These materials consider several of today's "hot" issues regarding the use of grantor trusts in contemporary estate planning. They are intended to give some answers to questions frequently asked by practitioners. In some cases, the answers are firm conclusions but most of the time they are little more than one person's opinion. Because of that, and because these materials focus on frontier issues, they are not intended to impart legal advice and no one should rely on their contents.

Despite best intentions, however, some of the statements in these materials could be construed as legal advice. Accordingly, we have to get more formal: please be advised that any federal tax advice contained in these materials is not intended or written to be used, and cannot be used, for the purpose of avoiding penalties under the Internal Revenue Code or for the purpose of promoting, marketing or recommending to another party any transaction or matter addressed herein.

While we're at it, any federal tax advice contained in these materials is not intended or written to be used, and cannot be used, to support any position taken on any tax or information return, to support a determination that any such position satisfies any return preparation standard or to avoid any penalties arising from any such position.

Finally, it should be noted that portions of these materials are adapted from published remarks given at the 40th Heckerling Institute on Estate Planning.[1] These materials elaborate

[1] Samuel A. Donaldson, *Understanding Grantor Trusts*, *in* 40 HECKERLING INSTITUTE ON ESTATE PLANNING 2-1 (Tina Portuando ed., 2006).

considerably on those initial remarks, but it is fair to acknowledge that the current materials stemmed from this original source.

Now that we have established that nothing herein is either reliable or innovative, let's get to the issues.

Options for Creating a Grantor Trust

Q1. In the lion's share of cases, the goal is to create the so-called "defective grantor trust," a grantor trust for income tax purposes that will not cause the trust assets to be included in the grantor's gross estate for estate tax purposes. Which of the powers in §§ 671 – 677 avoid gross estate inclusion?

A1. Planners tend to use one of the following three powers (others may be possible but they don't get the same press):

1. *Loans to the Grantor*. The grantor is treated as the deemed owner of at least a portion of the trust where the grantor or a "nonadverse party"[2] (or both) may exercise a power that enables the grantor to borrow principal or income without having to pay adequate interest or without having to give adequate security for the loan.[3] This rule will not apply, however, where a trustee (other than the grantor) has a general power under the trust instrument to make loans to anyone without regard to the payment of adequate interest or the giving of adequate security.[4] Furthermore, if the grantor-trustee has a general power under the trust instrument "to determine interest rates and the adequacy of security," it does not necessarily follow that the grantor holds a power to borrow principal or income without adequate interest or security.[5] A grantor's power to borrow from the trust without having to pay adequate interest or without having to give adequate security should not cause gross estate inclusion of the trust property. Such a power does not affect beneficial enjoyment of the trust property and

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[2] A nonadverse party is anyone who is not an "adverse party." IRC § 672(b). With me so far? An adverse party is anyone with a *substantial beneficial interest* in the trust that would be *adversely affected* by the exercise or non-exercise of a power with respect to the trust. IRC § 672(a). Generally, if a trust-related power is exercisable only with the consent or permission of an adverse party, such power by itself will not render the power-holder the tax owner of the portion of the trust to which the power relates. As for the question of what constitutes a "substantial beneficial interest," regulations say that "[a]n interest is a substantial interest if its value in relation to the total value of the property subject to the power is not insignificant." Reg. § 1.672(a)-1(a). Thanks to Treasury for the helpful insight.

[3] IRC § 675(2).

[4] Id. See also Reg. § 1.675-1(b)(2).

[5] Reg. § 1.675-1(b)(2).

does not constitute a power to alter or amend the terms of the trust. This power is thus a good candidate for "defective grantor trust" status.

Borrowing on a below-market interest basis, however, is fraught with income and gift tax consequences.[6] Accordingly, most planners seeking to create a defective grantor trust through the borrowing power should provide that any such loans must require the grantor to pay adequate interest. As long as the grantor (or the nonadverse party or both) has an express power to borrow from the trust on an unsecured basis, grantor trust status exists.

Even where the instrument does not contain an express power enabling the grantor to borrow on an unsecured basis, grantor trust treatment can arise in operation. Specifically, the grantor is treated as the deemed owner of at least a portion of the trust to the extent the grantor or the grantor's spouse has actually borrowed principal or income from the trust and has not completely repaid the amount borrowed (including interest) before the start of the taxable year.[7] Deemed ownership will not occur, however, if the loan provides for both adequate interest and adequate security, assuming the loan was made by a trustee other than the grantor, the grantor's spouse, or a "related or subordinate party" that is subservient to the grantor.[8] Merely borrowing from the trust would not necessarily indicate that the grantor has retained ownership of the trust property sufficient to warrant inclusion in the gross estate. For instance, where the grantor borrows trust principal from an independent trustee on an unsecured basis but has agreed to pay adequate interest to the trust, it is difficult to see how § 2036 or § 2038 (or any other gross estate inclusion provision) would be invoked. Thus, this power is also a good candidate for planners seeking to create a defective grantor trust. In fact, because of its flexibility this may be a better power than the power to borrow without adequate interest or security.

2. *Power to Add Charitable Beneficiary*. Generally, any power exercisable by the grantor or a nonadverse party to control beneficial enjoyment of trust property without the consent of an adverse party will render the grantor the deemed owner of the trust.[9] But most powers to affect beneficial enjoyment of trust property will also trigger inclusion in the grantor's gross estate under either or both of § 2036 and § 2038. One important exception is a power to add one or more charitable beneficiaries held by a nonadverse party. For example,

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[6] See IRC § 7872.

[7] IRC § 675(3).

[8] Reg. § 1.675-1(b)(3). A person is a "related or subordinate party" (with respect to the grantor) if such person meets two tests. First, such person must be a nonadverse party. See *supra* note 2. Second, such person must bear one of the following eight relationships to the grantor: (1) the grantor's spouse; (2) the grantor's parent; (3) the grantor's issue; (4) the grantor's sibling; (5) the grantor's employee; (6) a corporation in which either or both the grantor and the trust have "significant" voting power (a "controlled corporation"); (7) an employee of a controlled corporation; or (8) an employee of a corporation in which the grantor is an executive. IRC § 672(c).

[9] IRC § 674(a).

suppose Grantor creates an irrevocable trust for the benefit of Sibling and names a nonadverse party as trustee. If the trustee has the power to add one or more § 501(c)(3) organizations as beneficiaries to the trust, Grantor is treated as the owner of the trust for federal income tax purposes.[10] And assuming Grantor has no retained interest in the trust and no direct power to alter or amend the terms of the trust, no portion of the trust will be included in Grantor's gross estate.

3. *Power to Substitute Assets*. A power held by anyone in a nonfiduciary capacity to "reacquire the trust corpus by substituting other property of an equivalent value" will cause the grantor to be the deemed owner of the trust property.[11] For this purpose there is a presumption that a trustee holding such a power would exercise it in a fiduciary capacity,[12] so the power needs to be held by the grantor or a nonadverse party that has no fiduciary ties to the trust. A nonfiduciary power to substitute assets (a "swap power," as some[13] like to call it) should not cause inclusion of the trust assets in the grantor's gross estate because the right to swap assets does not allow the grantor to make additional wealth transfers or to diminish the value of the trust's holdings. In order for the grantor to take $2 million in assets out of the trust, for example, the grantor must transfer $2 million in assets to the trustee in exchange.

More on Estate Tax Inclusion Caused by Swap Powers

Q2. Didn't the *Jordahl* case hold that no gross estate inclusion results from the grantor's holding a swap power?

A2. Yes and no. In *Estate of Jordahl v. Commissioner*,[14] the Tax Court held that a swap power was not a power to alter beneficial enjoyment under § 2036(a) or § 2038(a) in that there could be no economic benefit to the grantor. Furthermore, the court held that there was no incident of ownership of life insurance by virtue of the swap power, thus negating inclusion under § 2042 where the trust owned a policy of insurance on the grantor's life.[15] But some practitioners think the *Jordahl* case was not very helpful because the grantor in that case arguably held the swap power in a fiduciary capacity. If that's the case, then the trust is not a grantor trust for income tax purposes.

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[10] *Madorin v. Commissioner*, 84 T.C. 667 (1985).

[11] IRC § 675(4)(C).

[12] Reg. § 1.675-1(b)(4).

[13] OK, maybe just me.

[14] 65 T.C. 92 (1975), acq. 1977-1 C.B. 1.

[15] See also *PLR 9227013*.

Q3. So does gross estate inclusion hinge on whether the grantor holds a swap power in a fiduciary capacity?

A3. It might, but it shouldn't. Two letter rulings from 2006 gave some practitioners pause to consider the estate tax consequences of giving the swap power to the grantor. In the first ruling,[16] the grantor contributed cash and stock to a trust and retained a swap power, but the trust instrument expressly provided that the swap power could only be exercised in a *fiduciary* capacity.[17] The Service ruled that the grantor's retention of the swap power will not cause the trust property to be included in the grantor's gross estate under § 2033, § 2036(a), § 2036(b), § 2038 or § 2039. In addition, the Service ruled that the grantor's exercise of the swap power would not constitute a gift to the trust by the grantor for federal gift tax purposes, and neither the grantor nor the trust will recognize gain or loss from exercise of the swap power.

A similar result followed in the second ruling.[18] Here, the grantor contributed cash and stocks to an unrelated party as trustee of an irrevocable trust. The trustee had discretion to distribute income and principal to the grantor's spouse both during the grantor's life and following the grantor's death. The spouse held a testamentary power of appointment over the trust; to the extent the power was not exercised, trust assets were to pass to the grantor's issue. The spouse also held a *Crummey* power with respect to trust contributions. The grantor also had the power to swap assets of equivalent value, although the power was exercisable only in a fiduciary capacity (i.e., undertaken in good faith, in the best interests of the trust and its beneficiaries, and subject to state law standards applicable to fiduciaries). The grantor in the ruling planned to exercise the swap power by transferring shares of one publicly-traded company into the trust in exchange for the trust's shares of another publicly-traded company. If necessary to equalize the value of the swapped assets, the grantor would add cash to the trust or withdraw cash from the trust. The Service ruled that the swap power will not cause the inclusion of the trust's assets in the grantor's gross estate under § 2033, § 2036, § 2038, or § 2039. The Service also ruled that the proposed swap would not be a gift to the trust by the grantor for federal gift tax purposes.

The very careful practitioner might read these two private rulings to mean the Service would reach a different result if the swap power in either case were held in a nonfiduciary capacity (which is often the case since the swap power is added solely to convert what is otherwise an ordinary trust into a grantor trust). But there appears to be no basis for treating nonfiduciary swap powers any differently. Presumably, a swap power is exercisable in a fiduciary capacity if its exercise is in the best interests of the trust's beneficiaries and is

[16] PLR 200603040.

[17] If a swap power is exercisable only in a fiduciary capacity, such power does not serve to make the trust a grantor trust for income tax purposes. Section 675(4)(C) states that a grantor trust is created where a swap power is exercisable in a "nonfiduciary" capacity.

[18] PLR 200606006.

consistent with duties applicable to fiduciaries. For example, one holding a swap power exercisable in fiduciary capacity could apparently “swap in” a more productive asset in exchange for an unproductive asset because such an exchange would improve the value of the beneficiaries’ interests (it is better to hold a productive asset than an unproductive asset, even if the assets have equivalent values), but could not swap in an unproductive asset in exchange for a productive asset because that would undermine the beneficiaries’ interests.

One holding a swap power in a nonfiduciary capacity, however, could exercise the power without regard to whether doing so is helpful or harmful to the interests of the beneficiaries. In other words, the power-holder could act in his or her self-interest. Should that fact alone cause the trust assets to be included in the grantor’s gross estate where the grantor holds the power? It is hard to see how that result could follow. Although the grantor holds the power to control the ultimate beneficial enjoyment of property contributed to the trust (he or she can always get it back for whatever reason by exercise of the swap power), the same is true of trust assets subject to a fiduciary swap power. The only difference is that a fiduciary swap power requires the grantor to part with an “as-good-or-better” asset to reclaim the trust property, while a nonfiduciary swap power permits the grantor to exchange a “worse” asset for the trust property subject only to the constraint that the “worse” asset have the same value as the trust property to be “swapped out.”

The requirement (applicable to fiduciary swap powers and nonfiduciary swap powers) that the exchanged assets have equivalent values is the key. A swap power does not permit the grantor to add to or subtract from the value of the trust’s holdings. There is, therefore, no ability to play with the ultimate value transferred to the trust.[19] The rulings reach the correct result in finding that the trust assets are not includible in the grantor’s gross estate. But these conclusions are not dependent on the fact that the swap powers in both rulings were exercisable in a fiduciary capacity.

Q4. In light of all of this, does it make sense to give the swap power to an independent third party instead of the grantor?

A4. This should work, but it’s not free from controversy either. Some practitioners prefer to give the swap power to someone other than the grantor because this preserves the grantor trust status of the trust and ensures that there is no possible way the grantor could face gross

[19] To the extent the grantor can “swap in” unproductive property and “swap out” productive property, the grantor can affect the future income stream of the trust and perhaps the long-term appreciation in the value of the trust’s principal. Perhaps a retained right to control future income and long-term appreciation is sufficient control over the trust property to justify inclusion of the trust assets in the grantor’s gross estate under § 2036(a). But this is true of both fiduciary swap powers and nonfiduciary swap powers; the fact that the grantor’s exercise of the swap power is constrained by the best interests of the beneficiaries does not change the fact that the grantor still controls the trust’s future income stream and long-term principal growth.

estate inclusion.[20] But there is an argument that only the grantor can hold the swap power if the intent is to create a grantor trust. Section 675(4)(C) refers to the swap power as a power to "reacquire trust property." If the grantor contributes the property but an independent third party has the swap power, the third party would not "reacquire" the property through exercise of the power. To some practitioners, therefore, a swap power in the hands of someone other than the grantor does not confer grantor trust status.

Q5. Didn't the Service recently rule that a swap power will not cause gross estate inclusion?

A5. Yes, but the ruling contains some important limitations. In *Revenue Ruling 2008-22*,[21] the Service concluded that a swap power "will not, by itself, cause the value of the trust corpus to be includible in the grantor's gross estate under § 2036 or 2038, provided the trustee has a fiduciary obligation (under local law or the trust instrument) to ensure the grantor's compliance with the terms of this power by satisfying itself that the properties acquired and substituted by the grantor are in fact of equivalent value, and further provided that the substitution power cannot be exercised in a manner that can shift benefits among the trust beneficiaries."

This language imposes two conditions on those seeking certainty from gross estate inclusion under § 2036 or § 2038. The first condition requires that the trustee have a fiduciary obligation to ensure that the assets being swapped have equal values. This duty must be imposed under local law or the trust instrument. Most local laws would probably impose this duty to the trustee, albeit generally as part of the trustee's general duty to act in the interests of the beneficiaries. Some practitioners have decided to add specific language to the their grantor trust instruments that impose the required duty on the trustee. But that can be dangerous because if the trust is supposed to be a grantor trust, the swap power must be exercisable "without the approval or consent of any person in a fiduciary capacity."[22] If the trust instrument makes the exercise of the swap power specifically contingent on the trustee's approval, there is great risk that the grantor will not be the deemed owner of the trust's assets. If the practitioner wants to add specific language to the trustee's powers to meet this first condition, therefore, it should be expressed as a duty to ensure that the grantor properly exercises the swap power by exchanging property of equivalent values. For example, the trust could provide that if the trustee suspects that the property to be received in exchange for the property to be returned to the grantor is not of equivalent value, the trustee must obtain a court determination that the properties have equivalent value.

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[20] Sections 2036 and 2038 require that the *grantor* retain the power to control beneficial enjoyment. If an independent third party holds such a power, there can be no inclusion in the grantor's gross estate.

[21] 2008-16 I.R.B. 796 (April 21, 2008).

[22] IRC § 675(4).

It's the second condition—that the power cannot be exercised so as to shift the relative benefits of the beneficiaries—that is key to the Service's conclusion. It is apparent that the Service is concerned with situations where the grantor could, for instance, reacquire income-producing property by substituting non-income-producing property of equal value. This would give the grantor the power to control an income beneficiary's stake, and that would normally trigger gross estate inclusion. But if the grantor cannot exercise a swap power in this manner, the swap power should not trigger gross estate inclusion.

The ruling gives two examples that meet this second condition. In the first example, "the trustee has both the power (under local law or the trust instrument) to reinvest the trust corpus and a duty of impartiality with respect to the trust beneficiaries." So if the grantor reacquires income-producing property by substituting non-income-producing property, no gross estate inclusion is required if the trustee converts the new property into income-producing property so as to protect an income beneficiary's interest.

In the second example, "the nature of the trust's investments or the level of income produced by any or all of the trust's investments does not impact the respective interests of the beneficiaries, such as when the trust is administered as a unitrust (under local law or the trust instrument) or when distributions from the trust are limited to discretionary distributions of principal and income." This is a very helpful example, for most irrevocable trusts are either structured as unitrusts or as trusts with only discretionary distributions. So in most cases, compliance with this second condition will not be problematic.

Q6. *Revenue Ruling 2008-22* speaks of inclusion under § 2036 and § 2038. But what about inclusion under § 2042? Maybe a swap power is an "incident of ownership" in a life insurance policy. If the grantor of an ILIT has a swap power, is there risk for inclusion of the policy in the grantor's gross estate?

A6. Not really. First, remember that *Jordahl* involved a trust with life insurance policies and the Tax Court (in a reviewed opinion) held against inclusion. In its acquiescence to the *Jordahl* result, the Service specifically noted that "it was Congresses [sic] intent that Code § 2042 should operate to give insurance policies estate tax treatment roughly parallel to the treatment given other types of property under Code §§ 2036, 2037, 2038, 2041." Under this reasoning, if a swap power does not cause gross estate inclusion under § 2036 or § 2038, it should not cause inclusion under § 2042 either.

Q7. *Revenue Ruling 2008-22* does not mention § 2036(b). Should one be concerned that a swap power in the hands of the grantor is an indirectly retained right to vote shares of controlled corporation stock?

A7. Maybe, but does this really happen a lot? Section 2036(b) will be an issue for a swap power if the trust is funded with voting stock, and most of the time grantors retain their voting shares directly. Even where the trust has voting stock, the grantor has to have the power (direct or indirect) to vote at least 20 percent of the corporation's voting stock. This might be an issue for closely-held stock but not for publicly traded stock. Finally, there is a question whether the power to reacquire such stock is the equivalent of a retained right to vote indirectly. Certainly if the power is exercised then the grantor will have the right to vote the shares. But if the shares stay in trust and are voted by the independent trustee, it might be difficult for the Service to convince a fact-finder that the grantor secretly retained voting power over the shares.

Still, one concerned with the issue could simply provide that the grantor's swap power does not extend to voting stock in a controlled corporation. If the trust will hold such stock, another "grantor trust power" will be required.

Exercising Swap Powers

Q8. I know the grantor never has to exercise the swap power in order to achieve grantor trust status, but are there any situations in which we might advise a grantor to exercise the swap power?

A8. Absolutely. Exercising a swap power can be a good technique for leveraging the benefit of a stepped-up basis at death.[23] Here are five situations where the exercise of a swap power could be advisable (and there may be more):

1. *Near-Death Swaps to Leverage the § 1014 Step-up*. Assets held in a properly structured "defective grantor trust" will not be included in the grantor's gross estate at death. But that means the assets will not be eligible for the § 1014(a) step-up in basis. Instead, the bases of the trust assets will be unchanged as a result of the grantor's death. In most cases, the trust assets will have the same basis that the grantor had in the assets at the time of contribution to the trust. Since the grantor will normally fund a grantor trust with rapidly appreciating assets in order to maximize the benefit of the estate planning strategies utilizing grantor trusts (most notably GRATs and installment sales), it is not uncommon for the trust to hold low-basis assets shortly before the grantor's death or the scheduled termination of the trust.

If the grantor's death is anticipated in the short-term, the grantor might exercise the swap power by exchanging high-basis assets for the trust's low-basis assets. This way, the grantor dies holding low-basis assets that will be eligible for the § 1014(a) step-up. The high-basis assets swapped into the trust will not be included in the grantor's gross estate, and the exchange of assets is not a taxable event.[24] Since those high-basis assets have the same value

[23] Kuno S. Bell, *Use Defective Grantor Trusts for an Effective Triple Play*, PRACTICAL TAX STRATEGIES 12 (July 2005).

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

as the low-basis assets, the grantor has preserved the asset appreciation inside the trust while maximizing use of the basis step-up at death for assets included in the gross estate.

For example, suppose Grantor transferred $1 million in non-depreciable assets (with an aggregate basis of $100,000) to an irrevocable trust in Year One. The trust instrument gave the grantor a swap power. By the end of Year Seven, the assets had grown in value to $2 million. Grantor owned $2 million in cash outside of the trust. Grantor expected to die early in Year Eight, so at the end of Year Seven, Grantor transferred the $2 million in cash to the trust in exchange for the trust's assets. At Grantor's death in Year Eight, the $2 million in low-basis assets is included in Grantor's gross estate, but the $2 million in cash, now held by the trust, is not included. The basis in the assets included in Grantor's gross estate is stepped up to $2 million. By making the swap shortly before death, Grantor maintains the same size of gross estate ($2 million), but is able to get a $1.9 million increase in income tax basis.

In other contexts, attempts to get a last-minute step-up in basis are often thwarted through § 1014(e). This provision states that if a donor makes a gift to a donee who dies within a year of the gift, the gifted property will not receive a step-up in basis to fair market value if the property is bequeathed or devised back to the donor. This rule does not apply to the exercise of a swap power because there is no "gift" of the low-basis assets to the grantor. Put another way, since the grantor and the trust are the same person for federal income tax purposes, there cannot be the gift required to invoke § 1014(e).

2. *Near-Death Swaps to Preserve Loss*. While we often refer to § 1014(a) as the "step-up" in basis, planners should never forget that there can be a step-down in basis too. If the grantor owns a loss asset (one with a basis in excess of value) outright, he or she should consider reacquiring one or more low-basis assets from the grantor trust by substituting the loss asset. This way, the loss is preserved in the trust.

3. *Swaps to Elude the Three-Year Rule*. Suppose the grantor owns an insurance policy outright but has other assets sitting in a defective grantor trust. The current fair market value of the policy might be substantially less than the promised death benefit but the grantor might not want to create an irrevocable life insurance trust because there is concern that the grantor may not survive for the requisite three years following the transfer of the policy.[25] The grantor could swap the policy into the trust to avoid inclusion of the death benefit in the grantor's gross estate. The three-year rule does not apply because, for transfer tax purposes, the exchange between the grantor and the trust is a sale for full and adequate consideration.[26] Moreover, as explained elsewhere in these materials, the exchange will not trigger the "transfer for value" rule, meaning the death benefit will still be excluded from gross income for federal income tax purposes.

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[25] See IRC § 2035(a).

[26] IRC § 2035(d).

4. *Swaps to Control Cash Flow*. Asset swaps can be helpful in situations outside the defective grantor trust context. For example, a GRAT is not a defective grantor trust because the trust's assets will be included in the grantor's gross estate if the grantor dies before the end of the annuity term. But the GRAT regulations do not prohibit giving the grantor a swap power, and doing so could prove useful if the assets inside the GRAT do not appreciate as expected or do not generate the cash flow required to make the GRAT successful.[27]

An asset swap might also be desirable near the end of a GRAT's term or just after the conclusion of an installment sale to a defective grantor trust. If the grantor wants to keep the asset(s) transferred to the trust at the start of the strategy for whatever reason, the grantor could swap in other assets at such time and reacquire the desired property.

5. *Swaps of a Residence*. Conventional wisdom says that a client's personal residence should be placed into a qualified personal residence trust.[28] That's fine, of course, but there are limits on what a qualified personal residence trust can do: the client has to survive the trust term in order for the arrangement to work and it is impossible to make a zeroed-out gift of the residence to the trust. But a swap of the client's residence into an existing defective grantor trust eliminates these hurdles while preserving the income and transfer tax benefits of the qualified personal residence trust strategy. Swapping the home into the defective grantor trust is not a gift (remember, it's a sale for full and adequate consideration for transfer tax purposes) and is not an income-recognition event (it's still a transfer between the grantor and the grantor trust).

In order for the swap to be meaningful, the client will have to pay rent to the trust if the client continues to reside in the home following the swap. This is perhaps a wonderful accident, since other cash payments to the trust would probably be considered gifts. Rent payments are not gifts yet they increase the amount of cash held in the trust.

Q9. If the exercise of a swap power is so great, why don't we hear about them happening on a daily basis?

A9. There is one significant caveat to the exercise of a swap power: the values of the exchanged assets need to be identical. Swaps involving easily valued assets (cash, marketable securities) present no problems, but swaps involving real property, closely-held business interests, or other assets often appraised by professionals invites dispute.

If the values of the exchanged assets are off by even a little bit, adverse tax consequences can follow. For instance, if the value of the reacquired property (the asset(s)

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[27] See Alev T. Lewis, *Planning in Turbulent Times: GRATs*, 33 Tax Adviser 664, 667 (October 2002).

[28] One of the best resources on qualified personal residence trusts is Natalie B. Choate, THE QPRT MANUAL (Ataxplan Publications 2004).

reclaimed from the grantor trust) turns out to be less than the value of the substituted property (the asset(s) transferred to the grantor trust), the grantor has made a gift of the difference in value to the trust. Likewise, if the value of the reacquired property is greater than the value of the substituted property, there is very likely a gift from the beneficiaries of the trust to the grantor, and that's usually a wealth transfer in the wrong direction.

The moral here is that appraisals of the reacquired property and the substituted property are absolutely vital. Planners may also consider written agreements between the grantor and the trustee providing that if the finally-determined values of the swapped assets do not match, the over-compensated party shall pay cash or transfer other assets to the under-compensated party in an amount necessary to equalize the transfers.

Crummey Powers in Grantor Trusts

Q10. Some commentators express concern about inserting *Crummey* powers into grantor trust instruments so that gifts to the trust can qualify for the federal gift tax annual exclusion. What's the reason for their concern?

A10. The concern stems from § 678(a). It says that the *beneficiary* (not the grantor) will be treated as the owner of the trust if the beneficiary has a "power exercisable solely by himself to vest the corpus or the income therefrom in himself." In the eyes of many commentators, a *Crummey* power is a power of the beneficiary to vest corpus in himself (or herself), meaning § 678(a) would apply. In public pronouncements, the Service has supported this view. In *Revenue Ruling 81-6*,[29] the Service concluded that a beneficiary was taxable under § 678(a) because the beneficiary held a *Crummey* power, even though the beneficiary was a minor and thus unable to exercise the power without the appointment of a legal guardian.

If the ruling is correct, this has profound consequences. For one thing, it means the beneficiary (not the grantor) is to be taxed on at least some portion of the trust's income. Unfortunately, *Revenue Ruling 81-6* did not indicate how the beneficiary was to be taxed. Regulations suggest that we apply the trust income to a fraction, the numerator being the amount subject to the *Crummey* power and the denominator being the fair market value of the principal as of the date the *Crummey* power arose.[30] In essence, therefore, the beneficiary will be taxed on a proportionate amount of trust income.

For example, assume Grantor creates a grantor trust and, in 2008, transfers $120,000 worth of income-producing property to the trust. There is one beneficiary of the trust, Child. So that the first $12,000 of Grantor's gift qualifies for the federal gift tax annual exclusion, Child

[29] 1981-1 C.B. 620.

[30] Reg. § 1.671-3(a)(3).

is given a *Crummey* power. Specifically, for 30 days following Grantor's contribution, Child has the power to withdraw up to $12,000 from the trust. Child's withdrawal right lapses in 2008. For the 2008 year, the trust had income of $15,000, $1,000 of which was earned during the 30-day period that Child's withdrawal right existed. Because Child had the right to withdraw $12,000 from the trust but allowed the right to lapse, *Revenue Ruling 81-6* and Regulation § 1.671-3(a)(3) suggest that Child will be taxed on a proportionate share of the trust's income. Child's share is determined by the following fraction:

$$\frac{\text{Amount subject to withdrawal}}{\text{FMV of trust at contribution}} \quad \text{x} \quad \text{trust income} \quad = \quad \text{A's income share}$$

Thus Child is taxed on ten percent of the trust income, but what we do not know for sure is whether Child is taxed on ten percent of $15,000 (trust income for the year) or ten percent of $1,000 (trust income during the period that the withdrawal right existed).

From a technical standpoint, the beneficiary should only be taxed on income that accrued while his or her withdrawal right was open. After all, under § 678(a)(1), the beneficiary only has the requisite "power…to vest the corpus or the income therefrom" during the period that the Crummey power is effective. At all other times, the beneficiary has no such power, so § 678(a)(1) should not apply. Under § 678(a)(2), the beneficiary will be treated as the owner for income tax purposes even if he or she has released the power to access trust funds, but only if the beneficiary "retains such control as would…subject a grantor of a trust to treatment as the owner thereof." When the right to withdraw lapses, a beneficiary retains no ongoing control over the trust corpus or income; thus, § 678(a)(2) should not apply to cause the beneficiary to be taxed. Even if the beneficiary had a "hanging power" with respect to the trust property, the beneficiary should be taxed only on his or her proportionate share of trust income that accrues during the period in which the "hanging power" can be exercised.

Another profound consequence of concluding that § 678(a) applies to *Crummey* powers in grantor trusts relates to installment sale transactions involving grantor trusts. If the grantor is no longer the deemed owner of the entire trust that purchased property from the grantor, the grantor likely must recognize at least a portion of the realized gain from the sale to the trust. But the exact amount of gain that the grantor would have to recognize is uncertain. Assume that Grantor from the previous example sold $1 million worth of assets (with a basis of $200,000) to the trust for a promissory note. Grantor did not recognize gain from the sale because the trust was a grantor trust. Must Grantor now recognize any portion of the $800,000 gain because Child is treated as a part-owner of the trust under § 678(a), though perhaps for only one month of each year? Certainly if Child were treated as a ten-percent owner at all times during the trust's existence, the answer would be easy: Grantor should recognize ten percent of the gain (or $80,000). But since Child is only the owner for one month (and in this case, for a period that ended prior to the sale), would we say that Grantor should recognize 1/12 of ten percent of the gain? Maybe it would be cleaner and simpler answer to say that

Grantor should not recognize the gain if Child's withdrawal right is not in existence at the date of the sale.

Q11. Yikes! There seems to be some uncertainty here about something that should be straightforward. Does this mean one should leave *Crummey* powers out of grantor trust instruments?

A11. Maybe not. Some practitioners take solace in § 678(b). It says that the general rule of § 678(a) does not apply "with respect to a power over income … if the grantor of the trust … is otherwise treated as the owner under the provisions of this subpart other than this section." In other words, § 678(a) does not apply "with respect to a power over income" if the trust is a grantor trust with respect to income. This *may* mean that a beneficiary will not be taxed on the trust's income if the *Crummey* power relates to income and the grantor has a power over trust income described in Subpart E. But most *Crummey* powers relate to principal: the beneficiary is typically given a power to withdraw and aliquot share of the principal contributed to the trust. The *Crummey* power is typically, therefore, a power over principal and not a power over income. So not everyone is convinced that § 678(b) makes for the safe use of *Crummey* powers in grantor trusts.

Recently, however, the Service adopted a relaxed and favorable interpretation of § 678(b). In *Private Letter Ruling 200606006*, the grantor contributed cash and stocks to an unrelated party as trustee of an irrevocable trust. The trustee had discretion to distribute income and principal to the grantor's spouse both during the grantor's life and following the grantor's death.[31] The spouse held a testamentary power of appointment over the trust; to the extent the power is not exercised, trust assets are to pass to the grantor's issue. The spouse also held a *Crummey* power with respect to trust contributions. The Service ruled that although the spouse's *Crummey* power would normally cause the trust income to be taxed to her to some extent under § 678(a), the trust will still be a wholly grantor trust under § 677, thanks to the exception in § 678(b). Although the spouse's *Crummey* power, by definition, is not simply a power over income, the Service is apparently willing to read the § 678(b) exception broadly enough such that the addition of *Crummey* powers in a defective grantor trust will not prevent the trust from being a wholly grantor trust for income tax purposes.

The Service reached similar results in a series of 12 related private letter rulings issued on the same day.[32] In each of the rulings, one or more grantors created a trust that provided for discretionary distributions to other beneficiaries. The grantor(s) in each ruling retained a swap power. Each trust instrument required the trustee to divide the trust assets into sub-trusts, one for each beneficiary. Each beneficiary was also given a *Crummey* power. Each of the grantors sought a ruling that they were the deemed owners of the trust for federal income tax

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[31] This power made the trust a grantor trust for income tax purposes. *See* § 677(a).

[32] *Private Letter Rulings 200729005 – 200729016*.

purposes, including the 100-shareholder limitation applicable to S corporations, even though the beneficiaries had withdrawal powers that would appear to be governed by § 678(a). The Service, citing § 678(b), gave them each the ruling they sought. Accordingly, the beneficiaries were not the deemed owners of the trusts.

More recently, in *Private Letter Ruling 200840025*, a trust created by the grantor gave a nonadverse trustee the power to make unsecured loans to the taxpayer. That made the trust a grantor trust under § 675(2), but the trust also stated that when a beneficiary attains a certain age, the beneficiary may withdraw all or any portion of the trust assets allocated to that beneficiary's separate share. The Service ruled that because the trust is otherwise a grantor trust under § 675(2), grantor trust status will not be lost when a beneficiary reaches the designated age for withdrawal. It also concluded that the trust could hold S corporation stock as long as a nonadverse trustee had the power to make unsecured loans to the grantor.

Q12. Well, if the Service has read § 678(b) favorably in 13 rulings, isn't that a green light to add *Crummey* powers to the form grantor trust instrument?

A12. No. Sure, the rulings may indicate the Service's current position on the application of § 678(b) to *Crummey* powers, but these rulings are not binding authority and generally cannot be cited as precedent. The only public, binding interpretation of the issue is *Revenue Ruling 81-6* and, as discussed above, it only applies the general rule of § 678(a).[33] Until the Service takes an official position on the matter, practitioners should not feel wholly confident about inserting *Crummey* powers into grantor trusts. *More* confident, perhaps—but not wholly confident.

<u>Life Insurance as a Grantor Trust Asset</u>

Q13. Is an irrevocable life insurance trust (ILIT) a grantor trust?

A13. Usually, yes. Most ILITs are grantor trusts since these trust instruments typically provide that income may be applied toward the payment of premiums on policies insuring the grantor's life (or the grantor's spouse's life).[34] Giving the trustee this discretion does not constitute an "incident of ownership" to the grantor; thus, an ILIT with this provision will not inclusion in the grantor's gross estate. It is critical to note that the trust instrument must expressly allow the application of trust *income* for this purpose. A trust instrument that is silent or that allows only the use of principal to pay premiums is not a grantor trust.

Q14. Most ILITs own nothing besides an insurance policy, so it's unusual for the trust to have taxable income. So why should one care whether an ILIT is a grantor trust?

[33] The ruling would not have applied § 678(b) one way or the other because the trust at issue was not a grantor trust.

[34] This provision makes the trust a grantor trust under § 677(a)(3).

A14. Because of the "transfer for value" rule in § 101(a)(2). Under this rule, if a taxpayer transfers a life insurance policy for valuable consideration, the income tax exclusion for death benefits under § 101(a)(1) will be limited to the amount of consideration paid. Since the value of most insurance policies is far less than the amount of the death benefits paid, application of this rule essentially converts tax-free death benefits into ordinary income to all but a very small extent. If the owner of a policy transfers it to a grantor trust, there is no risk that the transfer for value rule would apply.

Q15. OK, but I rarely see clients transferring a life insurance policy to an ILIT "for valuable consideration." Usually the client just makes a gift of the policy to the trust, so the transfer for value rule would not apply in the first place. Do I still care whether the ILIT is a grantor trust?

A15. You should. Suppose, for example, that Grantor owns an insurance policy on Grantor's life that will pay a death benefit of $1 million. Grantor is not expected to live for more than two years. If Grantor gratuitously transfers the policy to an ILIT, Grantor risks estate tax inclusion under § 2035(a). Accordingly, Grantor may fund an ILIT with cash transfers and, in the next taxable year, have the ILIT purchase the policy from Grantor for the policy's fair market value. Assuming the transactions are sufficiently distinct to avoid application of the step transaction doctrine, the purchase of the policy by the trust will eliminate the risk of estate tax inclusion.[35] If the ILIT is a grantor trust, the "transfer for value" rule will not apply and the ILIT will receive the $1 million tax-free, since the trust is ignored and the transaction is treated as though Grantor sold the policy to Grantor (a non-event). If the ILIT is not a grantor trust, Grantor would recognize gain to the extent the value of the policy exceeds the aggregate premiums paid by Grantor, and the ILIT could exclude from gross income that portion of the death benefit equal to the amount paid for the policy and any subsequent premiums it paid.

Q16. Are there other situations when I will wish that an ILIT was a grantor trust?

A16. Sure. Consider the facts from *Revenue Ruling 2007-13*.[36] In that ruling, a grantor created two trusts, cleverly titled TR1 and TR2. TR2 transferred a life insurance contract on the life of the grantor to TR1 in exchange for cash. TR1 was a grantor trust. The Service ruled that if TR2 is also a grantor trust, there is no "transfer for value" because the grantor is the deemed owner of both trusts. The transaction between two grantor trusts is disregarded because it is, in substance, a sale of the policy by the grantor to the grantor. The Service also ruled that if TR2 is not a grantor trust, then the transaction will not be disregarded, but the transaction will still be excepted from the "transfer for value" rule because it is treated as a transfer to the grantor, the insured.

[35] This is because there has been a sale of the policy for full and adequate consideration in money or money's worth. See § 2035(d).

[36] 2007-1 C.B. 684.

This ruling effectively green-lights a strategy for amending the otherwise irrevocable trust. Suppose, for example, that Grantor created an ILIT several years ago, but has since become unhappy with its dispositive provisions. Grantor could contribute cash to a new ILIT with satisfactory terms. The new ILIT could then buy the policy from the old ILIT at fair market value. Again, none of the proposed transactions is a "transfer for value" if both of the ILITs involved are grantor trusts. Further, there should be no inclusion in the grantor's gross estate here because the transaction between the trusts is a sale for full and adequate consideration.

Grantor's Payment of Tax on Trust's Income & Tax Reimbursement Clauses

Q17. Why is it good that the grantor pays the tax on the grantor trust's income?

A17. Two reasons. First, to the extent the income from a grantor trust is taxed to the grantor or some other individual, it is likely that less total federal income tax is paid. Consider, for example, Grantor, an individual with a taxable income of $100,100 in 2010, and Trust, a separate taxable entity with gross income of $100,100 and no deductions or credits attributable to its assets. On these facts, the total tax liability of Grantor and Trust for 2010 is $55,712.75:

Analysis for Grantor		Analysis for Trust	
Taxable Income	$100,100	Gross Income	$100,100
		Less Exemption	($100)
2010 Tax Liability	**$21,737.25**	Taxable Income	$100,000
		2010 Tax Liability	**$33,975.50**
Aggregate 2010 Tax Liability: $55,712.75			

But if Trust is a grantor trust, Trust's income is imputed to Grantor. Grantor cannot claim the $100 exemption available to trusts because that deduction is not attributable to the trust assets, but even so the total tax liability for 2010 is reduced to $51,182.75:

Analysis for Grantor		Analysis for Trust
Taxable Income	$200,200	None.
		All income imputed to G for 2010.
2010 Tax Liability	**$51,182.75**	
Aggregate 2010 Tax Liability: $51,182.75		

Second, the grantor's payment of the income tax attributable to the trust's assets allows all of such income to remain in the trust without making any additional gift. Where the trust is a separate taxable entity, the grantor would have to make an additional wealth transfer to the trust to restore the amount lost to taxes. By paying the taxes directly, the grantor effectively makes a tax-free wealth transfer to the trust. Speaking of which…

Q18. Are there adverse tax consequences when the grantor pays the federal income tax liability attributable to the grantor trust's income?

A18. No.[37] The tax liability belongs to the grantor, so the grantor's payment of the tax is not extra income to the trust and it is not a gift to the trust's beneficiaries. Treasury made this clear in *Revenue Ruling 2004-64*,[38] stating: "When the grantor of a trust, who is treated as the owner of the trust under subpart E, pays the income tax attributable to the inclusion of the trust's income in the grantor's taxable income, the grantor is not treated as making a gift of the amount of the tax to the trust beneficiaries."

Q19. Should the grantor trust instrument permit the trustee to reimburse the grantor for the extra income taxes attributable to the trust?

A19. It's fine for the trust instrument to include such a provision, but in practice the trustee should rarely, if ever, exercise the discretion to reimburse the grantor.

Tax reimbursement clauses became all the rage when Treasury issued *Revenue Ruling 2004-64*.[39] The ruling indicates that the reimbursement of the grantor's additional tax expense may cause inclusion of the trust assets in the grantor's gross income. The ruling holds that if the trust instrument requires the trustee to reimburse the grantor, the grantor has effectively retained the right to use trust property to discharge the grantor's obligation to pay federal income tax, meaning the full value of the trust assets must be included in the grantor's gross estate under § 2036(a)(1).[40] (The ruling offers one piece of good news here: the distribution from the trust is not an indirect gift *to* the grantor from the trust beneficiaries, since the distribution is required by the trust instrument.)

If, however, the trust instrument gives the trustee the discretion to make reimburse the grantor from trust funds, then—assuming there is no express or implied understanding between the grantor and the trustee that the trustee will exercise its discretion in favor of the grantor—there is no inclusion of the trust's assets in the grantor's gross estate at death under § 2036(a)(1), no matter whether the discretion is exercised and no matter whether the discretion

[37] Of course, the payment of the tax itself will be seen by some clients as an adverse consequence. But once the practitioner explains the income tax savings usually resulting from the grantor trust, a client should be convinced that this is the preferred result.

[38] 2004-2 C.B. 7.

[39] Id.

[40] The Service announced that the application of § 2036(a)(1) in this second situation will not occur with respect to any trust created before October 4, 2004.

is granted by the trust instrument or by virtue of state law.[41] (Here, too, by the way, the Service said there is no indirect gift by the trust beneficiaries to the grantor if the trustee exercises its discretion to reimburse the grantor—this time because the transfer was made "pursuant to the exercise of the trustee's discretionary authority granted under the terms of the trust instrument.")

These results are correct and hardly surprising. To the extent the trust is required to reimburse the grantor for income taxes paid, the grantor clearly has a retained interest in the trust property that warrants inclusion in the gross estate under § 2036(a) unless the grantor's right to reimbursement expires prior to the grantor's death. Discretionary tax reimbursements, however, should not be included in the gross estate because the grantor's interest in the trust property must go through a trustee. Unless the trustee has indicated that the trustee will always pay the reimbursement or will do so anytime the grantor makes a request, one cannot say that the grantor has formally retained any right to possess or enjoy the trust assets or the income therefrom.[42] The ruling properly makes note of this exception in concluding that § 2036(a)(1) does not apply.[43]

But just because a discretionary tax reimbursement clause does not automatically cause inclusion in the grantor's gross estate, it does not follow that they should be used. Because the grantor's payment of the taxes attributable to the trust's income is not a gift, the grantor's payment is a good vehicle for effecting additional wealth transfers to the trust's beneficiaries at no transfer tax cost. Where the grantor has sufficient assets to pay the trust's tax liability, the use of a tax reimbursement clause might undermine the opportunity to effect the equivalent of a transfer-tax-free contribution to the trust. If the trustee reimburses the grantor for income

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[41] The facts of the ruling involve a discretionary reimbursement power held by a trustee that is not a "related or subordinate party." Some commentators wonder whether the Service would reach a different result if the trustee was a related or subordinate party. Alan Halperin & Andrea Levine Sanft, *2004-64 Sparks Applause But Leaves Questions*, 143 TRUSTS & ESTATES 22, 25 (September 2004). They conclude that the Service might be more inclined to conclude that a related/subordinate trustee and the grantor have an implied agreement regarding the exercise of the reimbursement power. But since gross estate inclusion normally does not hinge on the relationship between the trustee and the grantor, it seems unlikely that the Service would maintain this presumption.

[42] At least one commentator prior to *Revenue Ruling 2004-64* felt that a discretionary tax reimbursement clause triggered § 2036(a) inclusion under Regulation § 20.2036-1(b)(2) because the grantor effectively retained the right to have trust property "applied toward discharge of a legal obligation of the (grantor)." Roy Adams, *Today's Lesson: Paying Taxes for Grantor Trusts*, 141 TRUSTS & ESTATES 41, 41-42 (May 2002). But the regulation contemplates a *mandatory* tax reimbursement clause, for it requires inclusion of trust assets where the income or principal "*is* to be applied toward discharge of a legal obligation" (emphasis added). Under a discretionary tax reimbursement clause, trust property *may* be applied to satisfying the grantor's obligation, but it is not required. Thus, the regulation probably does not apply to discretionary tax reimbursement clauses, and *Revenue Ruling 2004-64* acknowledges this.

[43] This was consistent with the Service's conclusion in *PLR 200120021* (ruling that a trustee's discretionary power to pay the grantor's income tax liability attributable to the trust's income did not cause gross estate inclusion under § 2036(a)).

taxes paid, one of two results will follow, and neither is pretty: either the trust will have less after-tax income available for the beneficiaries (whether distributed or accumulated), or the grantor will have to make a gift transfer to the trust in an amount equal to the reimbursement to keep the trust whole.

For example, suppose Grantor, an individual in the 35% federal income tax bracket, creates an irrevocable grantor trust for the benefit of Grantor's heirs. The gross income for the trust in Year One is $50,000. Because Grantor is the deemed owner of the trust, Grantor must include $50,000 in gross income. Grantor thus pays an additional $17,500 of federal income tax in Year Two attributable to the $50,000 of trust income from Year One (35% x $50,000 = $17,500). As a result of Grantor's payment, the trust can accumulate or distribute the full $50,000 to the beneficiaries, not just an after-tax amount. And, as *Revenue Ruling 2004-64* made clear, Grantor's payment of the $17,500 is not a gift to Grantor's heirs. But if the trust has a discretionary tax reimbursement clause and, in Year Two, the independent trustee distributes $17,500 to Grantor to reimburse Grantor for the taxes paid, the trust would have only $32,500 of after-tax income available to accumulate or distribute for the benefit of Grantor's heirs. If Grantor wants there to be $50,000 available after income taxes, Grantor will have to make a gift transfer of $17,500 back to the trust.

Still, the initial answer to this question said that having such a provision in the trust instrument is not a bad idea. If there is a chance that the tax burden associated with grantor trust status poses a cash-flow problem for the grantor, or if one fears unexpected events that may dramatically increase the tax burden associated with the trust (a surge in asset value or yield, a change in tax laws, or the like), a tax reimbursement clause makes sense, though the analysis above suggests that trustees should be careful to exercise the reimbursement power only as absolutely necessary.[44]

Another issue to consider is creditor protection. If the trustee has the discretion to reimburse the grantor from trust assets, perhaps state law might subject the trust property to the claims of the grantor's creditors.[45] Practitioners might want to avoid a tax reimbursement clause if applicable state law would cause the assets to be available to the grantor's creditors.

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[44] If the trust instrument gives the grantor a power to reacquire trust assets by substituting property of equivalent value, the grantor could also alleviate the income tax burden from the trust by exercising this power. If the tax burden is too high and the trust is not making payments to the grantor in some other capacity (like through an installment sale transaction), the grantor could swap in assets that will produce little or no taxable income and reclaim the income-producing assets that are triggering the adding tax liability. After the swap, the grantor will have the income from the assets that created this tax burden and thus will have the resources to pay the tax.

[45] See Halperin & Sanft, *supra* note 41, at 25. Some states have taken steps to keep creditors away from trusts that have tax reimbursement clauses. Delaware law, for example, provides that creditors cannot assert a claim against property transferred to an irrevocable trust simply because the instrument contains a provision allowing for:

> The transferor's potential or actual receipt of income or principal to pay, in whole or in part, income taxes due on income of the trust if such potential or actual receipt of income or principal is pursuant to a provision in the trust instrument that expressly provides for the payment of such

Q20. If I am going to add a discretionary tax reimbursement clause to my form grantor trust instrument, what should I make sure to include or omit?

A20. The foregoing analysis suggests two important considerations. First, if the planner seeks to avoid inclusion of the trust's assets in the grantor's gross estate, there should not be a mandatory tax reimbursement clause. This is not a significant sacrifice, since mandatory tax reimbursement undermines some of the effectiveness of the grantor trust strategy in contemporary estate planning.

Second, discretionary tax reimbursement clauses are acceptable provided the trust has an independent trustee and measures are taken to ensure that the trustee will not automatically accede to every reimbursement request from the grantor. For example, the discretionary tax reimbursement clause might limit the trustee's exercise of discretion to an ascertainable standard, providing that the trustee may reimburse the grantor only where the trustee determines that such reimbursement is necessary to allow the grantor to maintain the grantor's accustomed standard of living or for the grantor's maintenance, education, support or health. This limitation on the trustee's discretion is not required by *Revenue Ruling 2004-64*, but it should be an adequate safeguard against an assertion that that trustee and the grantor had an implied arrangement that the trustee would routinely exercise its discretion in favor of the grantor.

More aggressive (but still perfectly ethical and responsible) planners might simply insert a discretionary tax reimbursement clause and be willing to fight if the Service alleges an implied arrangement between the grantor and trustee. Even this more aggressive strategy should employ an independent trustee; neither the grantor nor a "related or subordinate party" should be the trustee if the trust will contain a naked discretionary tax reimbursement clause.

Planners contemplating a tax reimbursement clause in a GRAT might want to limit the ability of the trustee to pay a reimbursement to the grantor to those situations where the trust's income exceeds the amount of income required to pay the annuity amount to the grantor. Such payments from excess income to the grantor will not jeopardize the qualification of the grantor's annuity right as a qualified annuity interest.[46] The tax reimbursement should not count against the amount required to the distributed to the grantor; any reimbursement

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> taxes and if such potential or actual receipt of income or principal would be the result of a qualified trustee's or qualified trustees' acting: (A) In such qualified trustee's or qualified trustees' discretion; or (B) At the direction of an adviser described in paragraph (9)(c) of this section who is acting in such adviser's discretion. Distributions to pay income taxes made under discretion included in a governing instrument pursuant to … this subparagraph 9 of paragraph (10)(b) of this section may be made by direct payment to the taxing authorities.

Delaware Code § 3570(10)(b)(9). (Thanks to Richard W. Nenno for sharing the word about the Delaware law.)

[46] Reg. §25.2702-3(b)(1)(iii).

must be in excess of the amount required to be paid under the qualified annuity interest. Of course, a tax reimbursement clause may not be required at all if the grantor intends to use all or a portion of the distributed annuity amount to satisfy the federal income tax obligation associated with including the trust's income as part of the grantor's income. If the maximum transfer benefit of a GRAT arises from leaving principal and excess income inside the trust, a tax reimbursement clause on top of the qualified annuity interest may be antithetical to the trust's purpose; on the other hand, the tax reimbursement clause can provide a means for effecting a larger-than-otherwise-allowed distribution to the grantor should the grantor have a sudden or unexpected need for a larger distribution.

Q21. Suppose I have an existing trust that does not contain a discretionary tax reimbursement clause. The law in my state allows me to reform the trust to add such a clause if all interested parties agree. Would such a reformation have adverse tax consequences?

A21. Probably not. In *Private Letter Ruling 200822008*, the grantor created an irrevocable grantor trust that named his spouse as trustee. The original trust instrument prohibited the trustee from reimbursing the taxpayer for any income tax the grantor paid on the trust's income. The trustee wanted to petition a court for a judgment to modify the trust so as to authorize (but not require) the trustee—with the approval of a "Reimbursement Committee" (to be initially comprised only of the grantor's attorney) and at least one child beneficiary of majority age who qualifies as an "adverse party"—to reimburse the grantor for any federal, state, or local income tax liability attributable to the trust's income. The Service ruled that the proposed reformation would not, by itself, cause the assets of the trust to be included in the grantor's gross estate. In this particular case, "assuming there is no understanding, express or implied, between the [grantor], the members of the Reimbursement Committee and the trustee regarding the trustee's exercise of discretion," the grantor does not hold a retained interest that would trigger inclusion under § 2036.

However, the Service warned, "as noted in *Rev. Rul. 2004-64*, such discretion combined with other facts (including but not limited to: an understanding or pre-existing arrangement between [the grantor] and the trustee, or member(s) of the Reimbursement Committee regarding the trustee's exercise of this discretion; or applicable local law subjecting the trust assets to the claims of [the grantor's] creditors) may cause inclusion of Trust's assets in [the grantor's] gross estate for federal estate tax purposes." Furthermore, said the Service, the proposed reformation will not affect the status of the trust as a grantor trust.

<u>Toggling</u>

Q22. Is it possible to construct a "toggle switch" in the trust instrument to switch from grantor trust status to non-grantor trust status?

A22. Yes. In *Private Letter Ruling 9304017*, the Service ruled that the trusts at issue were grantor trusts where the trustee had the power to add or remove a beneficiary. The trust agreements also allowed the trustee to renounce this power irrevocably if done so in writing. Doing so would eliminate the power of control beneficial enjoyment of the trust property, so a waiver in compliance with the trust agreement would be effective in "turning off" grantor trust status.

Q23. Can one properly draft the trust instrument so that grantor trust status starts at some point in the future and not upon formation of the trust?

A23. Structuring a "springing power" (thus causing a non-grantor trust to convert to a grantor trust) may present a trickier drafting problem, but it should be possible. Presumably, the power would arise at a certain date or upon the occurrence of a stated event.

The trust could also be structured so that some person or persons hold the power to confer grantor trust status. Some have suggested the trustee could have the power to create grantor trust status (by giving the grantor a swap power, for example) that arises every two years. At such time, the trustee could decide whether to "turn on" grantor trust status. If the trustee decides against the power, he or she simply refuses the power and waits two years for the power to arise again. This is an untried technique and its validity is certainly open to speculation. Yet as long as the trustee may exercise this power to "turn on" grantor trust status only in a fiduciary capacity, the trustee should not face adverse income, estate, or gift tax consequences.

The concern is that a trustee acting in the best interests of the beneficiaries will almost always want grantor trust status. ("Gee," thinks the trustee, "why should the trust pay the tax on its income when I can make the grantor pay the tax?") If the trustee has the power to give the grantor a swap power but refuses to do so, there might be a legitimate question as to why the trustee would prefer to have the taxes paid at the expense of the beneficiaries. For this reason, it might be safer to have an independent committee of non-fiduciaries with the power to give the grantor a swap power. But one may wonder, if the committee members have no fiduciary duties, what standards would apply to guide them in deciding whether and when to confer the power to the grantor. Theoretically, therefore, a spring power is possible, but there is little firm guidance for how this is to be implemented in practice.

Q24. Like Miley Cyrus, I want the best of both worlds: I want to be able to turn grantor trust status on or off each year as circumstances dictate. Can this be done?

A24. I think so, and no special drafting should be required. As long as the grantor borrows principal or income from the trust and has not repaid the amount borrowed before the start of the trust's taxable year, the trust will be a grantor trust for that taxable year.[47] If the grantor wants to "turn off" grantor status, the grantor need only repay all amounts borrowed from the trust. If there are no loans outstanding, the grantor can "turn on" grantor trust status simply by borrowing from the trust in the year before the year in which the "turn on" is to occur. This ability to toggle back and forth from grantor trust status to non-grantor trust status is somewhat limited by the fact that grantor trust status is measured as of the *first* day of the taxable year. The grantor may not know at the beginning of the year whether grantor trust status would be desirable.

<u>Installment Sales with Grantor Trusts</u>

Q25. My client just sold some property to a "defective grantor trust." If the client survives to the repayment of the note, of course, all is good. But I am less certain about what happens if my client dies before the note has been repaid in full. So what happens?

A25. Upon the grantor's death, a grantor trust ceases to have such status. It becomes a non-grantor trust unless some other person becomes the deemed owner.

Q26. The original transaction did not give rise to gain because the grantor and the trust were the same person. God bless *Revenue Ruling 85-13.* But now that the trust is a separate taxpayer, do we have to recognize gain for income tax purposes?

A26. Conventional wisdom says yes, since *Revenue Ruling 85-13* concluded that sale to a grantor trust was ignored for income tax purposes because the trust and the grantor are considered the same person. Since the trust and the grantor are no longer the same person, perhaps the Service could require the grantor's final Form 1040 to report the gain from the sale. But several commentators have observed that this would violate *Revenue Ruling 85-13*, for reporting on the final Form 1040 assumes a sale in the moments before death, which does not occur. If the grantor's death is a taxable event at all, then, it must be taxable to the estate (or to the beneficiaries) on a Form 1041. As explained below, however, most commentators feel that because the payments from the trust are not IRD, there is no basis for reporting the gain on a Form 1041 either. Thus, a critical mass of commentators has made the case that the grantor's death should not cause recognition of the gain from the sale.[48]

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[47] IRC § 675(3). Deemed ownership will not occur, however, if the loan provides for both adequate interest and adequate security, assuming the loan was made by a trustee other than the grantor, the grantor's spouse, or an RSP subservient to the grantor. See discussion *supra* notes 7-8 and accompanying text.

[48] See, e.g., Laura H. Peebles, *Death of an IDIT Noteholder*, TRUSTS & ESTATES 28 (August, 2005); Jonathan G. Blattmachr, Mitchell M. Gans & Hugh H. Jacobson, *Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor's Death*, 97 J. TAX'N 149, 153 – 154 (September 2002); Shore & McClung, *Beyond the Basic SUPERFREEZE—An Update and Additional Planning Opportunities*, TAXES 41, 46 (January 1997).

Q27. What is the trust's basis in the assets it purchased from the now-deceased grantor?

A27. On this point, commentators take different approaches. We know from *Revenue Ruling 85-13* that the once-defective grantor trust ceases to be a grantor trust for federal income tax purposes upon the death of the grantor. Now that it is a separate taxpayer, it becomes necessary to compute the trust's basis in the property purchased in the installment sale transaction. The default rule for basis is § 1012, which provides that a taxpayer's basis is its cost "except as otherwise provided." That would likely mean the trust takes a basis equal to the purchase price it agreed to pay to the grantor from the installment sale transaction, unless some exception applies.

Arguably, there are *two* exceptions. One possibility is § 1014, which would provide a stepped-up basis in the case of property acquired from a decedent. Some commentators believe that because there is no "transfer" from the grantor to the trust until the grantor's death, the trust has acquired the property "from a decedent" and thus is eligible for a stepped-up basis.[49] Because the transfer from the grantor at death is structured as a part-bequest, part-sale (because the trust is paying for the property with an installment note), the basis rules effectively award the trust a stepped-up basis.

For example, suppose Grantor created a defective grantor trust in 2001, and in that year Grantor sold property worth $1,000,000 to the trust in exchange for a balloon note from the trustee in the principal amount of $1,000,000. Grantor's basis in the property was $100,000. The note provided for the payment of interest at the applicable Federal rate. Grantor died in 2007 when the value of the property is $1,800,000. Some commentators conclude that the trust's basis in the property immediately following Grantor's death is $1,800,000. This is because no transfer to the trust occurs until Grantor's death in 2007. At the time of the transfer, the trust receives property worth $1,800,000 in exchange for a note in the principal amount of $1,000,000. The trust has a "cost" basis of $1,000,000. But the trust is also receiving a bequest in the amount of $800,000 (the difference between the value of the property at the time of the "transfer" and the purchase price payable by the trust). Under § 1014, the bequest portion of the transaction gets a fair market value basis. Thus, the trust gets another $800,000 in basis, making its total basis in the property $1,800,000, the property's fair market value at death.

The weakness in this theory is that only ten forms of property are considered to have been acquired from or to have pass from a decedent for § 1014 purposes, and these forms are listed in § 1014(b). The property received by the new, non-grantor trust through a deemed transfer at the grantor's death is not clearly described in § 1014(b). Since the property transferred to the trust at death is not included in the grantor's gross estate (it was a defective

[49] See Blattmachr, Gans & Jacobson, *supra* note 48, at 154 – 155.

grantor trust, remember), § 1014(b)(9) is not available.[50] Likewise, § 1014(b)(1) would seem to be of little help. It covers property "acquired by bequest, devise, or inheritance, or by the decedent's estate from the decedent." It seems doubtful that the death-time transfer from the grantor to the trust, which occurs by operation of federal income tax law, could be classified as "bequest, devise or inheritance" from the grantor—the transfer is likely not provided for in the decedent's will and the transfer is not one resulting from the laws of intestate succession. At best, one could argue that the constructive transfer at death is really a two-step dance: first, the decedent's estate acquired the property from the decedent (qualifying the property for the § 1014 step-up); and, second, the estate then transferred the property to the trust immediately thereafter. This fiction is indeed a stretch, for it assumes the estate has rights to the property and perhaps that the fiduciary would agree to a sale of the property at less than arms-length.

Assuming § 1014 does not apply to determine the trust's basis, one must look for some other exception to § 1012. The other major exception is § 1015. Section 1015(a) is familiar turf for estate planners—we all know that a donee takes the donor's basis in gifted property (except when determining loss from the disposition of gifted property that had a basis in excess of its value at the time of the gift). But what is lesser known is § 1015(b). It provides that property acquired "by a transfer in trust (other than … by a gift, bequest, or devise)" has the same basis as it would in the hands of the donor, increased by any gain (or decreased by any loss) recognized to the grantor upon such a transfer. Since the trust acquired the purchased assets through a transfer in trust, some commentators believe § 1015(b) applies such that the trust takes the grantor's basis in the property purchased.[51] Although the transfer of the assets to the then-defective grantor trust was not recognized as a sale transaction for federal income tax purposes, it was, commentators say, a transfer to the trust nonetheless.

Q28. Going forward, must the grantor's beneficiaries, now holders of the trust's promissory note, report gain from the note as payments are made?

A28. Good question. Some commentators take the position that post-death payments on the note are income in respect of a decedent (IRD) and therefore taxable to the beneficiaries when they receive payments. Others conclude that the payments are not taxable to the beneficiaries, though their reasons for this conclusion are varied. Some say that because the payments would not be income to the grantor in the first place under *Revenue Ruling 85-13*, they could not be IRD under § 691.[52] Others read the regulations[53] to say that the payments could be IRD under §

[50] Nor are §§ 1014(b)(2) (property held by a revocable living trust), 1014(b)(3) (property held by a trust in which the decedent retained a power to alter or amend enjoyment), 1014(b)(4) (property passing for less than full consideration by testamentary exercise of a general power of appointment), 1014(b)(5) (a now-defunct rule for certain stock in a foreign personal holding company), 1014(b)(6) (the surviving spouse's share of community property), 1014(b)(7) (a pre-1947 rule for community property), 1014(b)(8) (a pre-1954 rule for joint and survivor annuities), and 1014(b)(10) (property includible under § 2044 because of a marital deduction previously allowed).

[51] See Peebles, *supra* note 48, at 33.

[52] See Blattmachr, Gans & Jacobson, *supra* note 48, at 153 – 154.

691(a)(4) only if the original transaction with the grantor was properly reportable as an installment sale subject to § 453. Since the original transaction was not subject to § 453 (it was not even recognized at the time!), the payments to the beneficiaries of the note could not be IRD.

[53] Reg. § 1.691-5. See Peebles, *supra* note 48, at 33.