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UNDERSTANDING GRANTOR TRUSTS

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I. Introduction

This article explores grantor trusts and the role they play in Subchapter J. Trusts treated as grantor trusts are "ignored" for income tax purposes with the grantor being viewed as the taxpayer. The need for probate avoidance in many states, the compressed income tax rates on complex trusts, and the desire of many taxpayers to accomplish sophisticated tax planning have led to the use of grantor trusts in many diverse circumstances. Determining whether a trust is or is not a grantor trust presents some challenges. The material which follows explores grantor trust status, its history, how to identify a grantor trust, and the tax consequences surrounding this status.

A. Overview of the Grantor Trust Status

A grantor trust is a trust in which either the grantor or another person possessing sufficient specifically enumerated rights and/or interests in or over the trust is considered to be the "owner" of the trust. The retention or possession of these rights gives the person identified as the grantor dominion and control over the trust property and/or the trust income.

The basic issue in the grantor trust area is who is going to be taxed when the grantor has retained a certain degree of control – the trust, the beneficiary or the grantor. Once a trust is characterized as a grantor trust, the grantor when determining his or her taxable income must include all of the income, deductions and credits available at the trust level.

In order to determine whether a grantor possesses the specifically enumerated rights and interests as described in the governing trust instrument to require classification of the trust as a grantor trust, Code Sections 673 through 677 must be examined, as they define the circumstances under which income of a trust is taxed to the grantor. Reg. 1.671-1(a.) In addition, a person who is not a transferor of property to the trust, but who, as a beneficiary of the trust possesses certain rights, such as a power of withdrawal over the trust income or principal, may be deemed a grantor of the trust and considered to be an owner of the entire trust or a portion of the trust for income tax purposes. Code Section 678.

To the extent that the grantor or another retains certain benefits or control over the trust, the normal rules governing taxation of nongrantor trusts contained in Subparts A – D of Part I of Subchapter J (i.e. primarily the discussion of simple trusts and complex trusts) do not apply. Instead, the trust income is taxed to the grantor or other person with control over the trust under the rules set forth in Subpart E of Subchapter J, Code Sections 671 -678 and the regulations promulgated thereunder.

B. The Historical Background of Grantor Trust Status

When the federal income tax was enacted in 1913, it did not require 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 Internal Revenue Code in 1924 required the income of a revocable trust to be taxed to the grantor. The next thirty years saw a number of planning techniques attempted by taxpayers and court challenges brought by the government to try to deny attempts by taxpayers to shift income to persons in lower tax brackets through the use of a variety of trust arrangements.

The early cases had a common theme. They all involved efforts by the grantor of a trust to use the trust or its beneficiaries as separate taxpayers in order to take advantage of the entity's lower income tax rates, even in situations where the grantor of the trust retained substantial control over the income and/or principal of the trust. In *Corliss v. Bowers,* for example, 281 U.S. 376 (1930), Mr. Corliss created a revocable trust for the benefit of his wife and children. The trust paid income to his wife, but the IRS assessed income tax against Mr. Corliss. The couple had filed separate income tax returns. Justice Holmes had no problem finding for the government, as he wrote, "[If] a man disposes of a fund in such a way that another is allowed to enjoy the income which it is in the power of the first to appropriate it does not matter whether the permission is given by assent or by failure to express dissent. The income that is subject to a man's unfettered command and that he is free to enjoy at his own option may be taxed to him as income, whether he sees fit to enjoy it or not."

These cases addressed issues involving attempted anticipatory assignments of income by high bracket taxpayers to shift the tax consequences of income receipts to the lowest bracket taxpayer. In *Lucas v. Earl*, 281 U.S. 111 (1930) the Supreme Court held that income must be taxed to the one who earns it, a theme seen later in the enactment of the grantor trust rules. In *Helvering v. Horst*, 311 U.S. 112 (1940), the passage of bond interest coupons from donor to donee was held ineffective to give away the right to income since the donor still controlled the bonds from which the interest coupons were derived. These cases led to the "fruit" (the coupons) and the "tree" (the bonds) analogy, with taxation imposed on the taxpayer who retained the "tree." However, where property rights were transferred, and the donor gave away his entire interest, the assignees of the property were recognized as valid donees, and the income was taxed to them. *Blair v. Commissioner*, 300 U.S. 5 (1937). *Blair* was then distinguished in *Harrison v. Schaffner*, 312 U.S. 579 (1941) where a trust beneficiary assigned specified amounts of trust income for a limited term and did not part with a substantial interest in the trust property itself.

The current grantor trust rules arose from this background of Supreme Court cases. Congress enacted these rules as part of the 1954 Internal Revenue Code. At that time, individual taxpayers were faced with extremely progressive and high tax rates. Under the 1939 Code there were twenty separate tax brackets, reaching from 19.2 percent on the first $2,000 to 89 percent on taxable income over $200,000. After 1953, the lowest bracket was due to decline to 17 percent, and the top bracket to 88 percent. The 50 percent tax rate was reached at $20,000. As a planning technique, wealthy taxpayers did whatever they could to shift income to persons, typically family members, in lower income tax brackets. Multiple trusts were created for these persons 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. However, the creators of these trusts tried to maintain as much control over them as they possibly could.

Enter the grantor trust rules. By including Sections 671-678 in the 1954 Internal Revenue Code, Congress forced trust grantors to make a choice—either transfer property into a trust for another person and relinquish control over the income and principal of the trust, and relinquish control over much of the administration of the trust, and shift the income taxation to the trust beneficiary—or retain one or more elements of control or administrative power, and be taxed on the trust income despite having created the trust arrangement for the benefit of another person.

The regulations provide that since the principle underlying Subpart E is generally that income of a trust over which the grantor or another person has retained substantial dominion and control should be taxed to the grantor or other person rather than to the trust which receives the income or to the beneficiary to whom the income may be distributed, it is ordinarily immaterial whether the income involved constitutes income or principal for trust accounting purposes. Accordingly, the references in Subpart E to “income” attributed to the grantor or another person, unless specifically limited, are references to income determined for tax purposes and not to income for trust accounting purposes. If there is an intent refer to trust accounting income, (as described in Reg. 1.643(b)-1) the Subpart E regulations use the phrase “ordinary income.” Reg. 1.671-2(b).

II. Grantor Trust Status – The “Ground Rules”

A. General Rules

Code Section 671 broadly describes the tax consequences associated with grantor trust status. It provides generally that a grantor of a trust will be taxed on all of the income, deductions and credits of a trust when such person retains certain powers over or interests in the trust. Code Section 672 provides a series of definitions, and Code Sections 673-678 (all discussed below) detail what powers will—and will not—cause a trust grantor to be subject to the grantor trust rules. A grantor can be taxable on the income or principal of a trust, or both. If the grantor is treated as the owner of only part of the trust, the grantor will be taxed on the income from that part of the trust, and the rest of the income will be taxed according to the regular rules regarding the income taxation of trusts and estates. Reg. 1.671-2(d).

Even if the grantor avoids being taxed on the trust income under the grantor trust rules, it is still possible for the grantor to be taxed under another rule of income taxation, such as the assignment of income doctrine. Code Section 671; Rev. Rul. 58-337, 1958-2 C.B. 13

Under the grantor trust rules a “grantor” includes “any person to the extent such person either creates a trust, or directly or indirectly makes a gratuitous transfer of property to a trust.” Reg. 1.671-2(e)(1). A gratuitous transfer is any transfer of property (including cash) to a trust for other than fair market value. Reg. 1.671-2(e)(2). A person who creates a trust but makes no gratuitous transfers to the trust is not treated as an owner of any portion of the trust under Code Sections 671-677. Reg. 1.671-2(e)(1). A trust can have multiple grantors. For example, assume Susan creates and funds a trust for the benefit of her children, Paula and Julian. Thereafter, Matthew makes a gift to the same trust. Both Susan and Matthew will be considered grantors of this trust. Reg. 1.671-2(e)(6), Ex.1

A grantor trust is a trust under which the grantor (or a person other than the grantor who has been granted the power to vest income or principal in himself) has retained substantial benefits or control of the trust so that the grantor (or other person) is treated as the "owner" of the trust assets for income tax purposes.

Code Section provides that where the grantor or another person is treated as the owner of any portion of a trust, the grantor or such other person must include in his or her own computation of income taxes all items of income, deductions and credits against tax attributable to the portion of the trust of which the grantor or such other person is deemed to be the owner. A person will be treated as a grantor or owner of a trust if "certain circumstances" are present. These "circumstances" refer to the retention of broad powers over and interests in a trust that constitute the basis of the remaining provisions of the grantor trust rules, Regulation Section 1.671-1(a):

• If the grantor has retained a reversionary interest in the trust of a certain amount, within specified time limits. Code Section 673; (*see* Part IV, below);

• If the grantor or a nonadverse party has certain powers over the beneficial interests in the trust. Code Section 674; (*see* Part V, below);

• If certain administrative powers over the trust exist under which the grantor can or does benefit. Code Section 675; (*see* Part VI, below);

• If the grantor or a nonadverse party has a power to revoke the trust or return the trust principal to the grantor. Code Section 676; (*see* Part VII, below);

• If the grantor or a nonadverse party has the power to distribute income to or for the benefit of the grantor or the grantor's spouse. Code Section 677; (*see* Part VIII, below); and

• If a person other than the grantor has the sole power to vest income or principal in himself or herself so as to be treated in the same manner as would be a grantor of the trust. Code Section 678; (*see* Part IX, below).

To re-emphasize the key distinction among trusts, to the extent there are other portions of a trust which are not treated as owned by the grantor or by another person with a grantor-like power over income or principal, these portions of the trust are taxed in accordance with the "normal" rules addressing the taxation of trusts and their beneficiaries as found in Subchapter J, Subparts A through D, Code Sections 641 and following. Code Section 671; Reg. 1.671-2(d).

The operative theory of the grantor trust rules is that the trust is not a separate taxpayer 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. An item of income, deduction or credit included in computing the taxable income and credits of a grantor or another person under Code Section 671 is treated as if it had been received or paid directly by the grantor or other person, whether or not an individual. Reg. 1.671-2(c). In applying the grantor trust rules, a grantor will be treated as holding any power held by an individual who was the spouse of the grantor at the time the power or interest was created, or an individual who became the spouse of the grantor after the power or interest was created (but, in the latter case, only for periods after the individual became the grantor's spouse). Code Section 672(e).

As a result of these rules, since an item of income, deduction or credit attributed to a grantor must be treated as if it had been received or paid directly by the grantor, the character of that item passes through to the grantor. The existence of the trust does not "filter" or otherwise alter the character of an item. For example, items of tax exempt income pass through the trust to the grantor, Rev. Rul. 60-370, 1960-2 C.B. 203, as do capital gain items. *Scheft. v. Commissioner*, 59 T.C. 428 (1972).

B. Compliance Issues: Tax Reporting Requirements for Grantor Trusts

Must a grantor trust obtain its own taxpayer identification number?

No separate taxpayer identification number is required when a trust is treated as a grantor trust due to the fact that the grantor retains a power to revoke the trust under Code Section 676 and the grantor is a trustee. Instead, such trusts should use the grantor's social security number. Reg. 301.6109-1(a)(2); Reg. 1.671-4(b)(1). Similarly, no separate taxpayer identification number is required for a trust if spouses are the sole grantors, one or both spouses serve as trustees or co-trustees, one or both spouses are the owner(s) of the trust and they file a joint return for the year. Reg. 1.671-4(b)(2). If any of these situations apply, the grantor does not file a separate income tax return for the trust, and reports the trust income on his or her Form 1040.

In all other situations, the trustee should obtain a federal identification number for the trust. If the grantor resigned as trustee, relinquished or lost the right to revoke the trust or died, a taxpayer identification number must be obtained by the trustee, subject to the tax reporting alternatives discussed below.

The Treasury regulations give the trustee three alternative methods to use to satisfy the reporting requirements for a grantor trust. There is the "traditional" reporting method of using Form 1041, or one of two optional Form 1099 reporting methods. Each of these options is described below.

1. **The 1041 alternative – Reg. 1.671-4(a)**

The trustee applies for a taxpayer identification number for the trust. The trustee files a Form 1041 information return, checks the "Grantor Trust" box, does not complete the separate lines on the return and instead attaches to the return a statement of items of income, deductions and credits for the year in question. The statement (usually a Schedule K-1 or a plain paper schedule) indicates that the reportable items of the trust are being reported by the grantor under the grantor's social security number, and is furnished to the grantor for use in preparing the grantor's income tax return. This method is the one that has traditionally been used by most fiduciaries and tax preparers.

2. The 1099 Grantor-TIN alternative – Reg. 1.671-4(b)(2)(i)(A)

The trustee "need not obtain" a taxpayer identification number until either (1) the first taxable year in which the trust, or any part of the trust is no longer a grantor trust, or (2) the first taxable year of the trust in which the trustee does not report using the grantor's social security number alternative. The trustee provides all payors of reportable income with the name and tax identification number of the grantor and the address of the trustee. The trustee is not required to file either a Form 1041 or Form 1099 with the IRS. Payors of the income to the trust send Form 1099 to the trust showing the reportable income as taxable to the grantor. The trustee delivers all of the Form 1099s it receives to the grantor. The trustee must obtain from the grantor a completed Form W-9. The trustee is required to furnish the grantor with a detailed statement of the applicable items of income, deductions and credits by the due date (including extensions) of the Form 1041. If the grantor is the trustee or a co-trustee of the trust, the statement need not be furnished to the grantor.

3. **The 1099 Trust-TIN alternative – Reg. 1.671-4(b)(2)(i)(B)**

The trustee applies for a tax identification number for the trust. The trustee provides all payors of reportable income with the name, tax identification number and address of the trust. The trustee is not required to file Form 1041, but must file Form 1099. Payors of income send the Form 1099 to the trust showing the reportable income as taxable to the trust. The trustee is required to file Form 1099 with the IRS by the end of February, reporting the total interest, dividends and gains and losses received on a Form 1099-INT or Form 1099-DIV, whichever is applicable. The applicable 1099 shows the trust as the payor and the grantor as both the owner of the trust and as payee. Gross proceeds of sales are reported separately for each sale on a 1099-B. Copies of the Form 1099 are not sent to the grantor. Instead, the trustee sends a statement summarizing this information to the grantor by the due date of the Form 1041. If the grantor is a trustee or co-trustee of the trust, the statement need not be furnished to the grantor. This alternative involves an extra layer of administrative duties i.e. issuance of Form 1099s from the trust to the IRS.

III. Code Section 672 – Grantor Trust Definitions and Rules

The purpose of Code Section 672 is to describe rules and definitions that are used throughout the grantor trust sections of the Internal Revenue Code. Code Sections 672(a) through (c) define the key terms "adverse party," "nonadverse party" and "related or subordinate party". The rules describing when conditions precedent must be satisfied to exercise a grantor power are found in Code Section 672(d). Important rules addressing the role of the grantor's spouse are described in Code Section 672(e). Rules addressing grantor trusts with domestic beneficiaries and foreign grantors are found in Code Section 672(f).

A. Adverse Party

Throughout the grantor trust rules, distinctions are made between an "adverse party" and a "nonadverse party." Often, the presence of an adverse party is significant since the grantor may be protected from a finding of grantor trust treatment (and required income taxation of the grantor) if a particular power of the grantor may only be exercised with the consent of or in conjunction with an adverse party. Conversely, under the various grantor trust provisions of Code Sections 673 through 678, if a nonadverse party holds a power over a trust, even if the grantor does not hold that power, the grantor may be treated as the owner of the trust.

Alternatively, if only the consent of a nonadverse party to a particular action of the grantor is required, the grantor may be treated as the owner of the trust. Clearly, then, the distinction between an adverse party and a nonadverse party is significant.

The term "adverse party" requires a person to have a beneficial interest in the trust. It is defined to mean "any person having a substantial beneficial interest in the trust which would be adversely affected by the exercise or nonexercise of the power which he possesses respecting the trust." A person holding a general power of appointment over a trust is regarded as having a beneficial interest in that trust. Code Section 672(a). A "nonadverse party" is defined broadly as any person who is not an adverse party. Code Section 672(b).

Payors of the income to the trust send Form 1099 to the trust showing the reportable income as taxable to the grantor. Reg. 1.672(a)-1(a) It is possible, however, that a trust beneficiary may be an adverse party only as to a portion of a trust, such as when the beneficiary's right to a share of the income or principal of the trust is limited as to only a part of the trust. Reg. 1.672(a)-1(b). A remainderman may have an interest adverse to the exercise of a power over the trust principal, but not adverse to the exercise of a power over an income interest that precedes her remainder interest. Reg. 1.672(a)-1(d).

The cases recognize a presumption that any adverse party will act in his or her own best interests independent of the wishes or desires of the grantor, regardless of the identity of the adverse party or the relationship between the adverse party and the grantor. Members of the grantor's family and the grantor's close friends can be considered adverse parties when they have substantial interests in a trust that are adverse to the exercise or nonexercise of a power held by the grantor or by an adverse party. *Savage v. Comm'r*, 82 F.2d 92 (3d Cir.1936).

In order for an interest to be considered adverse to the grantor's interest, it must be adverse to the exercise or nonexercise of the power held by the grantor or by a nonadverse party over the income or principal of the trust. It is not enough for just a relationship to be adverse—it is the actual interest in the trust that must be adverse. It is certainly possible for a party with a partial share in a trust to be adverse to the grantor only as to that partial share of the trust. Reg. 1.672(a)-1(b); Reg. 1.672(a)-1(d). A "beneficial interest" requires the adverse interest to be economically adverse. These regulations provide that attribution rules, such as those found in Code Section 318, are not applied to determine if a beneficiary has an interest in a trust.

A trustee is not an adverse party merely because of having an interest as trustee. Being a trustee in and of itself does not convey a beneficial interest in the trust. Having a right to fees and commissions as a fiduciary does not convey a beneficial interest in the trust. Reg. 1.672(a)-1(a); *Reinecke v. Smith*, 289 U.S. 172 (1933); *Duffy v. United States*, 487 F.2d 282 (6th Cir. 1973), c*ert. denied,* 416 U.S. 938 (1974)]. In order for a trustee to be considered as an adverse party, the trustee must also possess a substantial beneficial interest in the trust that would be adversely affected by the exercise or nonexercise of one or more of the powers granted to the trustee.

Example: If a grantor creates a trust, but provides that a trustee is given the power to distribute all of the income and principal of the trust to himself or herself, the trustee will be considered to be an adverse party to the grantor. *Estate of Paxton v. Commissioner*, 44 T.C.M. 771 (1982). Alternatively, if the trustee occupies merely an administrative role, and lacks discretion with respect to the beneficial interests in the trust, the trustee will not be considered an adverse party even if the trustee is also a beneficiary of the trust.

As the definition of adverse party indicates, the presence of a beneficial interest for such party is an essential element of the definition. Accordingly, a trust beneficiary will be an adverse party, if the beneficiary holds a general power of appointment over the trust. The interest of the beneficiary may be adverse with respect to the entire trust or be limited to either the income or principal portion of the trust, depending on whether the beneficiary is an income or a remainder beneficiary. If the beneficiary holds its partial interest in a trust (such as an interest in the income only, or in the principal only, or in a contingent remainder interest only) the beneficiary may be an adverse party only with respect to that part of the trust. Reg. 1.672(a)-1(a), 1.672(a)-1(b.) Of course, where a contingent interest is concerned, the remoteness of the contingency should be taken into account in evaluating whether the holder of such an interest is truly an adverse party.

Example 3-2: Alice, Brenda, Carrie and Donna are equal income beneficiaries of a trust. Sam is the grantor of the trust. Sam has the right to revoke the trust with the consent of Alice. In this situation, Sam is treated as the owner of three-fourths of the trust since only Alice is an adverse party with respect to Sam. Accordingly, the items of income, deduction and credit attributable to the three-fourths interest in the trust are included in determining Sam's income tax liability. Reg. 1.672(a)-1(b).

Another important component of the definition of an adverse party is the requirement that the interest of the person holding the beneficial interest must be "substantial." An interest is a substantial interest if its value in relation to the total value of the property subject to the power held by the adverse party is not insignificant. Reg. 1.672(a)-1(a). This limited guidance offered by the regulations has led to a number of cases attempting to define the meaning of a "substantial" beneficial interest. The cases typically depend on an analysis of the particular facts and circumstances. Where the interest of the beneficiary is wholly discretionary in the judgment of the trustee, the beneficiary does not have a substantial beneficial interest. However, where persons were both beneficiaries and also members of a distribution committee, they were found to have adverse interests in the trust. Priv. Ltr. Ruls. 200731019 (May 1, 2007), 200729025 (April 10, 2007), 200247013 (Aug. 14, 2002) and 200148028 (Aug. 27, 2001). Where the interest of the potential adverse party is remote and contingent, the cases indicate that the interest of such party is not "substantial." *Holt v. United States*, 669 F. Supp. 751 (W.D. Va. 1987), *aff'd*, 842 F.2d 1291 (4th Cir. 1988); *Barker v. Comm'r*, 25 T.C. 1230 (1956); *Chase National Bank v. Comm'r*, 225 F.2d 621 (8th Cir. 1955), *cert. denied,* 350 U.S. 965 (1956). However, an interest that is contingent as opposed to immediately vested is not automatically considered an "insignificant" interest. Actuarial calculations may be necessary in order to determine the potential significance of a contingent interest. Reg. 1.672(a)-1(c) Where an apparent adverse interest proves to be a sham (such as when the apparently adverse party has agreed in advance that the adverse interest will not be exercised) such an interest will be disregarded for purposes of the grantor trust rules. *Wesenberg v. Comm'r*, 69 T.C. 1005 (1978).

B. <u>Related or Subordinate Party</u>

There are situations arising under the grantor trust rules where so-called "independent trustees" who are not strictly defined as "adverse parties" are permitted to exercise certain powers without causing the trust grantor to be taxed as the owner of the trust. These powers include such things as distributing to or accumulating income or corpus for a beneficiary under Code Section 674(c); and permitting the trust grantor to borrow the income or principal of the trust under Code Section 675(3). These activities are only permitted, however, for purposes of avoiding the grantor trust rules, where the independent trustees, while not adverse, are not considered related or subordinate parties who are subservient to the wishes of the grantor.

Defined in Code Section 672(c), the phrase "related or subordinate party" means any nonadverse party who is either the grantor's spouse if living with the grantor; the grantor's father, mother, issue, brother or sister (including brothers and sisters of the half-blood) (see Rev. Rul. 58-19, 1958-1 C.B. 251); an employee of the grantor; a corporation or any employee of a corporation in which the stockholdings of the grantor and the trust are significant from the viewpoint of voting control; or a subordinate employee of a corporation in which the grantor is an executive. All of these persons are presumed to be subservient to the grantor with respect to the exercise or nonexercise of the powers conferred on them unless shown to not be subservient by a preponderance of the evidence. Code Section 672(c); Reg. 1.672(c)-1. Other relatives, such as step-brothers and step-sisters, nieces, nephews, cousins, grandparents, grandchildren and in-laws are not included in the definition of related or subordinate parties.
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If the grantor possesses a power to remove a trustee and appoint a successor trustee who is not considered "related or subordinate" to the grantor within the meaning of Code Section 672(c), the grantor will not be considered to have retained a power to affect the beneficial enjoyment of the trust property that will result in estate tax inclusion under Code Section 2036 or 2038. It is essential here that the grantor does not retain a power to appoint him or herself as a successor trustee. Rev. Rul. 95-58, 1995-2 C.B. 191; *Estate of Wall v. Commissioner*, 101 T.C. 300 (1993).

In order to rebut the presumption that a related or subordinate party acting as trustee is subservient to the grantor, the person making such a claim has the burden of proving that the trustee was not acting in accordance with the grantor's wishes. S. Rep. No. 1622, 83d Cong. 2d Sess. 87 (1954) A person who is serving as a corporate director is not, absent other evidence, considered an employee of the corporation, even where the holdings of the grantor and the trust are significant in terms of voting control. Rev. Rul. 66-160, 1966-1 C.B. 164. Nor does a partner of the grantor automatically fall within the definition of related or subordinate party. Similarly, persons who serve the grantor in the roles of accountant or attorney are generally independent contractors, not employees, so such persons should not be considered related or subordinate parties, even in situations where such "independent" persons allow the grantor to make virtually all of the decisions involving the trust. *Goodwyn Estate v. Comm'r*, 35 T.C.M. 1026 (1976).

There have been a number of rulings issued addressing the question of whether a family-owned private trust company is a related or subordinate party. The rulings address situations where the families involved have been careful to require a separation between the ownership of interests in property and acting on discretionary distribution committees where those property interests are involved. Where this separation is successfully accomplished, grantor trust characterization is avoided. In the fact patterns of the rulings, various trust grantors did not own any (or a significant amount of) interests in the stock of the private trust company. Only truly independent persons served on the distribution committees. In some situations, the members of the distribution committees had substantial beneficial interests in the income and corpus of the trusts, making them adverse parties. While the rulings are conditioned on the usual "particular facts and circumstances" limitations, they do provide guidance for persons wishing to utilize the private trust company as trustee and avoid attribution of the ownership of the trust to the grantor. Notice 2008-63, 2008-2 C.B. 261; Priv. Ltr. Ruls. 200637025 (June 5, 2006), 200546052 (Aug. 2, 2005), 200546053 (Aug. 2, 2005), 200546054 (Aug. 2, 2005), 200546055 (Aug. 2, 2005).

C. Grantor Power Limited by a Condition Precedent

A person is considered to have a power as the grantor of a trust even if this power is subject to certain limitations. The Code specifies two limitations which are ineffectual to preclude grantor trust status: (i) a condition precedent of the giving of notice or (ii) where an interest takes effect only on the expiration of a certain period of time after the exercise of the power. Code Section 672(d). These provisions are designed to reduce or eliminate any opportunity for a grantor to attempt to manipulate the rules by distinguishing a presently exercisable power from a contingent power.

Example: Kelly is the grantor of a trust for the benefit of her daughter Carol. Kelly retains the power to revoke the trust, but provides that the revocation is effective only after the expiration of three years from the date she exercises the power. Kathy will be treated as the owner of the trust from the date of its inception. Reg. 1.672(d)-1.

D. Powers and Interests Held by the Grantor's Spouse

Any power or interest held by a grantor's spouse is imputed to the grantor by Code Section 672(e). For purposes of the grantor trust rules, the grantor is treated as holding any power or interest held by any individual who was the spouse of the grantor at the time of the creation of such power or interest, or any individual who became the spouse of the grantor after the creation of such power or interest, but only with respect to those time periods after such individual became the grantor's spouse. Code Section 672(e)(1).

An individual legally separated from a spouse under a decree of divorce or separate maintenance when the power or interest in the trust is created shall not be considered as married. Code Section 672(e)(2). Accordingly, it is not necessary to have terminated the marriage by a formal divorce decree to prevent the application of the grantor trust rules.

It is important to note here that a person who is married at the time the transfer in trust occurs is deemed to hold the powers and interests in the trust held by his or her spouse, even if the parties later divorce. Priv. Ltr. Rul. 9625021 (March, 20, 1996). Code Section 672(e)'s test for marital status is applied when the trust is created. There is nothing in the law to allow a later retest if there is a change in marital status. If the transfer in trust is made after the dissolution of the marriage, then the parties are considered not married for purposes of the application of the grantor trust rules.

Code Section 672(e) was added to the Internal Revenue Code as part of the 1986 Tax Reform Act. There was concern that a grantor could circumvent the application of the grantor trust rules by using his or her spouse as an agent or as the holder of otherwise impermissible powers or interests in the trust. Code Section 672(e) is effective for transfers in trust made after March 1, 1986. The legislative history of Code Section 672(e) indicates that it is applicable only in cases where the spouse is living with the grantor and able to file a joint income tax return with the grantor for the relevant period.

One of the principal effects of the enactment of the spousal attribution rules is to prevent the grantor's spouse from ever being treated as an adverse party, since any power or interest which might otherwise make the spouse an adverse party is directly imputed to the grantor.

IV. Code Section 673 – Retention of a Reversionary Interest

Code Section 673 provides that the grantor is treated as the owner of any portion of a trust in which the grantor has a reversionary interest in the trust income or principal that has a value, determined at the inception of the trust, *i.e.*, the date of transfer of property to the trust, in excess of five percent of the value of the trust property. Code Section 673(a). The same rule applies to a reversionary interest held by the grantor's spouse, since the grantor is treated as the owner of any interest his or her spouse owns. Code Section 672(e). If the grantor is treated as the owner of a portion of the trust, all of the trust's income, attributes, etc. would be treated as belonging to the grantor or to the grantor's spouse, as if no trust had been created. Code Section 673 became effective for transfers in trust made after March 1, 1986.

A. Background on How Code Section 673 Evolved

The "old" Code Section 673 was the Code Section that provided the "roadmap" for the preparation of what was known for many years as a "Clifford Trust," *i.e.,* a trust by which the grantor transferred property for the benefit of a beneficiary for a period of at least ten years, the beneficiary became the taxpayer, after which period the trust property could then revert to the grantor. This was the response of Congress to the decision of the Supreme Court in *Clifford v. Helvering,* 309 U.S. 331 (1940), which held the grantor taxable on the income of an irrevocable trust in which the grantor retained significant control and which was to terminate in the grantor's favor after a five-year term. Congress allowed a transferred interest of ten years to counter the Court's holding. If the ten-year test of delaying the reversion was satisfied, the grantor was *not* taxed on the trust income under the old grantor trust rules, and had effectively shifted the taxation of the trust income to the beneficiary, a person presumably in a lower income tax bracket. The "old" Code Section 673 and the use of the ten-year Clifford Trust was a legislative guideline to a very popular acceptable avoidance of the assignment of income doctrine.

The repeal of "old" Code Section 673 and its replacement by current Code Section 673 was a repudiation of the "permitted" assignment of income exception, and the institution of a rule causing the grantor to be treated as the owner of a trust for income tax purposes if almost any reversionary interest is retained. When the current Code Section 673 was adopted, it became effective only with respect to trusts created after March 1, 1986. The previous version of Code

Section 673 continues to apply to trusts created on and before March 1, 1986. Many, if not all of those trusts (especially if designed as limited to ten year trusts) have now terminated, but if a grantor opted for a delayed reversion term well in excess of the ten year minimum statutory period, it is possible that the "old" version of Code Section 673 is still applicable to these trusts.

Despite possible distinctions between the "old" rules and the new rules of Code Section 673, and the outcome of the actuarial calculations to be performed, if a grantor retains a reversionary interest in the principal of a trust, the grantor will be treated as the owner of the principal of such trust, even if the five percent reversion rule of Code Section 673 is not violated. A grantor will be treated as the owner of any portion of a trust the income of which is or may be held or accumulated for future distribution to the grantor or the grantor's spouse. Where such items as capital gains are allocated to the trust principal under the trust instrument or local law, they are being held or accumulated for future distribution to the grantor as holder of the reversionary interest in the trust principal. Code Section 677(a)(2); Regs. 1.673(a)-1(a), 1.677(a)-1(g), Ex. 2. Accordingly, while Code Section 673 determines whether the retention of a reversionary interest alone makes a trust a grantor trust, Code Section 677(a)(2) is a broader inclusion provision that may require a finding of grantor trust status even if Code Section 673 does not. This suggests a note of caution to be raised for persons drafting trusts designed to minimize a reversionary interest so as to avoid Code Section 673, since Code Section 677 may cast a broader net.

B. The Reversionary Interest

A reversionary interest is an interest retained by the grantor in the trust property that will allow the grantor to recover either the principal of the trust or the income arising therefrom. For example, if a grantor creates a trust, transfers property to the trust for the benefit of a beneficiary, and provides that upon the death of the beneficiary or upon the expiration of a fixed number of years, the transferred property returns to the grantor, the grantor has retained a reversionary interest. If the actuarial value of the reversionary exceeds five percent, a grantor retaining such a reversionary interest will be treated as the owner of the entire trust. Reg. 1.671-3(b)(3); Priv. Ltr. Rul. 9519029 (Feb. 10, 1995).

C. Determining the 5 Percent Interest

The five percent reversionary interest is computed in accordance with standard actuarial principles. It is calculated by considering the maximum amount that the grantor could receive upon the termination of the trust. Code Section 673(c). Code Section 7520 and the regulations thereunder include actuarial tables that apply to reversionary interests that become possessory upon the expiration of a fixed period of time or at the death of a specified person or persons. The actuarial tables are based on the prevailing interest rates at the time the transfer occurs, using the monthly updated applicable federal rate (AFR) issued by the IRS. As a general rule, when interest rates are low, a longer term of the trust will be necessary to fall below the five percent threshold; conversely, in a higher interest rate environment, a shorter term of the trust will yield a reversionary interest that falls below the five percent interest threshold. The actuarial tables are also influenced by mortality rates. While variations will occur depending upon the fluctuations in the applicable interest rate, it presently appears that even using the highest AFRs in the IRS tables, a reversionary interest must be delayed in the range of 28 to 32 years if it is to be worth five percent or less of the value of the transferred property. Reg. 20.2031-7(d)(6) Table B.

When determining the value of the grantor's reversionary interest, it is to be assumed that if there is any discretion exercisable in favor of the grantor, such discretion will be exercised in the grantor's favor to the maximum possible extent. Code Section 673(c).

Example: The grantor creates and funds a trust with a duration of 20 years for the benefit of the grantor's children with distributions to be made in the discretion of the trustee, after which time the trust property will revert to the grantor or the grantor's estate. In determining the value of the grantor's interest under Code Section 673, it must be assumed that no distributions are made to the grantor's children during the 20-year term of the trust. Assume when the trust is created, the prevailing Code Section 7520 rate is 6.2 percent. The value of the reversionary interest would be approximately 30 percent, clearly greater than five percent, and the trust would be a grantor trust. If instead, the term of the trust was 50 years, the value of the reversionary interest would have been approximately 4.9 percent, clearly less than five percent, and the trust would not be a grantor trust. Alternatively, when using a 4 percent interest rate instead of a 6.2 percent rate, the actuarial value of a remainder interest is 5.0754 percent following a term certain of 76 years; the actuarial value of a remainder interest is 4.8801 percent following a term certain of 77 years. Rev. Rul. 76-178, 1976-1 C.B. 273.

As a general rule, the grantor's health is irrelevant in applying the rules of the actuarial tables indicated above. There is, however, an exception for situations when the grantor is terminally ill. A person suffering from an incurable disease or other deteriorating physical condition is considered terminally ill if there is at least a 50 percent probability that the individual will die within one year. Actual physical condition *is* relevant in determining the value of an interest for income tax purposes. Reg. 1.7520-3(b)(3). In such a case, the IRS can ignore the results of the actuarial tables. This exception is modified by an additional rule providing that an individual who survives 18 months or longer after the date of the property transfer is presumed not to have been terminally ill, absent clear and convincing evidence to the contrary. Where this exception applies, the IRS is required to use the actuarial tables to value the interest contingent upon the individual's life expectancy. Reg. 1.7520(b)(3); *Miami Beach First National Bank v. United States,* 443 F.2d 116 (5th Cir. 1971); Priv. Ltr. Rul. 9402011 (October 8, 1993). In these circumstances, it is worthwhile to obtain a physician's certification addressing the probability of death. *Fabric Estate v. Comm'r*, 83 T.C. 932 (1984).

A difficult valuation problem may arise where the trust beneficiary possesses a power of appointment over the trust property. Must (or should) the possibility that the beneficiary could affirmatively exercise that power in favor of the grantor be taken into account in determining the value of a reversionary interest of the grantor? Arguably, yes. Code Section 673(c) provides that the value of the grantor's reversionary interest shall be determined by assuming the maximum exercise of discretion by the power holder in favor of the grantor.

D. Exception for Lineal Descendants Who Die Before Age 21

A possible reversionary interest in the grantor or the grantor's spouse that follows the death of a lineal descendant of the grantor or the grantor's spouse prior to such descendant attaining age 21 will not be counted to attribute grantor trust status provided the lineal descendant holds all of the present interests in any portion of the trust, unless and until the reversion actually occurs. Code Section 673(b). This exception enables income earned by a Code Section 2503(c) trust to be taxed to the minor beneficiary of the trust rather than to the grantor. Thus, a traditional Code Section 2503(c) trust should not be a grantor trust merely because the grantor or the grantor's spouse will receive the trust funds back if the income beneficiary dies before attaining 21 – assuming the reversion was not the result of the exercise of a general power of appointment contained in the trust document.

V. Code Section 674 – Power to Control Beneficial Enjoyment

Code Section 674; Regulations 1.674(a)-1 through 1.674(d)-2

Code Section 674 provides a broad general rule making a trust a grantor trust where the grantor has the power to dispose of or affect the beneficial enjoyment of the trust for himself or herself or others, without prevention by an adverse party.

The broad general rule is then subjected to a series of exceptions that modify the general rule by enumerating circumstances allowing the grantor, independent trustees or certain others to exercise specific powers over the trust that do not confer grantor trust status on the grantor.

A. The General Rule of Code Section 674(a)

Code Section 674(a) states a broad general rule which, standing alone, would require almost any trust involving any grantor rights or powers to be treated as a grantor trust during the lifetime of the grantor. It provides that the grantor shall be treated as the owner of any portion of a trust in respect of which the beneficial enjoyment of the trust, *i.e.,* the principal or income therefrom, is subject to a power of disposition, exercisable by the grantor, the grantor's spouse, or by a nonadverse party, or both, without the approval or consent of any adverse party. The adverse party is an important consideration here. If a co-trustee is also a beneficiary who would be adverse to the exercise of a power by the grantor over the trust, and if the trust requires the trustees to act unanimously, Code Section 674(a) would not be applicable.

The "power of disposition" referred to is broadly viewed to include a fiduciary power, a power of appointment, and any other power to direct the enjoyment of the benefits of the trust, regardless of the capacity in which the power is held, and regardless of whether the power holder can personally benefit. Reg. 1.674(a)-1; Priv. Ltr. Ruls. 200730011 (July 27, 2007) and 9625021 (March 20, 1996). Unless there is an exception to this broad general rule found in Code Sections 674(b) through (d), discussed below, the broad general rule of Code Section 674(a) will prevail.

What constitutes a power to affect the beneficial enjoyment of a trust has been broadly interpreted by case law. It includes, but is not limited to, a power to name the distributees of the trust or to control the enjoyment of the trust income and principal. Several cases and a revenue ruling illustrate this point:

- The grantor's retained right to alter or amend the trust documents was sufficient to treat the grantor as the trust owner under Code Section 674 even though such a right could only be exercised in the capacity of a trustee, with no personal benefit possible for the grantor. *Swanson v. Commissioner*, 518 F.2d 59 (8th Cir. 1975).

- A power to allocate income between or among the beneficiaries of a trust is a power of disposition over beneficial enjoyment regardless of whether the grantor is a permissible recipient. Rev. Rul. 54-41, 1954-1 C.B. 22.

- The grantor's retaining a direct or indirect power to "sprinkle" income and principal of a trust will result in the finding of grantor trust status. *Carson v. Commissioner*, 92 T.C. 1134 (1989).

- The right to use the property of the trust without paying adequate compensation for it is a power of disposition over the beneficial enjoyment of the trust, classifying the trust as a grantor trust. *Wesenberg v. Commissioner*, 69 T.C. 1005 (1978), *nonacq*. 1978-2 C.B. 4.

- The power to determine which beneficiary would be the recipient of income is a power to affect beneficial enjoyment. *Laganas v. Commissioner*, 281 F.2d 731 (1st Cir. 1960).

- When a grantor borrowed money from a bank and loaned the borrowed funds to a trust, with the funds repayable to the grantor on demand, the court found the grantor taxable on the trust's income under Code Section 674(a) because the demand power gave the grantor the power to control the beneficial enjoyment of the trust corpus at any time. *Wysong v. Commissioner*, T.C. Memo 1988-344.

Example: Greg creates a trust for the benefit of Ann and Bart during Bart's life. The remainder will pass to Bart on Ann's death, or to Ann on Bart's death. Greg names his spouse, Wendy, as the trustee and gives her the discretionary power (not limited by an ascertainable standard) to distribute income and principal to Ann or Bart, or to both, during Ann's life. This is a power to alter or control the beneficial enjoyment of both the income and principal of the trust. While Wendy cannot exercise the power in favor of Greg, under Code Section 672(e) all powers held by Greg's wife are deemed to be held by Greg. As a result, he is treated as having the power to alter or control the beneficial enjoyment of the trust and therefore the trust is treated as a grantor trust for income tax purposes even though Greg personally has not retained any direct right to alter or control the beneficial enjoyment of the trust.

Example: Assume the same facts as above except that the trust now provides that Wendy and Ann serve as co-trustees, and that the trustees, acting jointly, have the power to distribute *income* to Ann or Bart, or both, but may not exercise this power in favor of Greg. The trust is not treated as a grantor trust with respect to the trust accounting income because the power to alter or control the beneficial enjoyment of the income interest is exercisable only with the consent of an adverse party (Ann). The trust is treated as a grantor trust with respect to principal because the power to alter or control the beneficial enjoyment of the principal is not subject to the consent or approval of an adverse party.

B. Exceptions to the General Rule of Code Section 674(a)

Notwithstanding the broad general rule of Code Section 674(a), however, there are a number of statutory exceptions to this general rule which specifically refute the general rule and accordingly negate grantor trust treatment. It is essential to address and understand these exceptions which limit the scope of Code Section 674(a) to fully appreciate whether and when a power of disposition over the trust property will, in fact, trigger grantor trust status. There are exceptions from the general rule for certain powers which the grantor or any other person may hold set forth in Code Section 674(b); there are exceptions for powers which a nonadverse, independent trustee may exercise as set forth in Code Section 674(c), and there is an exception for a power which a non-independent, non-adverse trustee (other than the grantor or the grantor's spouse) may exercise as indicated in Code Section 674(d). All of these exceptions allow actions that affect the beneficial enjoyment of the trust without causing the grantor to be treated as the owner of the trust.

Code Section 674(b) sets forth a series of retained powers that will not result in grantor trust status. It contains eight exceptions to the general rule that retention of a power to control who receives income or principal from a trust results in grantor trust status. The exceptions describe the powers that the grantor *or any other person* may hold without causing the grantor to be taxable as the owner of the trust. Discussion of the eight exceptions is provided below.

1. Power to apply income to discharge a legal support obligation.

A grantor is not taxable as the owner of a trust just because a trustee or the grantor, in a fiduciary capacity as trustee or co-trustee, possesses a power to use trust income to discharge a legal support obligation of the grantor. Code Section 674(b)(1); Reg. 1.674(b)-1(b)(1). Instead, the grantor is taxable as the trust's owner only to the extent the trust income is actually used to discharge a support obligation as described in Code Section 677(b). Reg. 1.677(b)-1. State law determines the extent of the grantor's support obligation. Rev. Rul. 56-484, 1956-2 C.B. 23. If the distribution that satisfies the grantor's support obligation is made from principal, the tax consequences of the distribution are governed by the normal rules of Subchapter J, i.e. Code Sections 661 and 662.

If the grantor possesses this power in a nonfiduciary capacity, mere possession of the power alone will cause the grantor to be taxed on the trust income whether or not the trust income is used to support the grantor's dependents. Code Section 674(b)(1) only protects the grantor when serving as a trustee of the trust.

Example: Gary creates a trust and retains the right to require the trustee to distribute income for the health, education, maintenance and support of his children. Gary is not a trustee of the trust. No distributions are made to Gary's children during the year. The trust is a grantor trust. The Code Section 674(b) exception does not apply because the power to distribute income can be exercised by Gary in a nonfiduciary capacity.

2. Power affecting beneficial enjoyment only after the occurrence of an event.

A postponed power to affect a trust's beneficial enjoyment creates a grantor trust unless it is postponed for a period which, were it a reversionary interest, would be protected from grantor trust status because the reversionary interest is 5% or less. Unless the power is relinquished, the grantor will be taxed on the income after the occurrence of the event. Code Section 674(b)(2); Reg. 1.674(b)-1(b)(2).

Example: Linda creates a trust at a time when the Code Section 7520 rate is four percent. Income is to be paid to Ryan for 20 years. At the expiration of the 20-year period, Linda will have discretion to determine who receives the income of the trust. Although Linda can only exercise her power after 20 years have elapsed from the date of the trust's creation, Linda still owns all of the trust from its inception under Code Section 674(b)(2), since the value of her reversionary interest in the trust is greater than five percent.

3. Power exercisable only by will.

A testamentary power, *i.e.*, a power exercisable only by a person's will, to control the beneficial enjoyment of a trust qualifies as another exception to the general rule of Code Section 674(a) and does not cause the grantor to be treated as the owner of any portion of a trust. This rule applies even in the case where the grantor or a nonadverse party, or both, hold the power and such power may be exercised without the approval or consent of an adverse party. Code Section 674(b)(3).

Example: Paul creates an irrevocable trust and names his friend, Larry, as the trustee. The trust provides that Larry, by his will, may appoint the principal of the trust among Paul's children in Larry's discretion. Paul will not be taxed as the owner of this trust.

This exception, however, is subject to the following two significant limitations (which constitute exceptions to the exception and thus result in grantor trust status):

(1) Without the approval or consent of an adverse party, if the grantor may accumulate income for testamentary disposition by him or herself, or the grantor's spouse accumulates income for testamentary disposition by the grantor or by a nonadverse party. Reg. 1.674(b)-1(b)(3).

(2) If a trust instrument provides that the income (referring to taxable income here, not fiduciary accounting income) is payable to another person for life, but the grantor (or the grantor's spouse) retains a testamentary power of appointment (general or limited) over the remainder, and under the trust instrument and local law capital gains are added to principal, the grantor is treated as the owner of a portion of the trust and capital gains and losses are included in that portion. Reg. 1.674(b)-1(b)(3); Reg. 1.671-3.

Example: Gina creates a trust during her lifetime. The trustee is given discretion to pay the income to Brian or accumulate it during Brian's lifetime. Gina retains the power to appoint the trust principal and any accumulated income by her will. The trust is a grantor trust. The Code

Section 674(b)(3) exception would not apply and Gina's retained power to control the trust property would subject Gina to taxation under the general rule of Code Section 674(a).

4. Power to allocate among charitable beneficiaries.

A grantor is not taxed as a trust's owner if the grantor retains a power to allocate the beneficial enjoyment of the trust principal or income among charitable beneficiaries if such charitable beneficiaries are irrevocably designated and are described in Code Section 170(c) (relating to the definition of charitable contributions). Code Section 674(b)(4); Reg. 1.674(b)-1(b)(4). Thus, a grantor can create a trust with an irrevocable gift of the income or principal to charity and retain a power to designate which charities shall receive distributions from the trust and how much they shall receive. For example, a grantor can retain the right to designate the remainder beneficiaries of a charitable remainder trust and the trust will not be treated as a grantor trust. Grantor trust status will also not be found if the grantor has retained the discretion to "sprinkle" the trust income or principal among the charities described in Code Section 170. If the grantor also retained the power to designate noncharitable beneficiaries of the same funds, this exception to the general rule of Code Section 674(a) would not apply.

Example: Norman creates a trust which provides that the trust income and principal are irrevocably payable solely to religious or educational institutions that are qualified charitable organizations under Code Section 170(c). Norman is not treated as the owner of the trust under Code Section 674(a) even though he retains the power to allocate the income and principal among such organizations in his discretion.

Example: Norman creates a second trust which is designed and qualifies as a charitable lead annuity trust. He names his friend, Lon, as the trustee of this trust. Lon is given full discretion to determine the charitable beneficiaries of this trust. Although Lon is a nonadverse trustee, since the trust beneficiaries are charitable organizations, the power of allocation given to Lon does not cause grantor trust status to be applied to Norman. Priv. Ltr. Ruls. 9604015 (Oct. 27, 1995) and 9604016 (Oct. 27, 1995).

5. Power to distribute principal.

Code Section 674(b)(5) provides two additional exceptions to the general rule of Code Section 674(a) with respect to the power to distribute the principal of a trust. The first provides that grantor trust treatment will not apply to a power to distribute principal either to or for a beneficiary or class of beneficiaries whether or not they are income beneficiaries or remaindermen, provided that the power is limited by a reasonably definite standard which is set forth in the trust instrument. Code Section 674(b)(5)(A). The second applies when principal distributions may be made solely in favor of current income beneficiaries, provided that the principal distributions are required to be charged against those beneficiaries' proportionate shares of the trust principal held in trust for payment of income to that beneficiary, as if the principal constituted a separate trust whether or not it was physically segregated. Code Section 674(b)(5)(B); Reg. 1.674(b)-1(b)(5).

Example: Karen creates a trust providing for the payment of income to her adult children in equal shares for 10 years, after which the principal is to be distributed to her grandchildren in equal shares. Karen reserves the power to pay each child up to one-half of the trust principal during the 10-year period, but if such payments are made, they will proportionately reduce subsequent income and principal payments made to the child receiving the principal. If one-half of the principal is paid to one child, all of the income from the remaining half is thereafter payable to the other child. In this situation, Karen is not treated as the owner of the trust since it qualifies under the Code Section 674(b)(5)(B) exception. Reg.1.674 (b)-1(b)(5)(iii), Ex. 3.

Note that these two exceptions apply to the enumerated powers regardless of by whom they are held, meaning that the grantor or a nonadverse party or both may hold these powers without requiring the approval or consent of an adverse party, and still avoid incurring grantor trust status. If a trust has only one beneficiary, then the grantor, or the grantor's spouse, or a nonadverse party can have complete discretion to distribute principal to a current income beneficiary without having the trust declared a grantor trust. If a trust has but a single beneficiary, principal distributions will necessarily be charged against such beneficiary's share of trust principal.

The "reasonably definite standard" exception will not apply, however, if any person has a right or power to add to the named beneficiaries or to a class of beneficiaries designated to receive the trust income or principal, except in the case where the additions are only to provide for after-born or after-adopted children as beneficiaries. Code Section 674(b)(5). The regulations clarify this point by indicating that in order to trigger grantor trust status; this power (to add beneficiaries) must be held by a non-adverse party. If a non-adverse party has the power to add beneficiaries, other than after-born or after-adopted children, the trust will be treated as owned by the grantor of the trust. Reg. 1.674(d)-(2)(b).

The regulations do offer some guidance as to what is meant by a "reasonably definite standard." The permissible distributees must be either income beneficiaries or remaindermen. The exception does not apply if the power could be exercised in favor of a person who was not otherwise a beneficiary of the trust. Reg.1.674(b)-1(b)(5)(iii), Ex. 1. The entire context and intent of a provision of a trust instrument creating a power must be considered in determining whether the power is limited by a reasonably definite standard. It is not required that the standard consist of the needs and circumstances of the beneficiary. A clearly measurable standard under which the holder of a power is legally accountable is deemed a reasonably definite standard for these purposes. A power to distribute trust principal for the education, support, maintenance, or health of the beneficiary, for the reasonable support and comfort of the beneficiary, or to enable the beneficiary to maintain an accustomed standard of living or to meet an emergency would all be considered limited by a reasonably definite standard. However, a power to distribute principal for the pleasure, desire or happiness of a beneficiary is not limited by a reasonably definite standard. There is no reasonably definite standard if the exercise or nonexercise of the power is left entirely to the conclusive discretion of the trustee. But if the trustee has discretion to act within the defined standard, that may be satisfactory. Reg. 1.674(b)-1(b)(5)(i); *see also United States v. DeBonchamps*, 278 F.2d 127 (9th Cir. 1960), where a standard referring to "needs, maintenance and comfort" was found to be a reasonably definite standard.

Example: Howard creates a trust that provides for the payment of income to his adult children for life with the principal payable to his grandchildren in equal shares. Howard reserves the power to distribute trust principal to pay medical expenses and education expenses that may be incurred by his children or his grandchildren. Howard will not be treated as the owner of this trust by reason of the reserved power to pay medical or educational expenses since it is limited by a reasonably definite standard. Alternatively, if the power reserved by Howard was the power to distribute the trust principal to his children and grandchildren for their general happiness, Howard would be treated as the owner of the trust since the power would not then be limited by a reasonably definite standard. Reg. 1.674(b)-1(b)(5)(iii), Examples 1 and 2.

Example: If, in the above example, Howard also retained the power to add the spouses of his children as additional trust beneficiaries, the trust would then be considered a grantor trust with respect to Howard. If the power was limited to add as additional beneficiaries only after-born or after-adopted children of his children, the trust would not be a grantor trust as to Howard.

6. Power to withhold income temporarily.

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A grantor will not be treated as the owner of a trust if the grantor or a nonadverse party has the power to distribute income to or for any current income beneficiary or to accumulate the income for such beneficiary so long as the accumulated income must be distributed in one of two ways. For purposes of Code Section 674(b)(6), the term “income” refers to fiduciary accounting income. Reg. 1.674(b)-1(b)(6).

Method #1: The first of the permissible methods of income payment that satisfies this exception involves making payments of the accumulated income to the beneficiary from whom it was withheld, or to the beneficiary’s estate or to the beneficiary’s appointees if the beneficiary possesses a limited (special) power of appointment. Such a power of appointment must be broad in scope, as it must not exclude from the class of permissible appointees anyone other than the beneficiary, the estate of the beneficiary, the creditors of the beneficiary, and the creditors of the beneficiary’s estate (*i.e.,* those potential appointees that would require the beneficiary’s power of appointment to be classified as a general power of appointment, rather than as a limited power of appointment under Code Sections 2041 and 2514). The appointees or alternate takers of the beneficiary must not in fact be the grantor, the grantor’s estate or the grantor’s spouse if eventual grantor trust treatment is to be avoided.

Example: Robert creates a trust and names Joanne as the trustee. The trust provides that Joanne, in her discretion, can pay the trust income to Robert’s two adult children, or accumulate the income until each child reaches age 40, at which time all accumulated income must be paid to Robert’s children. The trustee’s power does not cause Robert, the trust grantor, to be treated as the owner of the trust since the accumulated income must be distributed to the beneficiary when age 40 is attained.

Method #2: On the termination of the trust, or at a designated time when principal is distributed, the accumulated income that was withheld from a beneficiary or class of beneficiaries must be distributed to the current income beneficiaries in shares irrevocably specified in the trust instrument. Code Section 674(b)(6)(B); Reg. 1.674(b)-1(b)(6) The grantor or a nonadverse party is therefore permitted to divert current income from one beneficiary or class of beneficiaries to another, provided that the secondary beneficiaries are current beneficiaries of the trust and the trust clearly defines their shares. However, this exception will not apply if the power is in substance one to shift ordinary income from one beneficiary to another. Reg. 1.674(b)-1(b)(6)(i)(c). Furthermore, the exception under Code Section 674(b)(6) will not apply if anyone has the power to add trust beneficiaries, other than beneficiaries who are after-born or after-adopted children.

Achieving the protection of the Code Section 674(b)(6) exception from grantor trust status can thus be accomplished by providing that accumulated income will be paid to the current income beneficiary from whom it was withheld so long as the beneficiary survives to the distribution date designated by the trust. The trust must, in turn, provide for a distribution date that is reasonably expected to occur within the lifetime of such income beneficiary. The trust must also provide that should the income beneficiary die before the designated distribution date, the share allocated to the income beneficiary must pass to the estate of such beneficiary or to the appointees of the beneficiary or, in the absence of such appointees, to the takers in default of appointment, or to other beneficiaries specified irrevocably in the trust, but not to the grantor or the grantor's estate.

Example: David created a trust providing for payment of income to his adult son, Alex, with David retaining the power to accumulate the income until David's death, at which time all accumulated income is to be paid to Alex. If Alex predeceases David, all accumulations are, at David's death, to be paid to David's son, Matthew, or if he is not living, to alternate beneficiaries (which do not include David's estate) in specified shares. The power retained by David is covered by the exception to Code Section 674(a) since the date of distribution (the date of David's death) should, in the usual case, reasonably be expected to occur during the lifetime of Alex, the beneficiary. It is not necessary for this exception to apply that the accumulations be payable to the estate of Alex or to his appointees should Alex predecease David. Reg. 1.674(b)-1(b)(6)(ii), Ex. 3.

Example: A trust provides that the income shall be payable in equal shares to George's two adult daughters, but George reserves the power to withhold from either daughter any part of that daughter's share of the income and add it to principal of the trust until the younger daughter reaches age 30. When the younger daughter reaches age 30, the trust is to terminate and the principal is to be divided equally between the two daughters or their estates. This is a power to affect beneficial enjoyment. However, the grantor is not taxed on the trust income as the power falls under the exception of Code Section 674(b)(6)(B). Although the exercise of the power may permit the shifting of accumulated income from one beneficiary to the other, since the principal plus all accumulated income is going to be divided equally, the power is excepted by Code Section 674(b)(6)(B) because the shares passing to the two daughters at the termination of the trust are irrevocably set forth in the trust agreement. Thus, the grantor is not treated as owner of the trust.

Example: Assume the facts are the same as in the previous example except that George reserves the power to distribute accumulated income to the beneficiaries in such shares as he chooses. In this situation the power would not come within the exception of Code Section 674(b)(6)(A) (since the income is not payable to his daughter, her estate, her appointees or takers in default set forth in the trust instrument) nor Code Section 674(b)(6)(B) (since the income which may be accumulated pursuant to the power is neither required to be payable only in conjunction of the principal distribution nor is it required to be paid on shares which have been irrevocably specified in the trust instrument).

7. Power to withhold income during disability of a beneficiary.

A grantor will not be treated as the owner of a trust over which the grantor or a nonadverse party, or both, hold a power, exercisable without the approval or consent of an adverse party to distribute or apply income (*i.e.*, fiduciary accounting income) to or for a beneficiary or to accumulate and add the income to the principal of the trust during the legal disability of a current income beneficiary of the trust or while any income beneficiary is under age 21. Code Section 674(b)(7); Reg. 1.674(b)-1(b)(7). This exception is applicable even if the income is not ultimately distributed to the beneficiary from whom it is withheld, or to the estate or appointees of such beneficiary. Instead, the accumulated income can be added to principal and ultimately distributed to others, but not to the grantor or to the grantor's spouse. Reg. 1.674(b)-1(b)(7)(A) and (B) The term "legal disability" is not defined in the Code or in the regulations. *Query:* Would delayed distributions due to substance abuse, gambling addiction or cult membership qualify as a "legal disability"?

A power will not qualify for this exception if any person has a power to add beneficiaries or a class of beneficiaries designated to receive the income or principal of the trust, except where such action is taken to provide for beneficiaries who are after-born and/or after-adopted children.

Example: Bill creates an irrevocable trust for the benefit of his minor daughter, Laura, to pay her the income of the trust for her lifetime, remainder to his grandchildren. If Bill reserves the power to accumulate income and add it to the principal of the trust while Laura is under age 21, he will not be treated as the owner of the trust. Reg. 1.674(b)-1(b)(7). The trust may further provide that upon reaching age 21, the accumulated income may be paid to Laura or accumulated and added to principal so that it may never inure to her benefit but may pass to the grandchildren instead. The power to accumulate income prior to the time Laura is age 21 is a power to affect the beneficial enjoyment of the trust property, but Bill is not taxed on the trust income under Code Section 674(a) because of the exception of Code Section 674(b)(7) which permits Bill to accumulate trust income and withhold it from the income beneficiary and add it to principal as long as this power is exercisable only during the period the income beneficiary is under age 21 or under a legal disability.

8. Power to allocate between principal and income.

A power held by the grantor of a trust or a nonadverse person (or both) to allocate receipts and disbursements between principal and income, even though expressed in broad language, will not cause the grantor to be treated as the owner of the trust under the general rule of Code Section 674(a). Code Section 674(b)(8); Reg. 1.674(b)-1(b)(8). The Service has ruled that the power of a trustee to make a reasonable allocation to income from capital gains realized on assets that had produced limited or no income for the trust qualified for this exception and did not cause grantor trust status where state law authorized inclusion of such a power in the governing instrument. Priv. Ltr. Rul. 9442017 (July 19, 1994). This power can be quite significant where the income and principal beneficiaries are different persons and allocations of income and expense can benefit one interest to the detriment of the other.

Example: Glen creates a trust, income to Amy for life, remainder to Bob. Glen has the power to allocate receipts and disbursements between income and principal. When an item is received by the trust, Glen exercises his power and allocates the receipt to principal meaning that Bob will benefit at the termination of the trust. Glen pays a trustee's fee and charges it to income thereby reducing the income to be received by Amy for that year. The power to allocate receipts and disbursements between income and principal is a power to affect beneficial enjoyment, but Glen will not be taxed on the trust income as the result of possessing this power because Code Section 674(b)(8) says that no matter how broad the power to allocate trust receipts and disbursements between income and principal, the grantor (or nonadverse party) who has this power will not cause the grantor to be taxable on the income of the trust.

C. Exception for Powers Held by an Independent Trustee

The general rule of Code Section 674(a) will not be applied in the case of certain powers that are solely exercisable by "independent trustees." The powers falling within this exception include the power to distribute, apportion or accumulate income to or for a beneficiary or beneficiaries or to, for, or within a class of beneficiaries, or the power to pay out principal ("sprinkle") to or for a beneficiary or beneficiaries or to or for a class of beneficiaries, whether or not they are income beneficiaries. Code Section 674(c)(1) and (2).

This is clearly a powerful exception to the general rule of Code Section 674(a). The grantor will not be taxable on trust income when powers are exercisable solely by one or more trustees, none of which is the grantor, or the grantor's spouse, and no more than half of whom are related to or subordinate to the wishes of the grantor (as these terms are described in Code Section 672(c). Reg. 1.674(c)-1. Note that these are reasonably broad discretionary powers that may be exercised by a nonadverse person without the consent of an adverse person, and still avoid the grantor trust rules.

The exception provided in Code Section 674(c) will not be applicable if any person has a power to add a beneficiary or beneficiaries to a class of beneficiaries designated to receive the income or principal of the trust, with the exception of actions taken to provide for after-born and/or after-adopted children as beneficiaries. In order to trigger grantor trust status, a non-adverse party must hold this power to add beneficiaries. Reg. 1.674(d)-2(b). Where grantor trust status is desired, one power that planners often suggest to be included in a trust instrument is a power held by an independent trustee or a trust protector or other non-adverse party to add beneficiaries, typically charitable beneficiaries. *Madorin v. Commissioner*, 84 T.C. 667 (1985).

If the power to add beneficiaries is the only trust power causing characterization as a grantor trust, the grantor or the designated power holder can release this power to terminate grantor trust status if that should become desirable or necessary.

Example: Paula creates an irrevocable trust for the benefit of her three adult children. Paula names an independent trustee and gives the trustee the power to allocate without any restrictions the amount of income to be paid to each child each year. This power will not cause Paula to be treated as the owner of the trust. Alternatively, if Paula had named herself the trustee, or one of several co-trustees and retained this power, Paula would be treated as the owner of the trust. If Paula refrained from naming herself as a trustee or as a co-trustee, but named as trustees her spouse or her sister, Paula will be taxed as the owner of the trust.

D. Exception Related to Income Allocation Powers Limited by a Standard

The general rule of Code Section 674(a) is subject to another exception in Code Section 674(d). In this case, the general rule will not apply to a power to distribute, apportion or accumulate income to or for a beneficiary or beneficiaries, or to, for, or within a class of beneficiaries if the power is limited by a "reasonably definite external standard" set forth in the trust instrument. This exception is available if the power is solely exercisable without the approval or consent of any other person or by a nonadverse trustee or trustees, none of whom is the grantor or the grantor's spouse living with the grantor. Note that Code Section 674(d) refers to the spouse as one "living with the grantor," while Code Section 674(c) does not add this "living with" requirement. Code Section 674(d); Reg. 1.674(d)-1.

This exception is available whether or not the conditions discussed above of Code Sections 674(b)(6) and 674(b)(7) are satisfied. However, this exception is not available if a non-adverse party has a power to add to the beneficiary or beneficiaries or to a class of beneficiaries designated to receive the income or principal of the trust except where such action is to provide for after born and/or after-adopted children as beneficiaries. Note that there is no prohibition under Code Section 674(d) for the trustee being related or subordinate to the grantor as there is with respect to the independent trustee exception provided by Code Section 674(c) discussed above.

In determining what constitutes a "reasonably definite external standard," reference is made to the standard set forth in Reg. 1.674(b)-1(b)(5) as discussed above. Note that there may be a distinction between what constitutes a "reasonably definite external standard" and what constitutes an "ascertainable standard." Case law and guidance from the IRS are divided as to whether provisions for an "emergency" constitute an ascertainable standard. *See, e.g. Martin v. United States*, 780 F.2d 1147 (4th Cir. 1986), and *Estate of Sowell v. Commissioner*, 708 F.2d 1564 (10th Cir. 1983)—both finding an "emergency" acceptable as part of an ascertainable standard, and TAMs 8606002 (October 31, 1985) and 8304009 (October 25, 1982)—both finding references to an "emergency" not part of an ascertainable standard. The distinction may turn on the totality of the words used to fashion the desired standard—but the takeaway by the practitioner should be to be careful of the wording of a standard especially when the grantor is serving as a trustee in order to avoid an unwanted inclusion for estate tax purposes.

E. <u>The Power to Remove a Trustee</u>

A grantor must be careful if he or she wishes to retain an unrestricted power to remove or replace a trustee. A power in the grantor to remove, substitute or add trustees may prevent the trust from qualifying for the exceptions provided by Code Sections 674(c) and (d). If the grantor possesses an unrestricted power to remove an independent trustee and substitute any person including the grantor or the grantor's spouse as trustee, the trust will not qualify under these exceptions.

Conversely, if the power of the grantor to remove, substitute or add a trustee is limited so that the exercise of this power could not alter the trust in any manner that would disqualify it under Code Sections 674(c) or (d), the existence of the power itself will not disqualify the trust from the exceptions to grantor trust status provided under these sections. Reg. 1.674(d)-2(a).

Example: Ben creates a trust and names Dan, an unrelated party, as the sole trustee. Ben retains the power to remove Dan as the trustee and substitute any other person, including himself as the successor trustee. In this situation, Ben's power is too broad to permit the exceptions of Code Sections 674(c) and (d) to apply. *See Corning v. Commissioner*, 24 T.C. 907 (1955), *aff'd*, 239 F.2d 646 (6th Cir. 1956), where the grantor's power to substitute trustees without cause required that the powers of the trustee be attributed to the grantor. Alternatively, suppose Ben retained the power to remove Dan as the trustee and substitute another independent trustee in Dan's place, which trustee could not be Ben or Ben's spouse. In this latter case, such a power should not affect the availability of any of the exceptions allowed under Code Section 674. Similarly, if Ben named First Bank as the trustee and he retained the power to replace First Bank with another corporate trustee, such a retained power would not affect the availability of any of the exceptions allowed under Code Section 674.

F. The Power to Add Beneficiaries

The various exceptions to the general rule of Code Section 674(a) described in Code Sections 674(b)(5)(6) and (7) and Code Sections 674(c) and (d), are not available if any person, whether independent or adverse, has a power to add one or more beneficiaries or to a class of beneficiaries to receive the trust income or principal, except where the action is to provide for after-born and/or after-adopted children. However, this limitation does not apply to a power held by a beneficiary to substitute other beneficiaries to succeed to his or her own interest in the trust. In such a case, the beneficiary holding such a power would then become an adverse party as to the exercise or non-exercise of that power. Reg. 1.674(d)-2(b).

Example: Carol is a beneficiary of a trust created by her sister, Anne. The trust is not a spendthrift trust. Carol has the right to assign her interest in the trust to her children. This right of assignment is not considered to be a power to add to the group of beneficiaries (since Carol would be an adverse party as to the exercise or non-exercise of her power), so it does not threaten to trigger grantor trust status for Anne, the grantor. Similarly, if Carol had a testamentary power of appointment to name one or more additional beneficiaries by her will, that would not be considered a power to add to the group of beneficiaries and would not trigger grantor trust status for the grantor. Reg. 1.674(d)-2(b).

Sometimes grantors seek grantor trust status for the trusts they establish. One way to accomplish this would be to give a nonadverse party the power to add charitable beneficiaries as additional beneficiaries of the trust; another way would be to give a third party who is not a trustee and not a beneficiary (such as a trust protector) a presently exercisable power of appointment over the trust.

VI. Code Section 675 - Administrative Powers Retained by the Grantor

Code Section 675 provides that the retention of certain administrative powers by the grantor, the grantor's spouse or a nonadverse party will cause the grantor to be taxed on the trust income. Code Section 675 addresses situations where administrative controls are exercisable primarily for the benefit of the grantor rather than for the trust beneficiaries. The administrative power must affect all of the income and principal interests. Reg. 1.675-1(a). If the grantor or the spouse of the grantor possesses a power to amend the trust, even if that power would not be enough to cause Code Section 676 exposure (dealing with the power to revoke the trust, discussed in Section VII, below) the trust will be treated as if such an amendment had already been made and will cause a trust be treated as a grantor trust if the power of amendment would allow the grantor or the grantor's spouse to establish or exercise any of the administrative powers described in Code Section 675. Reg. 1.675-1(a).

There are four categories of administrative powers and controls that make a grantor the owner of the portion of the trust to which they apply: A) Power to Deal for Less than Adequate and Full Consideration; (B) Power to Borrow without Adequate Interest or Security; (C) Borrowing of Trust Funds; and (D) General Powers of Administration. Each of these four categories are discussed below.

A. The Power to Deal for Less than Adequate and Full Consideration

The grantor will be treated as the owner of a trust, or portion of a trust, if the grantor or a nonadverse party, or both, without the approval or consent of any adverse party, holds a power that enables the grantor or any person to purchase, exchange, or otherwise deal with or dispose of the trust principal or the income therefrom for less than an adequate consideration in money or money's worth. Code Section 675(1).

If a power exercisable by a trustee is described in broad terms, that does not necessarily mean that the trustee has the authority to purchase, exchange or otherwise deal with or dispose of the trust property for less than adequate and full consideration. However, examination of the actual administration of the trust may lead to the conclusion that such authority exists. Reg. 1.675-1(c).

Nothing in Code Section 675(1) prohibits the grantor or a nonadverse party from dealing with trust assets for adequate consideration in money or money's worth. Transactions such as entering into a purchase of the trust assets for their fair market value or entering into a lease at a fair rental price should not trigger Code Section 675(1). However, before concluding that the presence of fair and adequate consideration automatically removes the possibility of grantor trust status, one must consider the other administrative provisions of Code Section 675 discussed below, in particular the power to reacquire trust assets by substituting assets of equal value set forth in Code Section 675(4)(C). For example, a sale and leaseback to a trust by the grantor has been held to result in grantor trust status. Rev. Rul. 54-9, 1954-1 C.B. 20.

B. The Power to Borrow without Adequate Interest or Security

The grantor (or the grantor's spouse, as the result of Code Section 672(e)) will be treated as the owner of any portion of a trust where the grantor or a nonadverse party may exercise a power which enables the grantor to borrow the principal or income of the trust directly or indirectly, without providing both adequate interest and adequate security. Code Section 675(2). If the grantor's power extends to borrowing the principal or income of the trust, the grantor trust status will extend over the entire trust. The power held by a nonadverse trustee to lend to the grantor a portion of the trust property that was not limited to any particular portion of the trust caused the grantor to be treated as the owner of the entire trust for income tax purposes. Priv. Ltr. Rul. 200840025 (June 13, 2008).

There is an exception to the foregoing rule. It provides that when a trustee, (other than the grantor or the grantor's spouse acting alone as trustee), is authorized by the trust document under a general lending power to make loans to any person without regard to interest or security. Code Section 675(2). Should the grantor possess a general lending power, acting alone as trustee, under which the grantor has the power to determine interest rates and the adequacy of security, such power does not in itself indicate that the grantor in fact has the power to borrow the principal or income of the trust without adequate interest or adequate security. Reg. 1.675-1(b)(2). If the trust funds are actually loaned to the grantor without adequate interest or adequate security, this may result in a finding of grantor trust status. Reg. 1.675-1(c).

Note that the mere existence of the power to borrow without adequate interest or adequate security held by the grantor or the grantor's spouse will cause grantor trust status to be recognized, regardless of whether the power is actually exercised. Priv. Ltr. Ruls. 200840025 (October 3, 2008), 199942017 (October 22, 1999), 9645013 (November 8, 1996) and 9525032 (June 23, 1995).

Allowing the grantor to have the power to borrow funds from the trust without providing *either* adequate interest or adequate security is sufficient to cause the trust to be treated as a grantor trust. If a trustee is given the power to make an unsecured loan to the grantor, the trust will be treated as a grantor trust even if the loan provides for adequate interest. Priv. Ltr. Ruls. 199942017 (July 22, 1999), 9645013 (Aug. 9, 1996) and 9525032 (March 22, 1995). A sale of the assets of the trust to the grantor on credit (in exchange for the promissory note of the grantor) is considered an indirect borrowing by the grantor.

C. Borrowing of the Trust Funds

Code Section 675(3) provides a broad general rule that the grantor will be treated as the owner of any portion of a trust where the grantor has borrowed, directly or indirectly, principal or income of the trust and has not completely repaid the loan, including any interest, before the beginning of the next taxable year. That being the case, if a loan to the grantor has been outstanding at any time during the year, grantor trust status will apply for the entire year, even if the loan is repaid, with interest, before the end of the taxable year. Rev. Rul. 86-82, 1986-1 C.B. 253; *Mau v. United States*, 355 F. Supp. 909 (D. HI. 1973). Arguably, then, a loan made on December 31 of Year 1 and repaid on January 2 of Year 2 would cause a trust to be treated as a grantor trust for all of Year 1 and Year 2.

Code Section 675(3) provides an important exception to the foregoing rule. It states that grantor trust status will not result if the loan to the grantor or the grantor's spouse provides (i) adequate interest and adequate security and (ii) the loan is made by a trustee other than the grantor, the grantor's spouse or a related or subordinate party. Reg. 1.675-1(b)(3). Loans made to a grantor that provided for adequate interest and adequate security by trustees who were the grantor's attorneys and not considered related or subordinate parties were found to qualify under this exception and to not trigger grantor trust status. *Zand v. Commissioner*, 71 T.C.M. 1758 (1996), *aff'd on other grounds*, 143 F.3d 1393 (11th Cir. 1998).

The rule of Code Section 675(3) also extends to situations where it can be shown that the grantor or the grantor's spouse has "indirectly" borrowed from the trust, causing the trust to be treated as a grantor trust. A series of cases described below has addressed the indirect borrowing issue.

There has been controversy with the IRS as to what portion of the trust the grantor will be deemed to own. The IRS position is that a grantor who borrows any amount from a trust should be treated as owner of the entire trust. The Tax Court agreed with the IRS position in *Benson v. Commissioner*, 76 T.C. 1040 (1981) holding that a grantor who had borrowed all of the income of a trust should be treated as the owner of the entire trust. In another case, a grantor was treated as the owner of a trust where the trust purchased the grantor's notes. The Tax Court found that the grantor had indirectly borrowed the trust's assets in this situation, but only taxed the grantor on the income derived from the trust on the amount borrowed. *Holdeen Estate v. Commissioner*, 34 T.C.M. 129 (1975). Loans made from a trust to a general partnership of which the grantor was a partner were treated as if made to the grantor directly, causing grantor trust status. However, a loan from the trust to a corporation controlled by the same grantor was held to not create a grantor trust status. A distinction was made based on the grantor's personal liability for the obligations of the partnership and the basis increase in the partnership interest that resulted from the partnership borrowings. *Bennett v. Commissioner*, 79 T.C. 470 (1982); *Buehner v. Commissioner,* 65 T.C. 723 (1976). In *Bennett*, the Tax Court held that the grantor who borrowed principal should be should be taxed on the "portion of the current year's trust income which the total unpaid loans at the beginning of the taxable year bear to the total trust income of prior years plus the trust income for the taxable year at issue."

When the grantor borrows from a grantor trust, the grantor cannot claim an interest deduction for interest paid to the trust. The IRS position is that a grantor trust and its grantor are a single entity for purposes of income taxation, and that the grantor and the trust cannot enter into a bona fide sale or indebtedness situation for income tax purposes. Rev. Rul. 85-13, 1985-1 C.B. 184; *contra*, *Rothstein v. United States*, 735 F.2d 704 (2d Cir. 1984), which case the IRS specifically noted it will not follow when it issued Rev. Rul. 85-13. Even if a loan would otherwise satisfy the requirements for allowing the deduction of investment interest or business interest, and even if there was adequate interest and adequate security provided, and even if the trustee is not a related or subordinate party within the meaning of Code Section 672(c), the interest paid by the grantor to the trust is not deductible. There is no creation of a genuine debtor-creditor relationship in such a situation. *Wilken v. Commissioner*, 53 T.C.M. 965 (1987); Rev. Rul. 86-106, 1986-2 C.B. 28; TAM 8709001 (Nov. 10, 1986).

D. General Powers of Administration

There are several general powers of administration over a trust which, if exercisable by any person in a nonfiduciary capacity (i.e. other than as a trustee) without the approval or consent of any person in a fiduciary capacity, will cause the holder of those powers to be treated as the grantor of the trust. Code Section 675(4). If a power is exercisable by a trustee, it is presumed to be exercisable in a fiduciary capacity primarily in the interests of the beneficiaries. If the power is not exercisable by a trustee, the determination of whether the power is exercisable in a fiduciary capacity depends on the terms of the trust and all of the facts and circumstances surrounding its creation and administration. Reg. 1.675-1(b)(4). The IRS will typically not rule on whether a power is exercisable in a fiduciary or in a nonfiduciary capacity. The IRS has called this a question of fact that may only be resolved after the tax returns have been filed. Priv. Ltr. Ruls. 200731019 (August 3, 2007), 199942017 (October 22, 1999), and 9645013 (June 8, 1996).

Code Section 675(4) lists three powers of administration that must be taken into account here, namely:

1. A power to vote or direct the voting of the trust's stock or other securities of a corporation in which the holdings of the trust and the grantor are significant from the viewpoint of voting control, without the approval of any person in a fiduciary capacity. Code Section 675(4)(A); Reg. 1.675-1(b)(4)(i). No guidance is offered as to the meaning of "significant."

2. A power, exercisable in a nonfiduciary capacity, to control the trust's investments in stock or securities of a corporation in which the holdings of the trust and the grantor are significant from the viewpoint of voting control, either by directing or vetoing the trust's investments or reinvestments; Code Section 675(4)(B); Reg. 1.675-1(b)(4)(ii). Again, no guidance is offered as to the meaning of "significant."

3. A power, exercisable in a nonfiduciary capacity, to reacquire the assets of the trust by substituting other property of an equivalent value. Code Section 675(4)(C); Reg.1.675-1(b)(4)(iii). Note that the power to reacquire trust assets need not be expressly stated in the trust instrument in order to create a grantor trust. A grantor who retained a lien on property transferred to a trust was held to have a power to reacquire the trust assets by substituting assets of equal value. *Barber v. United States*, 251 F.2d 436 (5th Cir. 1948).

Possession of one or more of these powers creates a grantor trust regardless of the identity of the person (adverse, nonadverse, independent, etc.) holding the administrative power in a nonfiduciary capacity.

Planning Opportunity Using the Power of Substitution

It is possible for a person to hold a nonfiduciary power in a trust to substitute assets of equivalent value and be treated as the grantor of that trust for income tax purposes, without having the trust property included in his or her estate. This power has been a "favorite" of planners seeking to leave the grantor taxable on the income of a trust while alive, but keep the trust property from being taxed in the grantor's estate. It is one of the powers most often used in creating an "intentionally defective grantor trust."

Several important requirements should be observed if a trust is to be designed to achieve this result. The power to substitute property should not be held by the trustee. Since achieving the desired grantor trust status requires that the power of substitution be held in a nonfiduciary capacity, allowing the trustee to exercise this power would fail to meet this requirement. The trustee should be viewed as independent and should be required to certify that the "property of equivalent value" standard has been met.

The power of substitution should not be held by an adverse party, such as a trust beneficiary. The regulations refer to powers of administration held in a nonfiduciary capacity "by any nonadverse party" Reg. 1.675-1(b)(4). Accordingly, giving the power of substitution to anyone who could be deemed an adverse party or requiring approval of an adverse party would create a problem for the grantor who desired to be treated as the grantor of the trust.

The estate inclusion issue was addressed in Rev. Rul. 2008-22. 2008-1 C.B. 796 (April 17, 2008). The ruling concluded that a grantor's retained power, exercisable in a nonfiduciary capacity, to acquire property held in trust by substituting property of equivalent value will not, by itself, cause the value of the trust corpus to be includible in the grantor's gross estate under Code Section 2036 or Code Section 2038, provided an independent 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. The key factor seems to be the affirmation by the independent trustee of the equivalency of value with respect to the substitution of properties. This is the essence of the trustee's fiduciary obligation in these situations.

Modification of an irrevocable trust (through decanting or court order, for example) in accordance with state law provisions giving the donor a power of substitution in a non-fiduciary capacity without requiring the approval of anyone in a fiduciary capacity is the creation or affirmation of a grantor trust. Priv. Ltr. Ruls. 200848006 (November 27, 2008), 200848015, 200848016, 200848017 (November 28, 2008).

With the high federal transfer tax exemption enacted by the 2017 Tax Cuts and Jobs Act, planning for most taxpayers shifts to income tax planning. Securing stepped–up basis adjustments is a centerpiece for income tax planning. An advantage of the substitution power is the flexibility of exchanging low basis assets held by a grantor trust with higher basis assets owned by the grantor individually, without requiring recognition of gain or income. Rev. Rul. 85-13, 1985-1 C.B. 184. If the grantor holds the low basis assets returned to the grantor in the exchange until death, they will receive a fair market value basis at that time. Code Section 1014.

VII. Code Section 676 - The Power to Revoke a Trust

Code Section 676 provides the general rule that the grantor is treated as the owner of any portion of a trust as to which the grantor, the grantor's spouse or a nonadverse party (or both) can exercise the power to revoke or revest title to any portion of the trust in the grantor. (The power need not be actually exercised for these rules to apply). A typical living (inter vivos) trust over which the grantor retains the right to revoke the trust is a grantor trust. If a trustee has discretion to distribute trust principal to the grantor, and the trustee is a nonadverse party, Code Section 676 will apply. Rev. Rul. 57-8, 1957-1 C.B. 204.

A grantor will be treated as the owner of a trust which could be revoked only upon receiving the unanimous consent of the grantor and a trustee which was not adverse to the grantor. Rev. Rul. 75-257, 1975-2 C.B. 251. Conversely, if the power to revoke retained by the grantor is made conditional on receiving the consent of an adverse party, it will not be viewed as a power to revest the trust property in the grantor, and Code Section 676 will not apply. *See* Priv. Ltr. Ruls. 200731019 (May 1, 2007) and 200729025 (April 10, 2007) involving a "sprinkling" trust where the grantor was a permitted beneficiary based on the exercise of discretion by several other persons, who were also permitted beneficiaries.

The power to revest is broadly defined to include not only the power to revoke the trust, but also the power to terminate, alter or amend the trust, or to appoint the trust property, so long as the trust property will return to the grantor. Reg. 1.676(a)-1. The grantor's (or the grantor's spouse's) power to purchase trust assets for less than full and adequate consideration will trigger Code Section 676. The key point here is being able to exercise these powers to enable the trust property to return to the grantor. The transfer of stock to a trust and the retained power to direct the sale of that stock, terminate the trust and receive the trust property was held to be the power to revoke the trust. Rev. Rul. 71-548, 1971-2 C.B 250. The power to direct the trust investments was held not to constitute a power of revocation. *Maloy v. Commissioner*, 45 B.T.A. 1104 (1941)

Two grantors may not, however, succeed in getting around the nonadverse party rules by deliberately combining their property into a single trust, and conditioning their rights of revocation on the approval of the other person, which, if granted, would allow the trust property to be shared equally. In such a case, each grantor was found to be the owner of one-half of the trust property. *de Amodio v. Commissioner*, 299 F. 2d 623 (3d Cir. 1962).

Example: Christine creates a trust, funds it with her personal assets, names herself the beneficiary and trustee and retains the right to revoke the trust. During her lifetime, she is the income and principal beneficiary of the trust. This trust is an example of a "typical" living trust used by many persons in many states. It is a grantor trust for a number of reasons, not the least of which is the retained right to revoke the trust per Code Section 676. All of the trust income will be taxed to Christine. At her death, the right to revoke the trust will result in the inclusion of the trust assets in her estate. Code Section 2038.

In order to create a power to revoke in its simplest, most obvious form, the grantor states in the trust instrument that the grantor has reserved the power to revoke the trust. It is possible, however, that a trust may be deemed to be revocable by presumptions of state law where, for example, a state law provides that any trust not made explicitly irrevocable is deemed to be revocable. Such a situation could result in an unanticipated (and possibly unwanted) grantor trust characterization. *Gaylord v. Commissioner*, 153 F.2d 408 (9th Cir. 1946); *United States v. Pierce*, 137 F. 2d 428 (8th Cir. 1943) It may be possible to retroactively amend or reform a trust (or possibly to decant it) to avoid the state law presumption and obtain the desired characterization. *Flitcroft v. Commissioner*, 328 F. 2d 449 (9th Cir. 1964); *Heintz v. Commissioner,* T.C. Memo 1980-524.

A Totten trust is an arrangement whereby a person deposits funds in his or her own name in a savings or similar account for a chosen beneficiary and the depositor then names himself or herself as the designated "trustee" for such beneficiary. These accounts are sometimes designated as "ITF" trusts (in trust for) or P.O.D. (payable on death) accounts. The depositor/trustee generally has the unlimited right to withdraw the assets from the account while living and revest the property in himself or herself. Accordingly, the depositor/trustee is treated as the establishing the equivalent of a revocable trust and as such is taxable on all of the trust income. Rev. Rul. 62-148, 1962-2 C.B. 153. Whether or not the depositor/trustee actually withdrew funds from the trust is irrelevant. The right to withdraw is the determinative factor. *Oppenheimer v. Commissioner,* 52 T.C.M. 980 (1986).

Note that to be considered an "adverse interest," the interest of the adverse party must be a substantial beneficial interest that would be adversely affected by the distribution of trust income or principal. If the allegedly adverse interest is remote and/or contingent, whether it is truly "adverse" or not may be challenged by the IRS. In such cases, the question becomes an issue that turns on the facts and circumstances of the particular trust. *Holt v. United States*, 669 F.Supp. 751 (DC Va. 1987) (where the likelihood of the trustees ever becoming beneficiaries was after a chain of deaths of younger beneficiaries and highly unlikely, so no adverse interest was found); *Moore v. Commissioner*, 3 T.C. 1205 (1944), *acq*. 1944 C.B. 20 (where trust property could be recovered only with the approval of all corporate directors and shareholders, which was unlikely, so an adverse interest was found).

In the typical living trust, the grantor retains the right to revoke the entire trust, so, where that is the case, it follows that the grantor is treated as the owner of the entire trust. If, however, the grantor's power of revocation extends over only a portion of the trust, only that portion will be considered as owned by the grantor under Code Section 676. How the power to retain an interest in the trust is described in the trust document may be a key determining factor as to whether the grantor has retained a full or partial right to revest title in himself or herself.

If the grantor's spouse, but not the grantor, possesses the power to revoke the trust and revest title in the grantor, grantor trust status will apply.

Example: Craig creates a trust for the benefit of his children and retains the right to revoke the trust and revest the property in himself. The trust is a grantor trust as to Craig. Assume further that Craig is married to Ariel. If Craig relinquishes the power to revoke the trust and gives the exclusive power of revocation to Ariel, so long as title to the trust property can be revested in Craig if there is a revocation grantor trust status will apply.

The Code provides an exception to grantor trust status if the right to revoke is not immediate and commences after an event or period of time. Code Section 676(b). However, this exception only applies in those situations when, had the power been a reversionary interest, the grantor would not have been taxed as the owner of the trust under Code Section 673. Recall that Code Section 673 causes the grantor to be taxed as owner of a trust where the grantor possesses a more than five percent reversionary interest in the trust property. *See* Section IV, above. Once the deferral period ends, the grantor will be treated as the owner of the entire trust by virtue of the power to revoke, unless the grantor relinquishes that power.

Example: Bob creates a trust for the lifetime benefit of his son, remainder to his son's children, and provides that in the event his son remarries, Bob has the right to revoke the trust. Assuming that Bob's interest in this trust is valued at less than five percent, this trust would not be treated as a grantor trust. If Bob's son does remarry, then Bob's right to revoke would cause him to be treated as the owner of the trust, unless he relinquishes the power of revocation. Code Section 676(b); Reg. 1.676(b)-1.

Caution: the "Family Estate Trust" is not a viable planning tool. A number of taxpayers attempted to circumvent the grantor trust rules by using a technique that came to be known as the "family estate trust." An individual would transfer all of his or her assets, including a personal residence, rental property, investment holdings, business assets, personal assets, etc. to a trust, and assign his or her lifetime services to that trust. The trust was then divided into beneficial interest units, and the units distributed as gifts to the individual's family members. The trust collected the compensation earned by the transferor as either an employee or a self-employed person. The transferor typically received a fee for services performed for the trust, as well as basic living expenses from the trust, and retained the right to either revoke or terminate the trust. The taxpayer's intent was to have the income received by the beneficial interest units taxed to the individual unit holders, rather than to the trust grantor.

This position was never accepted by the IRS. The IRS rejected the concept that the grantor/transferor of a family estate trust had shifted the responsibility for income tax liability to other family members. The payments of salary and other compensation made to the trust for the services performed by the transferor were considered assignments of income, and taxed directly to the transferor as retained interests in the trust income of a grantor under Code Section 677. *See* Section VIII of this Chapter, below. The remaining income of the trust was taxed to the grantor/transferor under the revocable trust rules of Code Section 676. Rev. Rul. 75-257, 1975-2 C.B. 251. Among the many cases sustaining the government's position are the following: *Markosian v. Commissioner*, 73 T.C. 1235 (1980); *Vercio v. Commissioner*, 73 T.C. 1246

(1980); *Holman v. United States*, 728 F.2d 462 (10th Cir. 1984); *Vnuk v. Commissioner*, 621 F.2d 1318 (8th Cir. 1980).

VIII. Code Section 677: Income for the Benefit of the Grantor

A. General Rules of Code Section 677

Code Section 677(a) treats the grantor as the owner of any portion (or all) of a trust as to which the grantor or any nonadverse party (or both) may use the trust income for the benefit of the grantor or (for trusts created after October 9, 1969) the grantor's spouse without requiring the approval or consent of an adverse party. "Income" here is defined to mean income in a tax sense, rather than fiduciary accounting income. As described below, Code Section 677 covers a wide variety of situations where the grantor is benefitted by the trust income.

Just the possibility of payments to or accumulations for the grantor or the grantor's spouse is enough to trigger the application of Code Section 677(a), assuming no approval or consent of an adverse party is involved. It is not necessary to demonstrate that actual distributions were received from the trust. Code Section 677(a) applies both to actual distributions and constructive distributions from a trust. Constructive distributions to the grantor or to the grantor's spouse include distributions on behalf of the grantor or the grantor's spouse or payments made to others at the direction of the grantor or the grantor's spouse. Reg. 1.677(a)-1(c).

Example: Joe creates a trust for the benefit of himself and his wife, Betty. First Bank is named the trustee. The trustee is authorized to accumulate the income and only pay it to Joe or Betty in the event of an emergency. Code Section 677 applies to this trust treating Joe as the grantor whether or not any distributions are made.

As a general rule, the grantor is treated as the owner of a portion of a trust the income of which is, or in the discretion of the grantor or a nonadverse party, or both, may be applied to discharge a legal obligation of the grantor or the grantor's spouse. Reg. 1.677(a)-1(d). The "legal obligations" of a person are generally determined by the rules of local law. Obligations include not only support, but also debts, tax obligations, and general claims of creditors.

As the result of the 2017 Tax Cuts and Jobs Act, trusts created by persons after December 31, 2018 to satisfy alimony obligations will be taxed to the grantor. The 2017 Act prospectively repealed the deduction for alimony payments by the payor of Code Section 71, and also prospectively repealed Code Section 682 which had provided that the recipient of payments from a trust created to address alimony obligations was taxed on such payments, and not the grantor. If persons divorce before the end of 2018 and use a Section 682 alimony trust, the rules of Section 682 will continue to apply to that trust going forward. IRS Notice 2018-37.

B. Specific Situations Described in Code Section 677(a)

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Several specific situations are enumerated in Code Section 677(a) which will cause grantor trust status to be found when the trust income can be used in one or more of the situations listed below. These include having the trust income:

• Distributed to the grantor or to the grantor's spouse. Code Section 677(a)(1);
• Held or accumulated for future distribution to the grantor or the grantor's spouse. Code Section 677(a)(2); or
• Applied to the payment of premiums on life insurance policies on the life of the grantor or the grantor's spouse, other than life insurance policies which are irrevocably payable for charitable purposes. Code Section 677(a)(3).

Each of the specific situations noted above will be discussed in further detail below.

1. <u>Possible or actual income distributions to the grantor or to the grantor's spouse.</u>

Where a trust requires or permits the income to be distributed to the grantor or to the grantor's spouse, the grantor will be treated as the owner of the income portion of the trust, so long as such distributions may be made without the approval or consent of any adverse party. CCA 200445025 (Nov. 5, 2004). Where the grantor's spouse is a discretionary income beneficiary, and the trustee held no beneficial interest so was not an adverse party, the grantor will be treated as the owner of the trust. *Amabile v. Commissioner*, 51 T.C.M. 963 (1986).

The distinction between the presence of adverse parties or nonadverse parties is important. In a situation where the grantor was not entitled to receive the income of the trust under the terms of the trust agreement, but received it anyway based on the consent of all of the beneficiaries, Code Section 677(a) was held inapplicable since the beneficiaries were adverse parties, and but for their approval, no trust income would have been payable to the grantor. *Commissioner v. Makransky*, 321 F. 2d 598 (3d Cir. 1963). Where a power of appointment is involved, if the grantor can only receive distributions from the trust with the consent of the other potential appointees, they will be considered adverse parties, and the grantor will not be considered the owner of the trust. Priv. Ltr. Ruls. 200731019 (May 1, 2007), 200729025 (April 10, 2007) and 200148028 (August 27, 2001). However, where all of the discretion to make distributions to the grantor or the grantor's spouse is in the hands of a nonadverse trustee, even if the grantor and the grantor's spouse have the right to veto a distribution, that is not viewed as a sufficient power to make the spouses adverse as to each other. Consequently, the grantor will be treated as the owner of the trust. Reg. 1.677(a)-1(b)(2); Priv. Ltr. Rul. 9536002 (May 12, 1995)

Example: Grantor creates a trust with First Bank as trustee, providing that income may be paid to Grantor or Grantor's adult children as the trustee determines in the trustee's sole discretion. All income is paid to Grantor's adult children during the year in question. Since the income could have been paid to Grantor in the discretion of a nonadverse party (First Bank), Grantor is taxable on all of the trust income.

2. <u>Trust income being held or accumulated for future distribution to the grantor</u>.

Grantor trust treatment will result if the income of the trust may be accumulated without the consent of an adverse party for future distribution to the grantor or to the grantor's spouse. Code Section 677(a)(2).

It is not unusual for a trust to exist where the grantor has retained some form of a reversionary interest and income arises (typically capital gains allocable to the principal of the trust) throughout the duration of the trust. Since the trust principal is being held for future distribution to the grantor, whatever income that accrues to principal, whether under the governing trust instrument or under local law, is treated as being accumulated for future distribution to the grantor, even if no other interest or power would cause grantor trust exposure. In such a case, even though the grantor may not be considered the owner of the income portion of the trust (perhaps because the value of the grantor's reversionary interest falls below the five percent threshold set forth in Code Section 673) the grantor will be taxed on the trust income being accumulated for the grantor's benefit. This, in turn, may cause a cash flow hardship to the grantor, since this income may not be currently available for distribution to the grantor. *Duffy v. United States*, 487 F.2d 282 (6th Cir. 1973); cert. denied, 416 U.S. 938 (1974); Reg. 1.677(a)-1(g), Ex. 2; Rev. Rul. 79-223, 1979-2 C.B. 254; Rev. Rul. 75-267, 1975-2 C.B. 225.

3. <u>Trust income used to pay life insurance premiums on the life of the grantor or the grantor's spouse</u>.

The grantor of a trust is treated as the owner of any trust or portion of a trust the income from which can be used, without the consent of an adverse party, to pay the life insurance premiums on the life of the grantor or the grantor's spouse, unless the insurance proceeds are irrevocably payable for a charitable purpose specified in Code Section 170(c). Code Section 677(a)(3). The trust does not have to direct that the trust income be used to pay life insurance premiums. The fact that trust income is (or may be) actually used for this purpose is sufficient to make the grantor the owner of the portion of the trust allowing income to be so used. Reg. 1.677(a)-1(b)(2).

A series of older decisions took the view that the trust must actually own policies for Code Section 677(a)(3) to be applicable. According to these cases, the amount of income on which the grantor may be taxed is limited to the income actually used by the trustee to pay premiums on the policies held by the trust. *See*, e.g. *Commissioner v. Mott*, 85 F.2d 315 (6th Cir. 1936). A contrary view from the IRS later emerged in a series of private letter rulings suggesting that a mere premium payment power would be sufficient to cause a trust to be a wholly owned grantor trust. *See* Priv. Ltr. Ruls. 8852003 (Aug. 31, 1998) (holding that a power to pay premiums alone causes the entire trust to be a grantor trust) and 8839008 (June 23, 1988) (the IRS determined that it is immaterial whether the premium payments come from the income or principal of the trust for trust accounting purposes). The trustee's power to purchase life insurance on the life of the grantor or the grantor's spouse and pay the life insurance premiums coupled with the actual payment triggered the finding of grantor trust status.

Example: George owns a $500,000 life insurance policy on his life. He transfers it into an irrevocable trust for the benefit of his two children. He also transfers income producing property to the trust so that the trustee (Second Bank) can use the income to pay the premiums on the life insurance policy. In addition, George's spouse, Denise, also transfers income producing property to the trust. George will be taxed on the income generated by the property that he transferred to the trust because that income is being used to pay premiums on his life insurance. Denise will be taxed on the balance of the income (the trust income generated by the portion of the property Denise transferred to the trust). Because Denise transferred property to the trust, the income from which is being used to pay premiums on the life insurance on the life of her spouse, Denise is treated as the grantor of that portion of the trust to the extent of the property she contributed to the trust.

C. Using Trust Income to Satisfy the Grantor's Obligation of Support

The possibility that trust income may be used to discharge the obligation of the grantor or the grantor's spouse for support and maintenance of a trust beneficiary is not sufficient to cause the income of the trust to be taxed to the grantor. Instead, Code Section 677(b) provides a rather broad exception to the general rule of Code Section 677(a) discussed above. Trust income will not be considered taxable to the grantor merely because such income in the discretion of another person, or the trustee, or the grantor acting as trustee or co-trustee *may* be applied or distributed for the support or maintenance of a beneficiary (other than the grantor's spouse) whom the grantor is legally obligated to support or maintain—*except* to the extent that such income is so applied or distributed. Code Section 677(b). In the absence of the grantor's legal support obligation and in the absence of the grantor's nonfiduciary power to direct discretionary distributions, simply distributing trust income to a relative of the grantor (such as a child who the grantor is not obligated to support) will not trigger grantor trust status under Code Section 677(a).

The general rule of Code Section 677(a) (taxing the grantor on the trust income) and not the exception of Code Section 677(b) will apply if the discretion to apply or distribute trust income rests solely in the grantor, or in the grantor acting in conjunction with other persons, unless the grantor's discretion must be exercised as a trustee or as a co-trustee. Reg. 1.677(b)-1(e). Moreover, the general rule of Code Section 677(a) and not the exception of Code Section 677(b) will apply to the extent that the trust income is required, without any discretionary determination being made, to be applied to support a beneficiary whom the grantor is legally obligated to support. Reg. 1.677-1(b)-1(f). In that case, the grantor will be taxable on that part of the trust income required to be paid and applied, as well as any additional amounts that were actually paid and applied in discharge of the grantor's support obligation.

Example: Hugh creates a trust for the benefit of his minor daughter, Sharon. The trust provides that the trustee may, in the exercise of the trustee's discretion, pay income to or for the benefit of Sharon for her health, education, maintenance and support. Hugh's brother, Paul, is named trustee of the trust. In the first five years of the trust's operation, no income is paid to Sharon and the income is accumulated in the trust. The income is taxable to the trust, not to Hugh, as the exception contained in Code Section 677(b) applies. In year 6, Paul distributes all of the trust income for Sharon's benefit (assume she is still a minor) to pay for her medical expenses. The year 6 income is taxed to Hugh, since it has been used to discharge his obligation to support his daughter. At the end of year 6, Hugh removes Paul as the trustee of the trust, and names himself as the trustee. In years 7 and 8, no distributions are made from the trust as the income is again accumulated. Even though Hugh is the trustee, he is not taxed on the income since he is acting in a fiduciary capacity, and no distributions were made to satisfy his support obligation. In years 9 and 10 (assume Sharon is still a minor) Hugh uses the trust income to pay for a variety of Sharon's basic living expenses. Here, Hugh is taxed on the trust income even though he is acting in a fiduciary capacity, since he is using the income of the trust to satisfy his obligation of support, so that the exception of Code Section 677(b) is inapplicable, and the general rule of Code Section 677(a) now applies.

D. Determining the Grantor's Support Obligation

There are no rules in the Internal Revenue Code and no federal standard that defines what is meant by a legal obligation of support. The regulations only provide that the grantor's legal obligation of support is to be determined under local law. Reg. 1.662(a)-4. State laws vary widely in determining when a support obligation arises, and will be determinative of the extent of a parent's obligation. Rev. Rul. 56-484, 1956-2 C.B. 23. In most states parents have an obligation to provide support for children until age eighteen is attained, regardless of the resources of the child, but some states extend the support obligation to age twenty-one.

Payments of income received under statutes such as the Uniform Transfers to Minor's Act are taxable to the grantor when deemed to satisfy a support obligation. Rev. Rul. 59-357, 1959-2 C.B. 212; Rev. Rul. 56-484, 1956-2 C.B. 23. The cases addressing the support issue have not been uniformly decided. Private school tuition, music and dancing lessons were not support obligations under South Carolina law, so the grantor was not taxable on the income of a trust created to provide for these items. *Wyche v. United States*, 36 AFTR2d 75-5816 (Ct. Cl. Tr. J. 1974). College education expenses for emancipated children and private school expenses for minor children were found to be within the scope of a parental support obligation of a financially capable parent under New Jersey law so that the income of trusts used to provide for these expenses was taxed to the grantor. *Braun v. Commissioner*, 48 T.C.M. 210 (1984). A California parent was found to have an obligation to provide a private school education for a minor child. *Stone v. Commissioner*, 54 T.C.M. 462 (1987), *aff'd*, 867 F.2d 613 (9th Cir. 1989). Montana law does not establish a parental obligation to provide private school, musical instruments, or music, swimming, and public speaking lessons. *Brooke v. United States*, 300 F. Supp. 465 (D. Mont. 1969), *aff'd*, 468 F.2d 1155 (9th Cir. 1972). A different type of analysis was applied in *Morrill v. United States*, 228 F. Supp. 734 (D. Me. 1964) where it was found that a grantor had a contractual obligation (based on agreements executed) for private school tuition and other expenses for music and dance lessons, special camps, etc., so that using trust income to address these obligations rendered the grantor taxable on the trust income since the grantor's contractual obligation was discharged by the distributions from the trust.

IX. Code Section 678 – A Person Other than the Grantor Treated as Substantial Owner of the Trust

A. General Rules and Background of Code Section 678

A person other than the grantor of a trust, including a beneficiary, may be treated as the owner of any portion of a testamentary or inter vivos trust over which such person has a power, exercisable solely by himself or herself to vest the corpus or the income of the trust in himself or herself. Code Section 678(a)(1). The rule applies whether or not the power is exercised. Rev. Rul. 67-241, 1967-2 C.B. 225.

The power to vest the principal or income of a trust in oneself makes the holder of that power taxable as the owner of the trust under Code Section 678(a) only if the power is exercisable by the holder alone. If the consent of any third party is required for the exercise of the power, Code Section 678(a) does not apply, regardless of whether the third party who must consent is adverse or not. Accordingly, if a trust provides that a trustee may distribute the trust principal to himself or herself only with the consent of an adverse party, the trustee is not treated as the owner of the trust under Code Section 678(a). Priv. Ltr. Rul. 8926032 (March 31, 1989). If an actual distribution of trust income is made to such person, that person will be treated as a beneficiary of the trust under the standard beneficiary rules of Subchapter J, Code Sections 661 and 662, but not as the owner of the trust within the rules of Code Section 678(a). Priv. Ltr. Rul. 8213140 (Dec. 31, 1981).

In addition, a person other than the grantor of a trust will also be treated as the owner of any portion of a trust as to which although the person has previously modified or partially released a power to vest the trust principal or income in himself or herself, the person has still retained such control over the trust that would, had the power been retained by the grantor of the trust, cause the grantor trust rules as set forth in Code Sections 671 through 677 to be applicable. Code Section 678(a)(2); Reg 1.678(a)-1(a). The effect of Code Section 678(a)(2) is to treat a person who has modified or released a Code Section 678 power as though that person is the creator of the continuing trust. Powers that lapse may also be included within the reach of Code Section 678(a)(2).

A person with the power to vest in himself or herself only the fiduciary accounting income of a trust will be treated as the owner of only the ordinary income portion of the trust. If a person has the power to vest in himself or herself all of the trust principal, that person will be treated as the owner of the entire trust. Regs. 1.671-3(b)(1) and 1.671-3(b)(3).

Code Section 678 arose from the case of *Mallinckrodt v. Nunan*. 146 F.2d 1 (8th Cir. 1945), *cert. denied*, 324 U.S. 871 (1945). The case held that the beneficiary's unrestricted access to the trust property was the trigger for finding grantor trust status for the beneficiary. The case involved a trust beneficiary who was entitled to receive whatever portion of the trust income that he might request. The beneficiary was also a co-trustee with broad management powers, and had the right to terminate the trust at any time and receive the entire trust estate. The court found that the possession of the demand power over the trust income was so significant that the possessor of the power should be considered the taxpayer. This was the result, even if the income not demanded by the beneficiary during the year was added to trust principal at the end of the year, thereby putting the foregone income out of the beneficiary's control.

Example: Joanne created an irrevocable trust which provided that Bill was the income beneficiary for his lifetime, remainder to Cheryl in the event of Bill's death. The trust gave Bill a general power to appoint the trust income or principal to himself or his estate at any time during his lifetime or by his will. As the result of this power, Bill will be treated as the owner of the trust under Code Section 678(a). Rev. Rul. 67-241, 1967-2 C.B. 225.

Example: Terry created an irrevocable trust with separate shares for each designated trust beneficiary. The trust provided that any beneficiary who had attained age 30 had the right to withdraw some or all of the trust principal, but those beneficiaries who had not yet attained age 30 did not possess this right. Those beneficiaries over age 30 would be taxed as owners of the trust income and principal under Code Section 678(a), but those beneficiaries under age 30 would not be taxed as owners of the trust. *See* Priv. Ltr. Rul. 8545076 (Aug. 14, 1985)

A person will be treated as the owner of a trust under Code Section 678(a) if that person has a power exercisable solely by himself or herself to apply the trust income or principal in satisfaction of his or her legal obligations, other than the obligation to support a dependent. Reg. 1.678(a)-1(b). In such a case involving dependents, the person will be taxable as the owner of the portion of the trust that can be so used.

B. Obligations of Support

A person will not be taxable as the owner of a trust under the general rules of Code Section 678(a) if that person, acting in the capacity as trustee or co-trustee, holds a power to apply trust income for the support and maintenance of another person whom the holder of the power is legally obligated to support or maintain. Code Section 678(c). However, to the extent that a person, acting in the capacity of trustee or co-trustee, applies the income of the trust to the support or maintenance of a person to whom such an obligation is owed, the person acting as trustee or co-trustee will then be considered the owner of the trust. Code Section 678(c); Reg. 1.678(c)-1(a).

Note the parallel here with Code Section 677(b) which provides that a grantor of a trust will not be treated as the owner of the trust merely because the grantor, acting as a trustee or as a co-trustee, *may* apply the trust income for the support and maintenance of a beneficiary whom the grantor is legally obligated to support and maintain—except to the extent the income is *in fact* so applied or distributed. In Private Letter Ruling 8939012 (June 29, 1989), the IRS held that a sole trustee was not taxable as a grantor under Code Section 678 where the beneficiaries of the trust were the adult children and descendants of the trustee to whom no legal obligation of support was owed.

Code Section 678 does not make any reference to an ascertainable standard. However, many planners take the position that a person acting in the capacity of a trustee will not be taxed on the income of the trust under Code Section 678 if the discretion of the trustee is limited by an ascertainable standard. This position is based on the fact that the language of Code Section 678 requires that the trustee be able to vest income or principal in himself or herself "solely by himself," and if a decision as to distributions must be made in accordance with whether an ascertainable standard has been satisfied, the trustee is not making the determination "solely by himself." There is some support for this position in the legislative history of Code Section 678 where it is stated that a person would be treated as the owner of a trust if the person had an "unrestricted power to take the trust principal or income." S. Rep. No. 1622, 83d Cong., 2d Sess. 87 (1954).The obligation to apply an ascertainable standard has been viewed as a limitation on the "unrestricted power" referred to in the legislative history. Where there is an objective standard limiting the discretion of the beneficiary, ownership of the trust by the beneficiary has not been found. *United States v. DeBonchamps*, 278 F.2d 127 (9th Cir. 1960); *Funk v. Commissioner*, 185 F. 2d 127 (3d Cir. 1950).

If a person, acting in any capacity *other than* as a trustee or as a co-trustee, holds a power exercisable solely by himself or herself to apply trust income to discharge an obligation of support and maintenance for someone such person is legally obligated to support, such person will be treated as the owner of the trust, regardless of whether or not the income of the trust is so applied. In this situation, the general rule of Code Section 678(a) and not the protective exception of Code Section 678(c) is applied. Reg. 1.678(c)-1(b).

However, a power to vest income in oneself as a co-trustee will not be treated as a power "exercisable solely" by oneself. *See also* Priv. Ltr. Rul. 200901030 (Sept. 29, 2008). In *Mesker v. United States,* 261 F. Supp. 817 (E.D. Mo 1966), a husband was found to not be taxable on the income of a trust over which he had the power to direct the trustees to pay the trust income to his wife, since he did not have the power exercisable solely by himself to apply the trust income to discharge his legal obligation to support his wife under state law. He had no power to vest the trust income in himself, so that Code Section 678(a) did not apply, nor did Code Section 678(c), since the husband did not hold the power in the capacity of a trustee or a co-trustee.

Example: Anthony creates a trust for the benefit of his minor grandchild, Jane. Anthony names his daughter, Doris, the mother of Jane, as the trustee of this trust. Doris has the power under the trust document to use the trust income for the support and maintenance of Jane. If Doris does not distribute any of the trust income to or for the support and maintenance of Jane, Doris will not be treated as the owner of the trust. However, if Doris distributes trust income to or for the support and maintenance of Jane, Doris will be treated as the owner of the trust—to the extent of the distributions made for the support and maintenance of Jane.

Example: Assume in the example above that instead of naming Doris as the trustee of the trust, Anthony named First Bank, a corporate trustee, as the sole trustee of the trust, but gave Doris the power to direct that the income of the trust could be used or applied for the support and maintenance of Jane. In such a case, since Doris is not acting in a fiduciary capacity, she would be treated as the owner of the trust and all of the trust income would be taxable to Doris, whether or not she directed that the income of the trust be used for the support and maintenance of Jane.

A power of withdrawal over a trust held by a minor may qualify as a Code Section 678(a) power resulting in the taxation of the minor even if the minor is legally prohibited from exercising that power. A minor beneficiary of a trust was treated as the owner of the portion of the trust with respect to which the beneficiary had the power to vest the principal or income in himself, even though no guardian had yet been appointed for the minor. The position of the

IRS is that it is the existence of a power rather than the capacity to exercise it that determines whether a person other than the grantor shall be treated as the owner of any part of a trust. The minor may not know of his or her rights or have any way of exercising such rights absent the appointment of a legal guardian. Rev. Rul. 81-6, 1981-1 C.B. 385; Priv. Ltr. Rul. 9535047 (June 6, 1995). The courts have found it is the right to receive property from the trust, and not the actual amounts distributed, that controls the issue of who should be taxed as the owner of the trust property. *Spies v. United States*, 180 F.2d 336 (8th Cir. 1950); *Koffman v. United States,* 300 F.2d 176 (6th Cir. 1962). As the result of the 2017 Tax Cuts and Jobs Act, persons subject to the kiddie tax (applicable to most of the unearned income of children under age 19 or children who are full-time students under age 24) will result in much of the child's income being taxed at the tax rates applicable to trusts and estates, and not at their parents' tax rates. Code Section 1(j).

C. Renunciation or Disclaimer of a Power

Code Section 678(a) does not apply with respect to a power which has been renounced or disclaimed within a reasonable time after the holder of the power first became aware of its existence. Code Section 678(d); Reg. 1.678(d)-1 What constitutes a "reasonable time" or a valid disclaimer is a matter for determination by state law, since neither Code Section 678 nor its regulations provide any guidelines as to what will constitute a valid disclaimer for these purposes. While Code Sections 2518(a) and 2046 provide substantial guidance with respect to what constitutes a "qualified disclaimer" for federal gift and estate tax purposes (and set a nine-month period commencing at the time of the transfer for qualified disclaimers) they do not apply for income tax purposes. The IRS has taken the position that a trust beneficiary who disclaims the trust income remains taxable on the trust income realized prior to the disclaimer. The disclaimer of a Code Section 678 power did not allow the disclaimant to avoid income taxation on the income earned by the trust prior to the disclaimer. Rev. Rul. 64-62, 1964-1 C.B. 221.

D. Conflicting Powers of Grantor and Power Holder

The general rule of Code Section 678 does not apply with respect to a power over income whether originally granted or subsequently modified if the original trust grantor is otherwise treated as the trust owner under Code Sections 671 through 677. Code Section 678(b).

Trust beneficiaries are often given a right of withdrawal from the trust that is designed to fall within an exception to the estate tax and gift tax inclusion rules. If a beneficiary is given the power to withdraw from the trust on an annual, non-cumulative basis, an amount limited to the greater of $5,000 or five percent of the value of the trust property out of which the power could be satisfied, the lapse of such a power of withdrawal is excluded from the definition of "release" for estate tax purposes under Code Section 2041(b)(2) and for gift tax purposes under Code Section 2514(e).

However, for income tax purposes, the holder of a "five and five" power of withdrawal which lapses if not exercised in any given year is treated as an owner of that portion of the trust principal to which the power applies, regardless of whether or not the power of withdrawal is exercised, provided the holder of the power has retained such other control over the trust as would, if retained by the grantor of the trust, subject the grantor to being treated as the owner of the trust under Code Sections 671 through 677. Reg.1.678 (a)-1(a); Rev. Rul. 67-241, 1967-2 C.B. 225; Priv. Ltr. Rul. 200022035 (March 3, 2000).

A "Crummey power" is used in trust drafting to give a trust beneficiary a limited power of withdrawal over property contributed to the trust (*i.e*., additions made to the trust) for a limited period of time (often 30 days) all in an effort to qualify the beneficiary's right of withdrawal as a present interest for purposes of the gift tax. The Crummey power of withdrawal may apply to the initial funding of the trust as well as to later gifts to the trust. *Crummey v. Commissioner*, 397 F.2d 82 (9th Cir. 1968).

As a general rule, the IRS will treat the holder of a Crummey power as the owner of that portion of the trust as to which the withdrawal power applies while the power exists under Code Section 678(a)(1), and as the owner of a portion of the trust after the power lapses if the power holder is also a beneficiary of the trust under Code Section 678(a)(2). This rule will even extend to the case of a minor beneficiary with a Crummey power even though local law legally prevents the minor from exercising the power absent the appointment of a legal guardian. The existence of the withdrawal power, and not the legal ability of the minor beneficiary to exercise it, is viewed by the Service as the determinative factor. Rev. Rul. 81-6, 1981-1, C.B. 385; Priv. Ltr. Rul. 200011058 (Dec. 15, 1999). The withdrawal powers make the beneficiaries taxable as the owners of both the income and principal of their portion of the trust under Code Section 678(a). Rev. Rul. 67-241, 1967-2 C.B. 225.

Technically, each beneficiary may be required to report a portion of the trust income. In Private Letter Ruling 9541029, (July 14, 1995) the IRS ruled that each of seven beneficiaries who had a Crummey power over one-seventh of the contributions to the trust must each include those items of income, deduction and credit against tax attributable to or included in the portion of trust principal over which each beneficiary had a right of withdrawal during that calendar year.

The above discussion of the possible trust ownership status of the holder of a Crummey power suggests that situations may exist where a trust may appear to have multiple owners, especially where the grantor has retained powers over the trust, but has allowed another person to have powers (such as a Crummey power of withdrawal) over the trust as well. Code Section 678(b) resolves this dilemma at least in part as it provides that if a person (who is not the grantor) holds an original or subsequently modified power over the income of the trust, and the grantor of the trust is otherwise treated as the owner of the trust under Code Sections 671 through 677, then Code Section 678(a) does *not* apply with respect to such non-grantor person.

In effect, the presence of a "true" grantor "trumps" the status of a power holder as a potential grantor. There is not a shared grantor status in these situations. Code Section 678(b); Reg. 1.678(b)-1. The IRS has issued a number of private letter rulings holding that the grantor trust provisions will "trump" a Code Section 678(a) power attributable to a person holding a Crummey withdrawal right that lapses. The original grantor of the trust has been held to continue to be treated as the "owner" of all of the trust income and principal despite the existence of a Crummey clause in the trust giving other persons rights over the trust. Priv. Ltr. Ruls.

200729016 (March 27, 2007), 200603040 (October 24, 2005) and 200011054 (December 15, 1999).

Code Section 678(b) is necessary to prohibit a trust grantor who retains one or more grantor trust powers from allowing another person to have a power described in Code Section 678(a) and thereby shift the tax consequences of the trust to such person. If this could be done, grantors could create appropriate powers in low-bracket taxpayers which would most likely never be exercised, but would have the effect of allocating some of the trust's taxable income to such low-bracket persons. This would obviously undermine the intent of the grantor trust rules.

Example: Gina creates a revocable trust and gives Betty, the trust beneficiary, the power to demand annual distributions of the income of the trust. Since the trust is revocable, causing Gina to be treated as the trust grantor under Code Section 676, all of the trust income is taxable to Gina, even if Betty exercises her power of withdrawal and receives the trust income.

The literal language of Code Section 678(b) and Regulation Section 1.678(b)-1 does not end the discussion of this issue, however, since it addresses only a power over *income*, and many withdrawal powers over a trust, including Crummey powers, may also address powers over the trust principal. There is some useful guidance in the legislative history of these provisions where it is stated, "A person other than the grantor may be treated as a substantial owner of a trust if he has an unrestricted power to take the trust principal or income . . . unless the grantor himself is deemed taxable because of such a power." H.R. Rep. No. 1337, 83d Cong., 2d Sess. 63 (1954); S. Rep. No. 1622, 83d Cong. 2d Sess. 87 (1954).

Numerous commentators have cited this language and suggested that the power "over income" reference was a drafting error and should be disregarded, since Code Section 678(a) applies to powers over income and principal, or that the reference to "income" is broadly meant to refer to "taxable income," and not narrowly to trust accounting income. In its Private Letter Rulings, the IRS has not made a distinction between the power over income and the power over principal. Priv. Ltr. Ruls. 200840025 (June 13, 2008), 200732010 (May 1, 2007), In these rulings, the IRS often cites Regulation Section 1.671-2(b) referring to "income" as taxable income, not trust accounting income, without making any distinction between the ordinary income and capital gains of the trust. If different persons (the grantor and the beneficiaries) had specific and possibly separate rights in trust accounting income and/or trust accounting principal, a "shared" trust ownership may be a reasonable conclusion here. Without such clear distinctions, the "power over income" is likely to continue to be interpreted to refer to a power over income and principal.

X. Using the Grantor Trust in Tax Planning Situations

The grantor trust has become an especially useful and popular device for tax planning in many different contexts. While a non-grantor trust that does not distribute its income is subject to the highly compressed income tax rates imposed on trusts and estates, the income of a grantor trust is taxed at the tax rate of the individual grantor, which is typically much more favorable.

Some of the planning techniques that feature grantor trusts are discussed briefly below.

A. <u>The Revocable Trust</u>

A revocable trust is the most commonly used form of grantor trust. Often called a "living trust," the revocable trust allows the grantor to transfer assets to a trust while retaining the right to income from the trust and control over the trust assets. The revocable trust is a grantor trust under the rules of Code Section 676. In those states where probate is cumbersome and/or expensive, the revocable trust is often the centerpiece of an estate plan, as it allows the grantor to control assets while living and pass assets at death to heirs through the trust without being subjected to probate administration. Most states treat a will as a public document, and some state laws make public an inventory of a decedent's assets that pass through probate. The use of the revocable trust in these jurisdictions allows a grantor and the grantor's family to maintain privacy after the grantor's passing with respect to the grantor's assets.

Even where probate administration and privacy are not serious issues, a revocable trust is often used as a management vehicle for the grantor's assets. Perhaps the grantor is aging, and becoming less comfortable or capable of managing his or her assets. Placing those assets in a revocable management trust allows the grantor not only to remain in control of those assets as the trustee of the trust for as long as possible, but also to name a co-trustee or successor trustee to assist in management or to take over management, as the case may be. This planning may allow for an easy transition of control should the grantor become incapacitated without the need to have conservators or guardians appointed to manage the grantor's property. When the grantor dies, the fiduciaries are in place, the assets titled in the name of the trust are well-organized and easily identifiable, so that management of the grantor's estate can proceed efficiently.

If a person has real estate holdings in more than one state, a revocable trust is often a good way to hold title to those properties. If the grantor dies, instead of having to address ancillary probate proceedings in each state to transfer title from the grantor's name to the names of the grantor's heirs, the title in the name of the revocable trust is undisturbed and the trust beneficiaries can enjoy the property without the requirement of potentially cumbersome and expensive ancillary probate administrative proceedings.

From a tax perspective, the revocable trust is generally treated as the alter ego of the grantor. The taxable year of the trust and method of accounting used must follow those used by the grantor. Rev. Rul. 57-390, 1957-2 C.B. 326. All of the income of the trust is taxable to the grantor. There is no gain or loss recognized and no change to the income tax basis of the grantor's assets when those assets are placed in the trust. If a transfer is made by the grantor to the trust, it is not a taxable gift, since the grantor retains the right to revoke the trust. If the trust makes a gift to a third party, it is treated as a gift from the grantor individually to such third party. If the grantor of a revocable trust dies, all of the trust property is included in the grantor's taxable estate by reason of the grantor's right to revoke the trust. Code Section 2038.

When the grantor dies, the trust will cease to be characterized as a grantor trust. It will then be subjected to the general rules of trust income taxation as provided by Subchapter J of the Internal Revenue Code. However, a revocable trust is eligible to make an election under Code

Section 645 to be taxed as if it were part of the grantor's estate for the greater of two years from the grantor's date of death or the period necessary to resolve any federal estate tax proceedings. Such an election is recommended (File Form 8855 by the due date of the estate's first fiduciary income tax return) as the laws addressing estate income tax administration are somewhat more favorable than those available in the case of a trust's income tax administration.

Other income tax rules which would apply to the grantor as an individual remain applicable even though the grantor's property has been transferred to a revocable trust. The grantor can continue to claim itemized income tax deductions for home mortgage interest (Code Section 163) and real property taxes (Code Section 164) to the extent permitted after the 2017 Tax Cuts and Jobs Act even though the property is titled in the name of the revocable trust. Priv. Ltr. Rul. 9516026 (Jan. 19, 1995). The exclusion of gain from the sale of a principal residence available under Code Section 121 remains available to the grantor and the grantor's spouse even if the residence is held in a revocable trust at the time of the sale, assuming, of course, that the ownership and use requirements of Code Section 121 are satisfied. Priv. Ltr. Rul. 199912026 (Dec. 23, 1998).

Transferring Series E or Series EE U.S. Savings Bonds with untaxed interest to a revocable trust does not accelerate taxation of the deferred income on the bonds. Rev. Rul. 58-2, 1958-1 C.B. 236; Priv. Ltr. Rul. 9009053 (Dec. 6, 1989). A grantor who suffers an involuntary conversion of real property can use the deferral of gain provisions of Code Section 1033 even if the property is titled in the name of a revocable trust. Rev. Rul. 66-159, 1966-1 C.B. 162. Similarly, where a grantor owned property individually that was the subject of an involuntary conversion and later made the qualifying replacement property acquisition by using a grantor trust, the Service concluded that the trust's status would be disregarded for income tax purposes, and the grantor is considered to have purchased the property, thereby satisfying the requirements of Code Section 1033. The trust was viewed as the purchasing and entitling agent of the grantor. Rev. Rul. 88-103, 1988-2 C.B. 304.

A decedent spouse may transfer his or her qualified retirement plan benefits to a grantor trust of the surviving spouse where the surviving spouse is the sole trustee and the current income beneficiary. If the surviving spouse then rolls over the plan benefits to the survivor's own IRA, the transaction will be viewed as a proper tax-free rollover by the surviving spouse. The fact that the plan benefits went from the decedent to the grantor trust to the spouse does not disqualify the transfer from tax-free rollover treatment. Had the trust been a trust other than a grantor trust, the spouse would not have been eligible for tax-free rollover treatment, unless the spouse could show he or she was the sole trustee and sole trust beneficiary with complete discretion over the trust property. Priv. Ltr. Ruls. 9813018 (Dec. 30, 1997) and 9820020 (Feb. 18, 1998).

A grantor may transfer an installment obligation to a revocable trust or may receive an installment obligation from a revocable trust. Neither of such transfers will be treated as a disposition of an installment obligation which would have the effect of accelerating deferred gain. Rev. Rul. 74-613, 1974-2 C.B. 153; Rev. Rul. 73-584, 1973-2 C.B.162; Rev. Rul. 76-100, 1976-1 C.B 123. The transfer of an installment obligation to an irrevocable trust of which the grantor is *not* treated as the owner ordinarily triggers the recognition of gain by the grantor. Rev.

Rul. 67-167, 1967-1 C.B. 107; Rev. Rul. 76-530, 1976-2 C.B. 132. However, a transfer by a grantor to a grantor trust is not a disposition that triggers acceleration of the tax on an installment sale. Instead, the income from the installment obligation remains taxable to the grantor as it is received in accordance with the terms of the installment obligation. Rev. Rul. 67-70, 1967-1 C.B. 106; Rev. Rul. 74-613, 1974-2 C.B. 153.

For purposes of the net investment income tax (Code Section 1411) a grantor trust is not subjected to the trust's threshold for imposition of the tax, but rather the individual grantor is subject to the thresholds applicable to individual taxpayers depending on one's filing status.

A potential drawback to the use of the revocable trust is the requirement that the grantor's assets must be titled in the name of the trust to make the trust effective. Clients must consider the cost and complexity of undertaking and monitoring this complexity versus the probate avoidance, management advantages and privacy protection offered by the revocable trust.

B. The Grantor Trust as a Permitted Shareholder of an S Corporation

Grantor trusts are often used in the context of planning with S corporations since grantor trusts are qualified S corporation shareholders, provided the grantor (or deemed owner of the trust under Code Section 678, if applicable) is an individual who is a citizen or resident of the United States. Code Section 1361(c)(2)(A)(i). The entire trust must be owned by an individual meeting these criteria. If a grantor (or deemed trust owner) dies, and the trust met this test immediately before the grantor's death, the trust may continue to be a qualified S corporation shareholder, but only for the two-year period beginning on the date of the grantor's (or deemed owner's) death. Code Section 1361(c)(2)(A)(ii); Reg. 1.1361-1(h).

The grantor trust is often a far more flexible planning vehicle for owning S corporation stock in a trust than the other trusts permitted to hold S corporation stock, namely the qualified subchapter S trust ("QSST") and the electing small business trust ("ESBT"), which require election notification to the IRS and specific (and in the case of the ESBT, unfavorable) income tax reporting and payment rules.

C. The Grantor Retained Annuity Trust (GRAT)

The acronym "GRAT" refers to a Grantor Retained Annuity Trust. It is an irrevocable trust designed to meet the requirements for retaining a "qualified interest" in the trust. The grantor creates the trust and funds it with whatever property the grantor desires to use, including cash, stocks, bonds, mutual funds, real estate, business interests, etc. Generally, the intent of the GRAT is for the grantor to contribute property to the trust that has meaningful appreciation potential. The grantor of the GRAT retains the right to receive an annuity from the trust. The right to receive trust income makes the trust a grantor trust. Code Section 677. The annuity may take the form of either a fixed dollar amount or a fixed percentage of the initial fair market value of the trust property. Code Section 2702; Reg. 25. 2702-1.

The grantor is making a reportable gift for gift tax purposes of the reminder interest in the property transferred, i.e. the fair market value of the property less the value of the grantor's retained interest. This is not a gift eligible for the present interest gift tax exclusion. It is possible to value the gift to the beneficiaries at zero, eliminating all gift tax liability, if the retained interest by the grantor is substantial enough to zero-out the value of the remainder interest. The goal here is to have significant appreciation of the transferred property so that the trust property appreciates to an extent beyond what must be returned to the grantor, resulting in a transfer tax-free benefit to the remainder beneficiaries. This "zeroed-out GRAT" has been approved by the Tax Court and accepted by the IRS. *Walton v. Commissioner*, 115 TC 289 (2000); *acq*. Notice 2003-72, 2003-44 I.R.B. 964 (November 3, 2003); Reg. 25.2702-2(a)(5).

The annuity is created for a fixed period of years as selected by the grantor. Generally, the selected term is at least two years, and not more than twenty years. Since there are adverse federal estate tax consequences associated with the grantor of the GRAT dying before the end of the GRAT term (i.e. an estate inclusion of an amount necessary to produce the remaining annuity due to the grantor), it is advisable to select a term based on the age and health of the grantor that gives the grantor a reasonable likelihood of surviving the chosen retained interest term. Attention must be given to this "mortality risk." The annuity payments may be made to the grantor monthly, quarterly, semiannually or annually, as desired by the grantor, but in any event the annuity must be payable at least annually.

Since the grantor will be receiving an annuity, it is generally advisable, but not required, that the property selected to fund the GRAT be property that is income producing. Otherwise, principal is returned to the grantor to satisfy the required annual payments, defeating the goal of leaving more appreciated property to the remainder beneficiaries. During the annuity term of the trust, a GRAT is a grantor trust, so that the grantor is taxed on all of the income of the GRAT, whether or not such income is actually received by the grantor. Note that a GRAT is considered to be a 100% grantor trust so long as trust principal can be used to make the required GRAT annuity payments. (Most GRATs are drafted to provide this).

At the termination of the annuity period, the trust property passes to the beneficiaries selected by the grantor, thus avoiding probate issues as well as further transfer taxation (assuming the grantor survived the term of the trust), and ensuring a measure of succession planning desired by the grantor.

The basic "theory" of how the GRAT works and why it may be desirable is that property is transferred to fund a trust and the grantor retains an annuity interest that is calculated based on both the selected qualified retained interest of the grantor and an interest rate prescribed monthly by the IRS (the Code Section 7520 rate), with a remainder interest to pass to designated beneficiaries. The assumption by the government in permitting this planning is that the transferred property will generate a cash flow consistent with the prescribed interest rate, and that the value of the property will not fluctuate. If the property generates a return that exceeds the applicable Code Section 7520 interest rate (sometimes referred to as the "hurdle rate"), either attributable to increased cash flow or capital appreciation, the remainder interest will have been undervalued at the date of creation of the trust, and the remainder beneficiaries will acquire property without additional transfer tax being imposed on the grantor (beyond the original gift tax—or use of the applicable gift tax exclusion—when the trust was created). It is this expectation of future appreciation beyond the gift tax value that was used at the inception of the trust that makes the GRAT a popular planning technique.

D. The Qualified Personal Residence Trust (QPRT)

A Qualified Personal Residence Trust (QPRT) is typically created as an irrevocable trust for gift tax purposes. Since the trust is not revocable, Code Section 676 would not be applicable. However, because the Code treats a grantor as the owner of the trust property under Code Section 677 (by virtue of a retained right to the trust income), under Code Section 675 (by virtue of a retained administrative power over the trust) and under Code Section 673 (by virtue of a possible reversion to the grantor's estate) the trust will be treated as a grantor trust for federal income tax purposes. Once grantor trust status has been determined, the grantor will be able to claim the allowable deductions for taxes, mortgage interest and any other deductions or exclusions arising from the residential property that may be properly chargeable to or excluded from income. Code Section 2702; Reg. 25.2702-5.

Grantors who create qualified personal residence trusts are deemed to be the owners of their entire trusts for income tax purposes under Code Section 673(a). This is because the value of each grantor's reversionary interest in the trust property exceeds five percent of the value of the trust. Accordingly, the grantor is required to include all items of income, deduction and credit against tax attributable to each qualified personal residence trust in computing his or her personal income tax liability. Priv. Ltr. Rul. 9606003 (Nov. 7, 1995).

Example: In a "typical" personal residence trust, the grantor creates an irrevocable trust for the benefit of family members. The grantor transfers her personal residence to the trust, retaining the right to use and occupy the residence for a number of years, which number of years she reasonably expects to survive. If she survives the retained interest term, the residence is then owned by the remainder beneficiaries of the trust (the family members). The grantor is treated as having made a gift of the fair market value of the residence on the date of the transfer, less the value of her retained interest, i.e. a gift of the present value of the remainder interest. Determining these values requires an actuarial calculation. Since the gift to the remainder beneficiaries will only benefit them in the future, when the retained interest term expires, the gift to the remainder beneficiaries is a gift of a future interest, and the grantor may not use her present interest gift tax exclusion to offset any portion of the value of the gift. A gift tax return (Form 709) must be filed for the year the residence is transferred to report the gift. The goal for the QPRT is that the personal residence appreciates beyond its value upon transfer, so that the grantor has made a gift of property "frozen" at the date of gift value less the grantor's retained interest, and worth substantially more when the beneficiaries receive it, with no further transfer tax being due.

If the grantor dies before her retained interest term is exhausted, her death occurred while she retained the right to use and occupy the transferred personal residence property. Accordingly, the fair market value of the transferred property as of her date of death is included in her gross estate for federal estate tax purposes. Code Section 2036. In that case, the basis of the residence to the heirs is the fair market value of the property as of the deceased grantor's date of death.

Code Section 1014(a). If the grantor outlives the retained interest term, and later dies, the value of the residence is not included in her gross estate for federal estate tax purposes, as she did not retain any interest in the transferred property at the time of her death.

E. The Intentionally Defective Grantor Trust

The term "intentionally defective grantor trust" refers to an irrevocable trust that intentionally "violates" one or more of the grantor trust rules. As a result, the income of the trust remains taxable to the grantor. When working with the intentionally defective grantor trust as a planning technique, the general objective is to leave the grantor taxable on the trust income, but make certain that the trust property will not be included in the taxable estate of the grantor.

The rules relating to the taxation of trusts for income tax purposes and for transfer tax purposes are not necessarily consistent. Differences between the transfer tax rules and the income tax rules thus allow a discrepancy to exist—a trust grantor may be treated as the owner of the trust for income tax purposes, but the trust property may be excluded from the grantor's estate for estate tax purposes, so long as certain prohibited retained interests are avoided. This "asymmetrical" tax treatment allows the intentionally defective grantor trust to exist.

Where these circumstances are present, the trust is considered "defective" for income tax purposes (the grantor's transfer failed to relieve the grantor of the income tax obligations of the transferred property). Where the grantor created the trust specifically to achieve this result (in an attempt to accomplish some of the potentially advantageous tax planning objectives described below) the grantor trust is said to be "intentionally defective."

The intentionally defective grantor trust ("IDGT") has a number of desirable tax and estate planning uses. It can be used as an estate freezing technique whereby the value of property transferred by the grantor to the trust is "frozen" as of the date of transfer so that all future appreciation may benefit the trust beneficiaries. Gifts and/or sales to an intentionally defective grantor trust may be used to accomplish this goal. Depending on the assets used to fund the trust, valuation discounts may be available for transfers of partnership, LLC, real estate and closely-held corporate business interests.

IDGTs may also be used as an income tax planning technique. The grantor will transfer property with the intention of removing such property from the grantor's taxable estate. However, the grantor still wishes to be taxed on the income from the trust property for income tax purposes. Having the grantor remain subject to income tax, rather than the trust, serves three purposes. First, it leaves the income taxable to an individual who may be in a lower income tax bracket than the trust. Second, by having the grantor pay the income tax on the trust's income, the trust itself is allowed to grow in value, since the funds necessary to pay the income tax are not being removed from the trust when tax are paid. Accordingly, more funds remain in the trust to pass to the trust beneficiaries. Third, by having the grantor pay the income tax on the trust's income, the grantor's estate is reduced by the amount of income taxes paid by the grantor over the duration of the trust. This is sometimes referred to as "burning" off assets from the grantor's potential estate, a desirable result if the grantor's eventual estate will be large enough to be taxable.

Consider using an IDGT in any situation where the planning goal is to move family wealth from the grantor to the trust and its beneficiaries, including even a simple annual exclusion gift trust for the benefit of children or grandchildren. Leaving the grantor taxable on the trust income is a powerful estate reduction planning tool for the grantor. The former planning "mantra" of shifting taxation of income to persons in lower tax brackets has changed to retaining the income tax burden in the hands of the wealthy senior family member as an effective estate planning strategy.

Broadly stated, to accomplish the planning transaction called a "sale to an intentionally defective trust" a person (the grantor) creates a trust typically for the benefit of children or grandchildren, but retains certain specific and limited administrative powers over the trust. Once the trust has been created, the grantor gives and/or sells assets to the trust.

The grantor may sell assets to the trust in exchange for a long-term interest-bearing installment note. If the transaction is structured properly, the trust grantor has converted an appreciating asset (the asset sold) into an asset with a fixed value (the promissory note); hence the "freeze". The sale transaction is entered into at fair market value, so the sale by the grantor does not result in it being treated as a gift or bargain sale to the trust beneficiaries. The grantor will not be subject to income tax on the sale of the assets to the trust. Why? Because, for income tax purposes, the grantor is treated as the trust owner. See Rev. Rul. 85-13, 1985-1 C.B. 184 (transactions between the grantor and the grantor trust will not have any income tax consequences, since the grantor and the trust are treated as one taxpayer). This allows the sale of assets by the grantor to the trust to avoid capital gains taxes, and the note interest received by the grantor to avoid being subjected to income taxes. Appreciation on the assets sold to the trust grows outside of the grantor's estate. If the grantor dies before the note has been paid in full, only the unpaid note balance is included in the grantor's estate, not the date of death value of the transferred property.

The grantor of an IDGT will not retain any voting, economic or reversionary rights in the assets transferred to the trust. The grantor will not serve as the trustee.

The only gift tax element of this transaction arises from the belief that the trust must be capitalized ("seeded") with sufficient assets (aside from the property being transferred to the trust in exchange for the trust's note) to establish the independence of the trust from the assets to be sold by the grantor to the trust. This gift is considered to be a contribution of equity to the trust to be distinguished from the debt represented by the note arising from the sale of the property to the trust. The capitalization by gift is generally recommended to be at least 10% of the value of the installment note, so that there is a debt (*i.e.*, the amount of the note) to equity (*i.e.*, the amount of the gift) ratio of not more than 10:1. It is important that the trust have independent equity, so that the note owed to the grantor is not recharacterized as an equity interest, which could, in turn, result in the inclusion of the transferred property in the grantor's estate on the theory that an equity interest has been retained in the property sold to the trust by the grantor.

It is crucial to the success of this planning technique that the appropriate grantor power be retained by the grantor. If the power is too "big", such as the power to revoke the trust, retention of a reversionary interest or permission to receive the trust income, such a retained interest will require inclusion in the grantor's estate under Code Sections 2036 through 2038. The power to be used must be one "big enough" to leave the grantor taxable on the trust income, but not "so big" as to require inclusion in the grantor's estate.

Planners typically favor several of the grantor powers discussed earlier in this article to accomplish this goal.

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Drafters may give the trustee or a non-adverse third party (perhaps a "trust protector") the right to add a charitable beneficiary. Code Section 674. The grantor should not be the person allowed to possess the power to add beneficiaries. Retaining such a power in the hands of the grantor could cause an inclusion in the grantor's estate under Code Sections 2036 or 2038. Where this is the power utilized by the grantor, it is recommended that the power granted to the non-adverse party to add potential additional beneficiaries be limited to charitable beneficiaries.

There are several powers set forth in Code Section 675 that are administrative powers which the grantor may retain and thereby be taxed on the income of the trust, but retaining such administrative powers does not rise to the level of requiring inclusion of the trust property in the estate of the grantor. A power of administration is exercisable in a nonfiduciary capacity by any person without the approval or consent of any person in a fiduciary capacity. Code Section 675(4). Among the administrative powers satisfying these criteria are the following:

1. The power to borrow the income or principal of the trust, directly or indirectly, without providing adequate interest or without providing adequate security exercisable by the grantor or a non-adverse party will cause the grantor to be treated as the owner of the trust property for income tax purposes. Code Section 675(2). Properly created, this power should not be viewed as creating a threat that the trust property will be included in the grantor's estate. As a practical suggestion, it may not be advisable to allow the grantor to have the power to borrow without adequate interest, since that may cause the imputed interest rules and Code Section 7872 to apply, resulting in an unwanted complication for the trust. Allowing the grantor to borrow the trust income or principal without providing adequate security will provide the desired grantor trust status and avoid the unwanted estate tax inclusion.

2. The power to substitute trust assets. The power, exercisable by the grantor in a nonfiduciary capacity, to reacquire trust property by substituting other property of an equivalent value will cause the grantor to be treated as the owner of the trust assets for income tax purposes. Code Section 675(4)(C). However, Revenue Ruling 2008-22, 2008-1 C.B. 796 holds that a retained power by a trust grantor, acting in a non-fiduciary capacity, to substitute trust assets for other assets having an equivalent value does *not* cause the trust assets to be included in the grantor's estate under Code Sections 2036 or 2038.

The ruling indicates that this result will apply *provided* the trustee has a fiduciary obligation (either under local law or required by the terms of the governing instrument) to ensure that the properties acquired and substituted by the grantor are, in fact, of equivalent value, and *further provided* that the power of substitution cannot be exercised by the grantor in a manner to allow the shifting of interests among the beneficiaries of the trust. The trustee must have a duty of impartiality toward the beneficiaries. Where the power of substitution is used as the "defective" retained interest, the grantor should *not* be permitted to act as the trustee. Subsequent to the issuance of Rev. Rul. 2008-22, the IRS issued Private Letter Ruling 200944002 (July 15, 2009) which follows Revenue Ruling 2008-22 and provides a "roadmap" as to how to proceed using a power of substitution.

Taxpayers who created grantor trusts in the years prior to the passage of the 2017 Tax Cuts and Jobs Act may, due to the significant increase in the lifetime exemption amount, now find they have little estate tax exposure but substantial income tax exposure. That being the case, they may wish to relinquish the powers that made the trust a grantor trust and allow the trust (or more likely the trust beneficiaries) to be the income payors. Additionally, there may be a rush to establish non-grantor trusts for families with multiple members to create eligibility for the Code Section 199A deduction where that opportunity was not available to the grantor acting alone as the only income tax payor. As with so many tax planning issues, the circumstances of each taxpayer must be evaluated separately. No advisor should ever assume that "one size fits all" is a correct view of tax planning.