PLANNING WITH
GRANTOR TRUSTS

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THE UNIVERSITY OF TEXAS AT AUSTIN

J.D. - with honors, 1994 (Chancellors; Order of the Coif)
M.B.A. - 1994
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LECTURES & ARTICLES

Houston Estate and Financial Forum - *"Working with Grantor Trusts,"* February 24, 2017
State Bar of Texas Advanced Estate Planning & Probate Course - *"Difficult Issues with Grantor Trusts,"* June 2016
University of Colorado and University of Denver Charitable Planning Summit in Denver - *"Using Defined Value Clauses to Make Lifetime and Testamentary Charitable Gifts,"* May 2016
Tulane Tax Institute - *"Transactions with Defective Grantor Trusts,"* October 2015
Webcredenza Broadcast - *"Family Limited Partnerships,"* co-presented with Stacy Eastland, October 2013
The Texas Tax Lawyer - *"Defined-Value Transfers,"* co-authored with Richard Ramirez, Winter 2013
State Bar of Texas 21st Annual Estate Planning and Probate Drafting Course - "*Setting the Bar with Defined-Value Transfers,"* October 2010
Estate Planning - "*Estate Planning by the Numbers - Defined-Value and Other Formula Transfers,"* co-authored with Richard Ramirez, May 2010
Wednesday Tax Forum, Houston - *"Managing Tax Risk with Formula Transfers,"* August 2009
American Bar Association 20th Annual Spring Symposia, Section of Real Property, Trust and Estate Law - "*Use of Defined-Value Clauses (and Alternatives) in Transfers of Closely-Held Business Interests*," Panelist with Daniel H. McCarthy, April 2009
Probate & Property - "*Defined-Value Transfer Planning After McCord and Christiansen*," co-authored with John W. Porter, September/October 2008
State Bar of Texas 26th Annual Advanced Tax Law Course - "*Family Limited Partnerships*," August 2008
The State Bar of Texas 32nd Annual Advanced Estate Planning and Probate Course - "*Defined Value Gifts*," June 2008
American Bar Association, Section of Real Property, Trust, and Estate Law, Teleconference and Live Audio Webcast – "*The Christiansen Case and the Use of Formula Clauses*," panelist with Carlyn McCaffrey and John Porter, March 2008
Tulane Tax Institute - "*Family Limited Partnerships: Case Law Update and Planning Issues,"* October 2007
State Bar of Texas 18th Annual Advanced Drafting: Estate Planning and Probate Course - "*Planning for Spouses -- Not Just QTIPs*," October 2007
Corpus Christi Estate Planning Council - "*Implementation: Family Limited Partnerships*," February 2007
Houston Bar Association Probate, Trusts & Estates Section - "*FLPs - What Now?*," November 2005
Mississippi Tax Institute – "*Family Limited Partnerships: A How-To Primer from a Planner's Perspective,*" November 2004
Houston Bar Association Attorneys in Tax and Probate – "*FLP Basics*," September 2004
University of Texas School of Law – Current Issues Affecting Partnerships, Limited Partnerships, and Limited Liability Companies – "*Family Limited Partnerships: A How-To Primer from a Planner's Perspective,*" solo speaker and then panelist with Carol Cantrell and Norman Lofgren, July 2004
State Bar of Texas 28th Annual Advanced Estate Planning and Probate Course – "*A Current Look at Trust Committees, Trust Protectors and Co-Trustees*," June 2004
Moderator for Bar Association/WebCredenza Teleseminar Series – "*Estate Planning for All Seasons – How to Take Advantage of Low and Rising Interest Rates,*" February 2004
Houston Bar Association - *Panel Discussion on Business Transition Issues*, May 2003
University of Houston Law Center Continuing Legal Education Seminar on Corporate, Partnership, & Business Law, "*Family Limited Partnerships – Uses, Limits, and Ethical Considerations*," June 2002
Houston Business Journal - "*Planning Can Help Firm Owner Reduce or Avoid Federal Transfer Tax*," co-authored with Jeffrey E. Raley, May/June 2002

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I. INTRODUCTION

Grantor trusts usually play an integral role when it comes to successful estate planning for clients of very high net worth. Planning with so-called "intentionally defective grantor trusts" was frequently in use at Baker Botts L.L.P. when I arrived in the fall of 1994. We have continued to utilize the structure throughout my time at the firm. It is a weird device, though, and explaining the concept to a client can be something of a challenge. Stacy Eastland, when he was at our firm (he left for Goldman Sachs in the fall of 2000), would give clients a short lesson in tax history. Many times I have borrowed from Stacy's approach, as here.

Efforts to shift income to lower bracket taxpayers have existed pretty much since the income tax came into existence following the 16th Amendment in 1913. Those efforts became especially important when marginal income tax rates spiked in connection with World War II. Those rates topped out at 94% in 1944 and stayed at or above 70% for a long time. That predicament led wealthy taxpayers, likely more frequently than in the past, to create so-called "Clifford" trusts[1] for their children and others in an effort to shift income to those in lower income tax brackets.

As in the *Clifford* case, taxpayers did not necessarily want to part with dominion and control over the assets in question. Instead, they would retain some sort of power over the property or trust (retaining a stick in the bundle of property rights). Often the trusts were short-term trusts that reverted to the grantor after some period of years. As one example, the original Clifford trust was established in 1934 for a term of five years. After the term, the corpus reverted to Mr. Clifford, but accrued income was payable to his wife. Mr. Clifford served as trustee and kept pretty much total control over the trust (*e.g.*, distribution of income to his wife during the term of the trust was in his absolute discretion).

The IRS would bring challenges to cases that were perceived as abusive, and the courts, without any statutory help, followed the approach of the Supreme Court in *Clifford*. The courts were left to settle things, determining where the tax burden should lie based on all the facts and circumstances. That case-by-case approach ultimately led to some regulations and then the modern-day grantor trust rules, adopted in the 1954 tax code. The 1954 tax code contained most of what we now find in the Internal Revenue Code under Subtitle A, Chapter 1, Subchapter J, Subpart E. Subpart E contains Code[2] §671 through §679 and is the focal point of this outline.

The Tax Reform Act of 1986 brought about an incredible compression of income tax rates, lowering the top income tax rate for individuals from 50% to 28% and raising the bottom rate from 11% to 15%, while reducing the number of tax brackets from 14 to 2 (at least initially). From there, things have changed, but what has remained constant is that most high net worth families have everyone in the top marginal income tax bracket, and almost certainly a trust that is an important component of an estate plan would be in the top marginal income tax bracket.

If most family members and their trusts are in the top income tax bracket, it makes great sense to have mom and dad pay the income tax on family assets rather than the children or their trusts. And so we have the intentionally defective grantor trust as a useful planning tool. Each tax payment by mom or dad is the functional equivalent of a tax-free gift to the trust that reduces the taxable estate but does not "use

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1 Named for the seminal case of *Helvering v. Clifford*, 309 U.S. 331, 60 Sup. Ct. 554, 84 L.Ed. 788 (1940), in which the taxpayer retained too many controls and powers for the Supreme Court to allow the income shifting. The result of that opinion was a case-by-case approach to determining the taxability of trust income under all of the circumstances.

2 Throughout this outline, unless otherwise indicated by the context, section references are to the Internal Revenue Code of 1986, as amended, or the United States Treasury Regulations. References to the tax code are abbreviated as the "Code." The Treasury Regulations often are referred to simply as the "regulations."

up" any gift tax exemption. Add to that feature the ability to sell assets to a grantor trust without triggering gain,[3] and the planning possibilities begin to add up.

II. GENERAL PRINCIPLES

Section 671 tells us in a short but convoluted way that some portion or all of a trust's income is taxable to the grantor (or another person), rather than the trust itself, if any part of subpart E says so. Specifically, the Code says that if any provision from §671 through §679 specifies that the grantor or another person shall be treated as the owner of any portion of a trust, then, for purpose of computing the taxable income and credits of that grantor or other person, all of the trust's items of income, deduction, and credit that are attributable to that portion shall be taken into account, and any other portion of the trust is subject to the normal rules applicable to the taxation of trusts.[4] Accordingly, subpart E (§671 through §679) contains the "grantor trust rules" and provides for the taxation of the income of a trust to the grantor or another person even though he or she is not treated as a beneficiary under subparts A through D.[5]

Sections 671 and 672 contain general provisions and definitions relating to the entirety of subpart E, while §673 through §677 define the circumstances under which income of a trust is taxed to the grantor.[6] Section 678 provides for the circumstance when someone other than the grantor must pay tax on trust income.[7] Finally, section 679 deals with foreign trusts but will not be considered in this outline.[8]

The last sentence of §671 and the regulations thereunder further state that subpart E contains the exclusive rules that render trust income taxable to the grantor (or other person) rather than the trust. Specifically, the Code expressly provides that trust income shall not be included solely on the grounds of the grantor's or other person's "dominion and control over the trust under section 61 (relating to definition of gross income) or any other provision of [the Code], except as specified in this subpart."[9] That provision indicates the objective of leaving behind the case-by-case approach of reviewing all of the facts and circumstances in the courts, as suggested by *Clifford*.

There are exceptions to these general rules found in the regulations under §671, as follows:

(i) Sections 671 and 677 do not apply if the income of a trust is taxable to a grantor's spouse under §71 or §682,[10] relating to the taxation of alimony and separate maintenance payments (in the case of §71) and the taxation of the income of an estate or trust on divorce (in the case of §682). However, section 682 was repealed by what is often but incorrectly referred to as the Tax Cuts and Jobs Act of 2017, effective as of January 1, 2019. Notice 2018-37 states that the Treasury Department and the IRS plan to issue regulations to clarify the effective date provisions relating to the repeal of §682. The notice says that the regulations will provide that §682, as in effect prior to December 22, 2017 (the date of the 2017 tax act), will continue to apply with regard to trust income payable to a former spouse who was divorced or legally separated under a divorce or separation instrument executed on or before December 31, 2018, unless the instrument is modified after that date and the modification provides that the changes made by the 2017 tax act apply to the modification.

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3 *See* Rev. Rul. 85-13, 1985-1 C.B. 184.
4 Code §671.
5 Treas. Reg. §1.671-1(a).
6 *Id*.
7 *Id*.
8 Foreign trusts and estate planning for international matters are not covered by this outline.
9 Code §671 (last sentence). *See also* Treas. Reg. §1.671-1(c).
10 Treas. Reg. §1.671-1(b).

(ii) Subpart E does not apply in situations involving an assignment of future income, whether or not the assignment is to a trust. Accordingly, the assignment of future income to a trust may be taxable to the assignor even though the assignment is to a trust over which the assignor has retained none of the controls specified in §671 through §677.[11]

(iii) The rules applicable to family partnerships are not affected by subpart E even though a partnership interest may be held in trust.[12]

(iv) Subpart E has no part in determining the right of a grantor to deductions for payments to a trust under a transfer and leaseback arrangement.[13]

(v) The limitation in the last sentence of §671 and the first sentence of Treas. Reg. §1.671-1(c) (where it is provided that subpart E contains the exclusive rules that render trust income taxable to the grantor or other person, in lieu of considering dominion and control) does not prevent any person from being taxed on the income of a trust when it is used to discharge his or her legal obligation (*see* Treas. Reg. §1.662(a)-4). In those circumstances, he or she is treated as a beneficiary under subparts A through D or is treated as an owner under §677 because the income is distributed for his or her benefit, but not because of his or her dominion or control over the trust.[14]

(vi) Subpart E does not apply to a pooled income fund, a charitable remainder annuity trust, or a charitable remainder unitrust.[15] Note that subpart E can apply to a charitable lead trust.

The general principle underlying the grantor trust rules is that the income of a trust over which the grantor or another person has retained "substantial dominion or control" should be taxed to the grantor or that other person rather than to the trust or the beneficiary.[16] Because of that overall principle, "it is ordinarily immaterial whether the income involved constitutes income or corpus for trust accounting purposes."[17] Accordingly, when the regulations under subpart E use the word "income," the reference is to income determined for tax purposes and not to income for trust accounting purposes, unless the reference is specifically limited.[18] Furthermore, when the regulations under subpart E are intending to emphasize that trust accounting income is, in fact, what is meant (determined in accordance with Treas. Reg. §1.643(b)-1), the regulations use the term "ordinary income."[19]

An item of income, deduction, or credit included in computing the tax of the grantor or other person under §671 is treated as if it is received or paid directly by the grantor or other person.[20] Thus, charitable contributions by a trust to which §671 applies will be aggregated with the grantor's or other person's other charitable contributions to determine their deductibility under the limitations of §170(b)(1).[21]

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11 Treas. Reg. §1.671-1(c).

12 *Id*.

13 *Id*.

14 *Id*. For additional discussion of these principles, refer to the portion of this outline that covers Code §678.

15 Treas. Reg. §1.671-1(d).

16 Treas. Reg. §1.671-2(b).

17 *Id*.

18 *Id*.

19 *Id*.

20 Treas. Reg. §1.671-2(c).

21 *Id*.

The regulations tell us that, for purposes of §641 through §685,[22] the term "grantor" includes any person to the extent such person either (i) creates a trust or (ii) directly or indirectly makes a gratuitous transfer of property to a trust.[23] However, for purposes of the grantor trust rules, the regulations indicate that if a person merely creates a trust, but he or she makes no gratuitous transfers to the trust, then he or she will not be treated as the owner of any portion of the trust under §671 through §677.[24] Accordingly, the deemed trust ownership rules from §673 through §677 do not apply unless there is a gratuitous transfer. It is the other provisions from §641 through §685, exclusive of §671 through §677, that include as a grantor any person who merely creates a trust.

A "gratuitous transfer" is any transfer other than a transfer for fair market value, without regard to whether it is treated as a gift for gift tax purposes.[25] Accordingly:

(i) If a father creates a trust for his children and someone else makes a gratuitous transfer to that trust, then both are considered to be grantors for purposes of §641 through 685.[26] But the father cannot be deemed an owner under §671 through §677 unless he also funded the trust with a gratuitous transfer.[27]

(ii) If a mother creates and funds a trust for the benefit of her son and his descendants but does not herself retain any powers covered by §673 through §677, yet she gives her son an unrestricted power to withdraw certain amounts contributed to the trust before the end of the calendar year and vest those amounts in himself,[28] then the son is treated as the owner of the portion of the trust that is subject to his withdrawal power (under §678), but the son is not a grantor of the trust for purposes of §641 through §685 because the son has not created the trust or made a gratuitous transfer to the trust.[29] Instead, the mother would be the grantor of the trust for purposes of §641 through §685, because she is the one who has created and funded the trust with gratuitous transfers to the trust that the son either does or does not withdraw each year.

(iii) If a brother creates a trust for his sister with a gift of $50,000 that subsequently doubles to $100,000 in value, at which time an uncle transfers property worth $1 million to the trust in exchange for that $100,000, then the brother and uncle are both grantors of the trust for purposes of §641 through §685 (the brother as to the portion valued at $100,000 and the uncle as to the portion valued at $900,000), and one or the other of them (or both of them) would be treated as owners of their respective grantor portions of the trust to the extent that they retain powers over or interests in such portions under §673 through §677.[30]

III. DEEMED OWNERSHIP OF DIFFERENT PORTIONS OF A TRUST

The grantor trust rules contemplate that a grantor or other person can be deemed under subpart E to own all or only a portion of a trust. In computing his or her tax liability, the taxpayer should include those items of income, deduction, and credit attributable to or included in that portion.[31] The regulations discuss three examples.

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22 These sections of the Code make up part I of subchapter J, including subparts A through F. Part II of subchapter J contains the statutes relating to income in respect of a decedent found in §691 and §692.

23 Treas. Reg. §1.671-2(e)(1).

24 *Id*.

25 Treas. Reg. §1.671-(2)(e)(2)(i).

26 Treas. Reg. §1.671-2)(e)(6), Example 1.

27 Treas. Reg. §1.671-2(e)(1).

28 A general power of appointment, sometimes called a "Crummey" withdrawal power.

29 Treas. Reg. §1.671-2)(e)(6), Example 4.

30 Treas. Reg. §1.671-2)(e)(6), Example 7.

31 Treas. Reg. §1.671-3(a).

A. Deemed ownership of the entirety of the trust

In the first example, the regulations state the obvious. If a grantor or other person is treated as the owner of an entire trust (corpus as well as ordinary income), then he or she should take into account when computing tax liability all of the trust's items of income, deduction, and credit (including capital gains and losses).[32]

B. Owned portion defined by reference to specific trust property

In the second example, the regulations consider a grantor or other person's deemed ownership of a portion of a trust consisting of specific trust property but not all trust property. If the portion of a trust deemed owned by the grantor or other person consists of specific trust property and its income,[33] then all items of income, deduction, and credit (including capital gains and losses) that are directly related to that property are attributable to the portion.[34] On the other hand, such items that are directly related to the balance of the trust property are governed by subparts A through D (§641 through §668). Items that relate both to the deemed ownership portion and the balance "must be apportioned in a manner that is reasonable in the light of all the circumstances of each case, including the terms of the governing instrument, local law, and the practice of the trustee if it is reasonable and consistent."[35]

C. Owned portion defined by reference to a fractional share or dollar amount

In the third example, the regulations consider a grantor or other person's deemed ownership of a portion of a trust consisting of (i) an undivided fractional interest in the trust or (ii) an interest represented by a dollar amount. In both circumstances, a pro rata share of each item of income, deduction, and credit is normally allocated to the portion.[36] Accordingly:

(i) If the deemed ownership portion is an interest in or right to an amount of corpus only, then a fraction of each item of income, deduction, and credit is attributed to the portion (including those items allocable to corpus, such as capital gains and losses), with the numerator being the amount subject to control of the grantor or other person and the denominator normally being the fair market value of the trust corpus at the beginning of the year.[37]

(ii) The share that is not deemed owned by the grantor or other person is governed by subparts A through D (§641 through §668).[38]

(iii) If the portion that is deemed owned by the grantor or other person consists of an interest in part of the ordinary income of a trust (in contrast to an interest in corpus alone),[39] such as, for example, a power over or right to a dollar amount of ordinary income, then the grantor or other person first should take into account a portion of those items of income and expense entering into the computation of ordinary income under the trust instrument or local law sufficient to produce income of the dollar amount required. Next,

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32 Treas. Reg. §1.671-3(a)(1).

33 The reference in this example from the regulations is to "income" rather than "ordinary income" and thus should be considered in the light of Treas. Reg. §1.671-2(b) as being income for tax purposes rather than income for trust accounting purposes determined in accordance with Treas. Reg. §1.643(b)-1.

34 Treas. Reg. §1.671-3(a)(2).

35 *Id.*

36 Treas. Reg. §1.671-3(a)(3).

37 *Id.*

38 *Id.*

39 Treas. Reg. §1.671-2(b) provides that "ordinary income" is used to mean income for trust accounting purposes determined in accordance with Treas. Reg. §1.643(b)-1.

there will be attributed to him or her a pro rata portion of other items entering into the computation of distributable net income under subparts A through D (§641 through §668), such as expenses allocable to corpus, and a pro rata portion of credits of the trust.

D. Owned portion includes income only, corpus only, or both

The portion of a trust treated as being owned by the grantor or other person also may or may not include both ordinary income (*i.e.*, trust accounting income) and "other income allocable to corpus" (*e.g.*, capital gains and losses).[40] Specifically:

(i) Ordinary Income Only

"Only ordinary income is included by reason of an interest in or power over ordinary income alone."[41] Said another way, if the grantor or other person has an interest in or power over trust accounting income, but no corresponding interest in or power over corpus, then only trust accounting income is included, and items of income allocable to corpus (*e.g.*, capital gains and losses) are not included.

The regulations mention, as examples, a grantor treated as an owner under §673 because of a reversionary interest in ordinary income only and a grantor or other person treated under §674 through §678 as an owner of a portion of a trust due to a power over ordinary income only.[42]

In cases such as these, where only ordinary income is included, the grantor or other deemed owner who is making the tax computation is supposed to take into account only those items that would be included in computing the tax liability of a current income beneficiary, including expenses allocable to corpus that enter into the computation of distributable net income.[43]

Rules relating to the treatment of deductions and credits in this circumstance are discussed below.[44]

(ii) Corpus Only

"Only income allocable to corpus is included by reason of an interest in or power over corpus alone, if satisfaction of the interest or an exercise of the power will ***not*** result in an interest in or the exercise of a power over ordinary income which would itself cause that income to be included" (emphasis added).[45] Two examples from the regulations are:

Example #1 -- If a grantor has a reversionary interest in a trust that does not require the grantor to be treated as an owner under §673, the grantor still may be treated as an owner under §677(a)(2) because any income allocable to corpus is accumulated for future distribution to the grantor, but "items of income included in determining ordinary income are not included in the portion he is treated as owning."[46]

Example #2 -- A grantor may have a power over corpus that treats the grantor as an owner under §674 or §676(a), but ordinary income will not be included in the portion if the grantor's power can affect

40 Treas. Reg. §1.671-3(b).
41 Treas. Reg. §1.671-3(b)(1).
42 *Id*.
43 Treas. Reg. §1.671-3(c).
44 Treas. Reg. §1.671-3(b)(1). *See* Treas. Reg. §1.671-3(c).
45 Treas. Reg. §1.671-3(b)(2).
46 *Id*.

only income received after a period of time such that the grantor would not be treated as an owner of the income if the power were a reversionary interest.[47]

In cases such as these, where only income allocable to corpus is included, the grantor who is making the tax computation is supposed to take into account only those items of income, deduction, and credit that would not be included under subparts A through D (§641 through §668) in computing the tax for current income beneficiaries if all distributable net income were distributed.[48] In other words, the grantor computes the items allocable to the mandatory income beneficiaries and then allocates the rest to himself or herself.

(iii) Ordinary Income and Corpus

Both ordinary income and other income allocable to corpus (*e.g.*, capital gains and losses) are included by reason of (A) an interest in or power over both ordinary income and corpus or, importantly, (B) an interest in or power over corpus alone that does not come within the description in the immediately preceding subparagraph (ii).[49] This rule is extremely important in planning with intentionally defective grantor trusts, particularly where a power of substitution over corpus under §675(4)(C) might be utilized (see example #2 below). Examples from the regulations are:

Example #1 -- If a grantor is treated under §673 as an owner of a portion of a trust because of a reversionary interest in corpus, then both ordinary income and other income allocable to corpus are included in the portion.[50]

Example #2 -- If a grantor or other person is treated as an owner under §675 or §678 because of a power over corpus, then he or she includes both ordinary income and other income allocable to corpus in the portion he or she is treated as owning.[51]

Example #3 -- A grantor includes both ordinary income and other income allocable to corpus in the portion the grantor is treated as owning if the grantor is treated under §674 or §676 as an owner because of a power over corpus that can affect income received within a period such that the grantor would be treated as an owner under §673 if the power were a reversionary interest.[52]

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47 *Id*. As elsewhere, it is important here to take note of the fact that the regulations under §673 and elsewhere do not reflect statutory changes made in 1986 to §673, eliminating the old 10-year rule and the exception for reversionary interests taking effect at the income beneficiary's death in favor of today's 5% approach to reversionary interests. Tax Reform Act of 1986 (P.L. 99-514, §1402(a). Being unaware of the statutory changes to §673 makes the regulations rather hard to understand. The 5% approach to §673 can indicate a time period much longer than ten years and does indicate a different time period for each taxpayer based on the facts and circumstances of each case. As noted elsewhere in reference to the current version of §673, the only issue under §673 is the value of the reversionary interest at 5% or less to avoid grantor trust treatment or greater than 5% to result in grantor trust treatment.

48 Treas. Reg. §1.671-3(c).

49 Treas. Reg. §1.671-3(b)(3).

50 *Id*.

51 *Id*.

52 *Id*. As elsewhere, it is important here to take note of the fact that the regulations under §673 and elsewhere do not reflect statutory changes made in 1986 to §673, eliminating the old 10-year rule and the exception for reversionary interests taking effect at the income beneficiary's death in favor of today's 5% approach to reversionary interests. Tax Reform Act of 1986 (P.L. 99-514, §1402(a). Being unaware of the statutory changes to §673 makes the regulations rather hard to understand. The 5% approach to §673 can indicate a time period much longer than ten years and does indicate a different time period for each taxpayer based on the facts and circumstances of each case. As noted elsewhere in reference to the current version of §673, the only issue under

IV. METHOD OF REPORTING

A. General Rules

This outline will not cover anywhere near all of the details relating to tax reporting. Instead, this outline is focused more on the rules and issues that are relevant to an estate planning lawyer. Those who are on the compliance team can make note of some of the bigger picture issues here but should look elsewhere for more detail.

It does not matter to me which method of reporting a client might select. I have found that most CPAs have a bias one way or another and thus choose one method and try to follow that one method as often as possible. Many CPAs have told me that it is easier to go ahead and get a taxpayer identification number for the trust, as opposed to following the method that allows the use of the grantor's social security number, because there is less work to do later on when there is a change from grantor trust status to regular trust status.

The general rule for reporting is found in Treas. Reg. §1.671-4(a). It provides that items of income, deduction, and credit attributable to any portion of a trust that, under subpart E, is treated as owned by the grantor or another person, are <u>not</u> reported by the trustee on Form 1041 but rather are shown on a separate statement to be attached to the Form 1041.[53] There are some exceptions to that general rule (alternative methods of reporting). Those are discussed generally below. There also are some key definitional provisions to note at the outset, as follows:

(i) For purposes of Treas. Reg. §1.671-4, and also as used in this portion of the outline, the term "payor" means any person who is required under the Code and regulations to make any type of information return with respect to the trust for the taxable year, including persons who make payments to the trust or who collect (or otherwise act as middlemen with respect to) payments on behalf of the trust (this would include Forms 1099 and Schedules K-1).[54]

(ii) If all of a trust is treated as being owned by a husband and wife, and if they file their income taxes jointly on a single return, then the trust is considered to be owned by *one* grantor for purposes of the exceptions to the general rule of Treas. Reg. §1.671-4(a) that are found under Treas. Reg. §1.671-4(b).[55] Otherwise, the intended simplification of the optional reporting method would not be achieved.

B. Exceptions to the general rules (alternative methods of reporting)

If all of a trust is treated as being owned by one or more grantors or other persons, then, subject to certain exceptions noted below, the trustee may, but is not required to, report by one of the alternative methods noted below.

(i) Alternatives if only one grantor (or husband and wife)

If the trust is considered to be owned by in its entirety by only one grantor or other person (or a husband and wife), then the trustee has two choices, as follows:

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§673 is the value of the reversionary interest at 5% or less to avoid grantor trust treatment or greater than 5% to result in grantor trust treatment.

[53] Treas. Reg. §1.671-4(a).

[54] Treas. Reg. §1.671-4(b)(4).

[55] Treas. Reg. §1.671-4(b)(8).

A. Furnish the name and taxpayer identification number of the grantor or other person treated as the owner of the trust, and the address of the trust, to all payors.[56] In order to report under this method, the grantor or other person treated as the owner of the trust must provide the trustee with a complete Form W-9 or acceptable substitute.[57] In addition, unless the grantor or other person treated as the owner of the trust is the trustee or a co-trustee, then the trustee must furnish to the grantor or other person treated as the owner a statement that: (i) shows all items of income, deduction, and credit, (ii) identifies each payor, (iii) provides the information necessary to take the items into account for purposes of computing tax liability, and (iv) informs that the items and information shown on the statement must be included on the income tax return of the grantor or other person treated as the owner of the trust.[58]

B. Furnish the name, taxpayer identification number, and address of the trust to all payors.[59] In addition, the trustee must file with the IRS the appropriate Forms 1099, reporting the income or gross proceeds paid to the trust, and showing the trust as the payor and the grantor or other person treated as owning the trust as the payee, with the same obligations for filing the appropriate Forms 1099 as would a payor making reportable payments, except that the trustee must report each type of income in the aggregate, and each item of gross proceeds separately.[60] Furthermore, unless the grantor or other person treated as the owner of the trust is the trustee or a co-trustee, then the trustee must furnish to the grantor or other person treated as the owner a statement that: (i) shows all items of income, deduction, and credit, (ii) provides the information necessary to take the items into account for purposes of computing tax liability, and (iii) informs that the items and information shown on the statement must be included on the income tax return of the grantor or other person treated as the owner of the trust.[61]

(ii) Alternative if all of the trust is deemed owned by two or more grantors or other persons

If the trust is treated as being owned in its entirety by two or more grantors or other persons, the trustee *must* furnish the name, taxpayer identification number, and address of the trust to all payors.[62] In addition, the trustee must file with the IRS the appropriate Forms 1099, reporting the items of income paid to the trust by all payors attributable to the portion of the trust treated as owned by each grantor or other person and showing the trust as the payor and each grantor or other person treated as an owner as the payee, with the same obligation for filing the appropriate Forms 1099 as a payor making reportable payments except that the trustee must report each type of income in the aggregate and each item of gross proceeds separately.[63] Furthermore, the trustee must furnish to each grantor or other person treated as an owner a statement that: (i) shows all items of income, deduction, and credit attributable to the portion of the trust treated as owned by the grantor or other person, (ii) provides the information necessary to take the items into account for purposes of computing tax liability, and (iii) informs that the items and information shown on the statement must be included on the income tax return of the grantor or other person treated as the owner of the trust.[64]

(iii) Exceptions - when alternative approach is not allowed

Reporting under the alternative methods allowed by Treas. Reg. §1.671-4(b) is not allowed for: (i) common trust funds, (ii) a trust with situs or any assets outside the U.S., (iii) a qualified subchapter S

56 Treas. Reg. §1.674-4(b)(2)(i)(A).
57 Treas. Reg. §1.674-4(b)(1).
58 Treas. Reg. §1.671-4(b)(2)(ii).
59 Treas. Reg. §1.671-4(b)(2)(i)(B).
60 Treas. Reg. §1.671-4(b)(2)(iii)(A).
61 Treas. Reg. §1.671-4(b)(2)(iii)(B).
62 Treas. Reg. §1.671-4(b)(3)(i).
63 Treas. Reg. §1.671-4(b)(3)(ii)(A).
64 Treas. Reg. §1.671-4(b)(3)(ii)(B).

trust as defined in §1361(d)(3), (iv) a trust treated as owned entirely by one grantor or one other person whose taxable year is a fiscal year, (v) a trust treated as owned entirely by one grantor or one other person who is not a U.S. person, or (vi) a trust treated as owned entirely by two or more grantors or other persons, one of whom is not a U.S. person.[65] Furthermore, a trustee may not report under the alternative methods if any grantor or other person treated as an owner is an exempt recipient for information reporting purposes.[66]

V. DEFINITIONS AND RULES -- §672

Section 672 sets forth definitions and rules that apply throughout the grantor trust rules. Key among the definitions and rules of §672 for purposes of this outline are those relating to adverse parties, non-adverse parties, related or subordinate parties, conditions precedent, and a grantor being treated as holding any interest of his or her spouse. The provisions of §672 relating to foreign matters are not covered in this outline.

A. Adverse party and non-adverse party

"Adverse party" and "non-adverse party" are opposites, clearly enough, so the Code and the regulations define a non-adverse party as any person who is not an adverse party.[67] The Code defines an adverse party to mean any person having a substantial beneficial interest in the trust that would be adversely affected by the exercise or non-exercise of the power that he or she possesses with respect to the trust, adding that a person with a general power of appointment over the trust is deemed to have a beneficial interest in the trust (but without indicating whether that interest would be substantial).[68] The regulations add several points of clarification to the rule in the Code:

(i) Trustee. A trustee is not an adverse party merely because of his or her interest as trustee.[69]

(ii) Substantial = Not Insignificant. An interest is a substantial interest if its value in relation to the total value of the property subject to the power is not insignificant.[70] By itself, that provision does not help very much, although "not insignificant" suggests that not much of an interest is required in order to have a substantial interest.

(iii) Limited Beneficial Interest. While a beneficiary ordinarily will be an adverse party, if the beneficiary's right to share in income or corpus is limited to only a part, then he or she may be an adverse party only as to that part.[71] As an example, the regulations indicate that a trust with four equal income beneficiaries that is revocable by the grantor but only with the consent of one of those income beneficiaries results in the grantor being treated as the owner of three-fourths of the trust.[72]

(iv) Ordinary Income v. Corpus. The interest of a beneficiary in the ordinary income of a trust may or may not be adverse with respect to the exercise of a power over corpus.[73] Similarly, the interest of a contingent income beneficiary is adverse to a return of corpus to the grantor before the termination of the

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65 Treas. Reg. §§1.671-4(b)(1) and (b)(6).
66 Treas. Reg. §§1.671-4(b)(1) and (b)(7).
67 Code §672(b) and Treas. Reg. §1.672(b)-1.
68 Code §672(a). See also Treas. Reg. §1.672(a)-1(a).
69 Treas. Reg. §1.672(a)-1(a).
70 *Id*.
71 Treas. Reg. §1.672(a)-1(b).
72 *Id*.
73 Treas. Reg. §1.672 (a)-1(c).

contingent beneficiary's interest but not after.[74] As an example, the regulations indicate that if the income of a trust is payable to the income beneficiary for life, and if the income beneficiary has a non-general lifetime and testamentary power to appoint trust corpus to the grantor, then the income beneficiary's interest is adverse to the return of corpus to the grantor during the income beneficiary's life but not after his or her death.[75] Said differently, the income beneficiary's interest is "adverse as to ordinary income but is not adverse as to income allocable to corpus."[76] Based on that example, the regulations indicate that, absent no other relevant facts, the grantor would not be taxable on ordinary income under §674, §676, or §677 but would be taxable under §677 on income allocable to corpus (*e.g.*, capital gains or losses) because income allocable to corpus may, in the discretion of a non-adverse party, be accumulated for future distribution to the grantor.[77]

(v) Remainder Beneficiaries. The interest of a remainder beneficiary is adverse to the exercise of any power over corpus but not adverse to the exercise of a power over any income interest preceding his or her remainder.[78] As an example, the regulations posit that a ten-year trust with income payable to the income beneficiary and the remaining corpus payable to the remainder beneficiary, combined with a power held by the remainder beneficiary to return the corpus to the grantor, has a power exercisable by an adverse party; however, a power by the remainder beneficiary to distribute part or all of the ordinary income to the grantor may be a power exercisable by a non-adverse party that would cause the ordinary income to be taxable to the grantor.[79]

B. Related or subordinate party

(i) Must be non-adverse party

As a preliminary matter when defining the term "related or subordinate party," the Code requires that party to be a non-adverse party.[80] Therefore, adverse parties cannot be related or subordinate parties.

(ii) Includes most relatives and employees

Otherwise, a related or subordinate party includes the grantor's spouse if living with the grantor[81] and any one of the following: the grantor's father, mother, issue, brother or sister; an employee of the grantor; a corporation or any employee of a corporation if the grantor and the trust own stock in that corporation that is "significant" from the viewpoint of voting control; and a subordinate employee of a corporation in which the grantor is an executive.[82]

(iii) Presumption of subservience to the grantor

The Code adds that, for purposes of §674 and §675, a related or subordinate party shall be presumed to be subservient to the grantor in respect of the exercise or non-exercise of the powers "conferred on

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74 *Id*.
75 *Id*.
76 *Id*.
77 *Id*. *See also* Treas. Reg. §1.671-3(b)(2) (providing that if a grantor has a reversionary interest in a trust that does not require the grantor to be treated as an owner under §673, the grantor still may be treated as an owner under §677(a)(2) because any income allocable to corpus is accumulated for future distribution to the grantor, but "items of income included in determining ordinary income are not included in the portion he is treated as owning.").
78 Treas. Reg. §1.672(a)-1(d).
79 *Id*.
80 *See* the lead-in language of Code §672(c).
81 Code §672(c)(1).
82 Code §672(c)(2).

him" unless such party is shown not to be subservient by a preponderance of the evidence.[83] The use of the word "him" seems to refer to powers held by the related or subordinate party rather than powers held by the grantor. The regulations are more precise in referencing the use of the term "related or subordinate party" only in reference to §674(c) and §675(3).[84] Furthermore, the regulations more clearly indicate the relevant power holder. After identifying all of the different relatives, corporations, and employees who would be related or subordinate parties, the regulations indicate that "these persons" are presumed to be subservient to the grantor in the exercise or non-exercise of powers "conferred on them."[85]

C. Power subject to a condition precedent (or effective after some time)

Under the Code, a person is considered to have a power even though its exercise is subject to a precedent giving of notice or takes effect only after some period of time.[86]

Regarding a power that takes effect only after some period of time, the regulations[87] follow section 674(b)(2), section 676(b), and the last sentence of section 677(a). Those sections refer to a power, the exercise of which can only affect the beneficial enjoyment of trust income for a period of time commencing "after the occurrence of an event" such that the grantor would not be treated as the owner under §673 if the power were a reversionary interest, but each section adds that the grantor may be treated as the owner after the occurrence of the event unless the power is relinquished.[88] The regulations simply repeat the rule, but they also give an example that is based upon the out-dated 10-year rule of §673.[89] As noted below in reference to the current version of §673, the only issue under §673 is the value of the reversionary interest at 5% or less (to avoid grantor trust treatment). Accordingly, if the power affects beneficial enjoyment that otherwise would occur far enough in the future that it would correspond to a reversionary interest worth less than 5%, then perhaps this example has some utility.

D. Grantor holds any power or interest of grantor's spouse

A grantor is deemed to hold any power or interest of the grantor's spouse. Specifically, the grantor is treated as holding any power or interest held by anyone who was the grantor's spouse at the time of the creation of that power or interest, as well as anyone who becomes the spouse of the grantor after the creation of that power or interest (but only with respect to the period of time after the marriage).[90] For

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83 *See* flush language of Code §672(c) just after §672(c)(2).

84 Treas. Reg. §1.672(c)-1.

85 *Id*.

86 Code §672(d).

87 Treas. Reg. §1.672(d)-1.

88 *See* Code §674(b)(2), §676(b), and the last sentence of §677(a).

89 Treas. Reg. §1.672(d)-1 ("Thus, for example, if a grantor creates a trust for the benefit of his son and retains a power to revoke which takes effect only after the expiration of 2 years from the date of its exercise, he is treated as an owner from the inception of the trust. However, if the grantor retains a power to revoke, exercisable at any time, which can only affect the beneficial enjoyment of the ordinary income of a trust received after the expiration of 10 years commencing with the date of the transfer in trust, or after the death of the income beneficiary, the power does not cause him to be treated as an owner with respect to ordinary income during the first 10 years of the trust or during the income beneficiary's life, as the case may be. See section 676(b).") As elsewhere, it is important here to take note of the fact that the regulations under §673 and elsewhere do not reflect statutory changes made in 1986 to §673, eliminating the old 10-year rule and the exception for reversionary interests taking effect at the income beneficiary's death in favor of today's 5% approach to reversionary interests. Tax Reform Act of 1986 (P.L. 99-514, §1402(a). Being unaware of the statutory changes to §673 makes the regulations rather hard to understand. The 5% approach to §673 can indicate a time period much longer than ten years and does indicate a different time period for each taxpayer based on the facts and circumstances of each case.

90 Code §672(e)(1)(A) and (B).

purposes of the former situation, there is no marriage if there is a legal separation under a decree of divorce or a decree of separate maintenance.[91]

The exception for independent trustees provided by §674(c) also contains a special provision relating to the grantor's spouse. Specifically, the last sentence of §674(c) indicates that, for periods when a person is the spouse of the grantor, any reference in §674(c) to the grantor shall be treated as including a reference to such spouse.[92] This particular treatment of spouses is somewhat different than the attribution of powers between spouses under §672(e) because in §674(c) the focus is not on powers held by the grantor (or spouse) but rather that no trustee can be the grantor (or spouse) and no more than half of the trustees can be someone related or subordinate to the grantor (or spouse).

Similarly, section 675(3) contains a special provision relating to the grantor's spouse. Specifically, the last sentence of §675(3) indicates that, for periods when a person is the spouse of the grantor, any reference in §675(3) to the grantor shall be treated as including a reference to such spouse.[93] This particular treatment of spouses is different than the attribution of powers between spouses under §672(e) because in §675(3) the focus is not on powers held by the grantor (or spouse) but rather whether the grantor (or spouse) has borrowed from the trust for less than adequate interest or security under a loan made by a related or subordinate trustee.

Some notable authors have indicated as follows about the spousal attribution rules:

> [The spousal attribution rules] enlarge the grantor trust rules only slightly, as the grantor's spouse was always considered a 'related or subordinate' party, and often a nonadverse party under §672(c)(1). The principal objective of the spousal attribution rule is to eliminate the so-called spousal remainder trust as an income-shifting device by taxing as a grantor trust any trust in which the grantor's spouse holds a reversionary interest worth more than 5%. This rule also prevents the grantor's spouse from ever being an adverse party, as the interest or power that would otherwise make the spouse an adverse party would be imputed to the grantor.
>
> Thus, the spousal attribution rule taxes any trust as a grantor trust if the grantor's spouse holds a power:
>
> * to deal with the trust funds for less than adequate and full consideration under §675(1);
>
> * to lend trust funds to the grantor without adequate interest and security and on terms more favorable than the trustee may lend funds generally under §675(2); or
>
> * to revoke the trust funds and revest them in the grantor under §676.[94]

One very serious problem with the spousal attribution rule is that there is no apparent "off switch" upon divorce. The rule states that the grantor is treated as holding any power or interest held by anyone who was the grantor's spouse *<u>at the time of the creation of that power or interest</u>*, but it says nothing about the implications of a subsequent divorce. The prospect of continued grantor trust status post-divorce

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[91] Code §672(e)(2).

[92] Code §674(c) (last sentence). The regulations do not include this provision.

[93] Code §675(3) (last sentence). The regulations do not include this provision.

[94] Robert T. Danforth & Howard M. Zaritsky, *Grantor Trusts: Income Taxation Under Subpart E*, 819 TAX MGMT. (BNA) ESTATES, GIFTS, AND TRUSTS, at A-28 (Oct. 6, 2014).

is covered in more detail toward the end of this outline. Needless to say, it is a very serious issue in many divorces.

Most commentators believe grantor trust status continues post-divorce if the spousal attribution rule created the grantor trust status in the first place. Further, the repeal of §682 by the 2017 tax act only makes the situation worse. On the other hand, perhaps the repeal of §682 will focus enough attention on the problem that there could be a legislative fix.

VI. REVERSIONARY INTERESTS -- §673

A. General principles; 5% rule

Remember that *Clifford* involved a five-year trust with the corpus reverting to the grantor after the term. Until 1986, section 673 utilized a ten-year rule to determine grantor trust status. Since 1986, we have had the current 5% rule.

In general, the grantor is treated as the owner of any portion of a trust if he or she has a reversionary interest in either the corpus or income of the trust if, as of the inception of that portion of the trust, the value of the reversionary interest exceeds 5% of the value of that portion.[95] For purposes of the general rule, the value of the grantor's reversionary interest is determined by assuming the maximum exercise of discretion in his or her favor.[96]

This provision of the grantor trust rules is somewhat parallel to §2037 of the Code. Here, the 5% test applies at the inception of the trust (or portion of the trust), whereas the estate tax rules under §2037 applies the 5% test immediately before the grantor's death.

It also is important to note the connection of §673 with §677(a)(2) of the Code. The latter statute provides for grantor trust treatment in the case of any portion of a trust "whose income" without the approval or consent of any adverse party is or, in the discretion of the grantor or a non-adverse party, or both, may be "held or accumulated for future distribution to the grantor or the grantor's spouse." As a consequence, a trust might not be a grantor trust under the reversionary interest rules of §673, but yet the grantor still could be treated as an owner under §677(a)(2) if he or she has a reversionary interest in the corpus.[97] In that case, "items of income, deduction, and credit allocable to corpus, such as capital gains and losses, will be included in the portion he owns."[98] For that proposition, the regulations cite to Treas. Reg. §1.671-3 and the regulations under §677 of the Code.[99] In turn, the regulations at §1.671-3 repeat with a bit more clarity that if a grantor has a reversionary interest in a trust that does not require the grantor to be treated as an owner under §673, the grantor still may be treated as an owner under §677(a)(2) because any income allocable to corpus is accumulated for future distribution to the grantor, but "items of income included in determining ordinary income are not included in the portion he is treated as owning."[100]

B. Exception -- trusts for issue to age 21

There is an exception to the general rule in the case of a trust (or portion of a trust) as to which any beneficiary is a lineal descendant of the grantor who holds all of the present interests in that trust (or that

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95 Code §673(a).
96 Code §673(c).
97 Treas. Reg. §1.673(a)-1(a).
98 *Id.*
99 *Id.*
100 Treas. Reg. §1.671-3(b)(2).

portion of the trust).[101] In those cases, the grantor is not treated as the owner of the trust (or that portion) solely by reason of a reversionary interest in the trust (or that portion) if the reversionary interest takes effect upon the death of the beneficiary prior to the beneficiary's attaining twenty-one years of age.[102]

This rule makes the average §2503(c) trust not taxable as a grantor trust (absent other provisions). However, in my experience it seems that most §2503(c) trusts do not provide for a reversionary interest in the first place due to estate tax considerations.

C. Postponement of date specified for reacquisition

If there is any postponement of the grantor's reacquisition of possession or enjoyment, then that postponement is treated as a new transfer in trust by the grantor, starting with the date of the postponement and ending with the date specified in the postponement, but income for any period is not included in the grantor's income just because of such a postponement if the income otherwise would not be included absent the postponement.[103] This provision perhaps had more meaning before the 1986 changes to §673 that left us with the 5% rule (and eliminated the 10-year rule).[104]

VII. POWER TO CONTROL BENEFICIAL ENJOYMENT -- §674

Section 674 of the Code is mostly known for its long list of exceptions to the otherwise rather apparent general rule. The general rule, in and of itself, does not say very much and makes perfect sense given the history behind the creation of the grantor trust rules in the first place.

A. General rule - §674(a)

Under §674(a), a grantor is treated as the owner of any portion of a trust if the beneficial enjoyment of the corpus or income therefrom is subject to a power of disposition exercisable by the grantor or a non-adverse party (or both) without the approval or consent of an adverse party.[105] The regulations indicate that the rule applies "whether the power is a fiduciary power, a power of appointment, or any other power."[106] The regulations further state that "the grantor is treated as the owner in every case in which he or a non-adverse party *can affect* the beneficial enjoyment of a portion of a trust" -- subject to the exceptions allowed by Code §674(b), (c), and (d)[107] -- indicating that Treasury takes a broad view of powers of disposition.

In the simplest case, if the grantor or a non-adverse person (or both) has the power to distribute (or cause retention of) income or corpus without consent from an adverse party, the grantor trust rules apply unless one of the many exceptions of §674 applies.

Bear in mind some examples of what the term "adverse party" means from the regulations under §672. From those regulations, we know that the interest of a beneficiary in the ordinary income of a trust may or may not be adverse with respect to the exercise of a power over corpus.[108] Similarly, the interest of a contingent income beneficiary is adverse to a return of corpus to the grantor before the termination of

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101 Code §673(b).
102 *Id*.
103 Code §673(d) and Treas. Reg. §1.673(d)-1.
104 *See* the example in Treas. Reg. §1.673(d)-1.
105 Code §674(a).
106 Treas. Reg. §1.674(a)-1(a).
107 *Id*. (emphasis added)
108 Treas. Reg. §1.672 (a)-1(c).

the contingent beneficiary's interest but not after.[109] As an example, the regulations indicate that if the income of a trust is payable to the income beneficiary for life, and if the income beneficiary has a non-general lifetime and testamentary power to appoint trust corpus to the grantor, then the income beneficiary's interest is adverse to the return of corpus to the grantor during the income beneficiary's life but not after his or her death.[110] Said differently, the income beneficiary's interest is "adverse as to ordinary income but is not adverse as to income allocable to corpus."[111] Based on that example, the regulations indicate that, absent no other relevant facts, the grantor would not be taxable on ordinary income under §674 (or §676 or §677) but would be taxable under §677 on income allocable to corpus (*e.g.*, capital gains or losses) because income allocable to corpus may, in the discretion of a non-adverse party, be accumulated for future distribution to the grantor.[112]

B. Exception -- powers that can be held by anybody, including the grantor

Section §674(b) and Treas. Reg. §1.674(b)-1 provide us with rules governing powers that can be exercisable by any person without causing grantor trust treatment. These powers can be held by the grantor or any non-adverse person without regard to whether their exercise is conditioned upon consent or approval of an adverse party.

(i) Income in support of a dependent - §674(b)(1)

Without triggering grantor trust treatment, any person can have a power described in §677(b) to the extent that the grantor would not be subject to tax under that section.[113] Under §677(b) of the Code, a grantor is not taxable on trust income under any provision of chapter 1 of the Code merely because the income of the trust 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 the income is so applied or distributed.[114] That rule applies if the discretion is held by another person, the trustee, or the grantor acting as a trustee, but not if the grantor has that discretion in a non-trustee capacity.[115]

Accordingly, any trustee (including the grantor) can have a power to distribute trust income in support of a grantor's dependents (other than the spouse) without triggering grantor trust treatment unless the income is actually used to support a dependent.

(ii) Powers affecting beneficial enjoyment only after some event - §674(b)(2)

Without triggering grantor trust treatment, any person can have a power that can affect the beneficial enjoyment of the income for a period that begins after the occurrence of a time or event such that the grantor would not be treated as the owner under §673 if the power were a reversionary interest, but the grantor may be treated as the owner after that occurrence unless he or she has relinquished the power.[116]

This rule was aimed at the approach of §673 before its amendment in 1986 when the 10-year rule was eliminated. Now, the only issue under §673 is the value of the reversionary interest at 5% or less (to avoid grantor trust treatment). Accordingly, if the power affects beneficial enjoyment that otherwise would occur far enough in the future that it would correspond to a reversionary interest worth less than

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109 *Id.*
110 *Id.*
111 *Id.*
112 *Id.*
113 Code §674(b)(1).
114 Code §677(b). *See also* Treas. Reg. §1.674(b)-1(b)(1).
115 *Id.*
116 Code §674(b)(2).

5%, then there is no grantor trust treatment. As an example, consider a non-adverse trustee having an unrestricted discretionary "sprinkle" power that takes effect only in the distant future.

(iii) Powers exercisable only by will - §674(b)(3)

Without triggering grantor trust treatment, any person can have a power exercisable only by will -- except in the case where the grantor can dispose of trust income accumulated for disposition by the grantor or that may be so accumulated in the discretion of the grantor or a non-adverse party (or both) without the approval or consent of any adverse party.[117] After stating the rule, the regulations provide the obvious example of grantor trust treatment as the result of a trust that provides for income to be accumulated during the grantor's life with the grantor having the power to appoint that accumulated income by will.[118] That example tracks the language in the Code.

In those fairly obvious factual circumstances, we can avoid grantor trust treatment only if an adverse party is involved in the decision to accumulate or distribute trust income. Though not stated in the Code or the regulations, it would seem to be the same result if the approval or consent of an adverse party were required for the grantor's exercise of his or her power of appointment to be effective. The rule does allow a grantor to give a related person (or anyone) a testamentary power without triggering grantor trust treatment, presumably on the theory that the grantor is not in control of that person's death and therefore the power's exercise.

The regulations go further with another example relating to corpus.[119] In that example, the trust provides for income to be payable to a beneficiary for life, but the grantor has a testamentary power of appointment over the remainder (it has to be corpus) when the trust instrument and local law treat capital gains as corpus, leading Treasury to the conclusions that the grantor is treated as the owner of a portion of the trust and capital gains and losses are included in that portion.[120] For that example to make sense, and it has been in the regulations for over fifty years, we have to fall back on the idea that "it is ordinarily immaterial whether the income involved constitutes income or corpus for trust accounting purposes."[121] Specifically, when the regulations, as here, use the word "income," the reference is to income determined for tax purposes and not to income for trust accounting purposes, unless the reference is specifically limited.[122] Here, the regulations refer only to income, not ordinary income. That example perhaps ties to the rule in the Code about the grantor having a testamentary power over accumulated income, but it arguably goes further as applied to corpus unless we think that the Code uses "income" in the same broad sense as the regulations. In any event, based on that example, a grantor's testamentary power of appointment over trust principal results in his or her deemed ownership over items of income, deduction, and credit allocable to principal unless the exercise of the power is conditioned upon approval or consent of an adverse party.

(iv) Power to allocate among charitable beneficiaries - §674(b)(4)

Without triggering grantor trust treatment, any person can have a power to determine the beneficial enjoyment of corpus or the income therefrom if the corpus or income is irrevocably payable (currently or in the future) for a charitable purpose.[123] As an example, the regulations provide no grantor trust treatment for a trust that irrevocably makes income payable to charities even though the grantor retains

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117 Code §674(b)(3) and Treas. Reg. §1.674(b)-(1)(b)(3).
118 Treas. Reg. §1.674(b)-(1)(b)(3).
119 *Id*.
120 *Id*.
121 Treas. Reg. §1.671-2(b).
122 *Id*.
123 Code §674(b)(4) and Treas. Reg. §1.674(b)-(1)(b)(4).

the power to allocate the income among the charities.[124] There is not much to be said about this rule from a planning perspective although it does have some effect in the area of charitable split interest trusts (not covered by this outline).

(v) Certain powers to distribute corpus - §674(b)(5)

Without triggering grantor trust treatment, any person can have the following powers to distribute corpus as long as no person has a power to add beneficiaries (except to provide for after-born or after-adopted children):

> a power to distribute corpus to or for any single beneficiary or group of beneficiaries (whether income or remainder beneficiaries) if the power is limited by a reasonably definite standard in the trust instrument; and[125]
>
> a power to distribute corpus to or for any current income beneficiary that is not limited by a reasonably definite standard but yet the distribution is chargeable against the proportionate share of corpus held in trust for the payment of income to the beneficiary as if the corpus were a separate trust (whether or not physically segregated).[126]

As to the former acceptable powers over corpus (reasonably definite standards), the regulations are somewhat similar to the approach under §2041, looking for a "clearly measurable standard under which the holder of a power is legally accountable" given the "entire context" of a trust instrument.[127] Listed as acceptable powers are those allowing distributions for a beneficiary's health, education, maintenance, or support; for his or her reasonable support and comfort; to enable maintenance of an accustomed standard of living; or to meet an emergency.[128] Not satisfactory are powers referring to pleasure, desire, or happiness.[129] If a trust instrument provides that the trustee's determination with respect to the exercise or non-exercise of a power is conclusive, then the power is not sufficiently limited, but a trust instrument that is phrased in discretionary terms is not in itself determinative.[130]

The regulations provide three examples that are illustrative of both acceptable powers over corpus.

In the first example, the trust instrument provides for income distributions to the grantor's two brothers for life, with corpus payable to the grantor's nephews in equal shares, but the grantor has reserved a power to distribute corpus to pay any medical expenses of the grantor's brothers or nephews, so the conclusion is that there is no grantor trust treatment because the grantor's power is limited by a reasonably definite standard set forth in the trust instrument.[131] The regulation goes on to say that a contrary result would occur if the power were also exercisable in favor of a person who was not otherwise a beneficiary of the trust (like the grantor's sister).[132]

The second example is the same but the grantor's power allows the grantor to distribute to his brothers or his nephews for their happiness, so the conclusion is grantor trust status exists because the trust lacks a reasonably definite standard and because the trust permits distribution of corpus to someone

124 Treas. Reg. §1.674(b)-(1)(b)(4).
125 Code §674(b)(5)(A) and Treas. Reg. §1.674(b)-(1)(b)(5)(i).
126 Code §674(b)(5)(B) and Treas. Reg. §1.674(b)-(1)(b)(5)(ii).
127 Treas. Reg. §1.674(b)-(1)(b)(5)(i).
128 *Id*.
129 *Id*.
130 *Id*.
131 Treas. Reg. §1.674(b)-(1)(b)(5)(iii), Example (1).
132 *Id*.

(the nephews) other than a current income beneficiary (the brothers), thus failing §674(b)(5)(A) and §674(b)(5)(B).[133]

The third example involves a trust that provides for payment of trust income to the grantor's two adult sons in equal shares for ten years, after which corpus is to be distributed to the grantor's grandchildren in equal shares.[134] Without triggering grantor trust status, the grantor reserves the power to distribute up to one-half of the corpus to each son during the ten-year period, but any such corpus distribution will proportionately reduce subsequent income and corpus payments to the recipient of that corpus distribution, such that if one-half of the corpus were paid to one son, all of the trust income thereafter would be payable to the other son.[135]

The limitation regarding a person having a power to add beneficiaries does not apply to a power held by a beneficiary to substitute other beneficiaries to succeed his or her interest (so that he or she would be an adverse party as to the exercise or non-exercise of that power).[136] As an example, the regulations indicate that the limitation on adding beneficiaries does not apply if a beneficiary of a non-spendthrift trust has a power to assign his or her beneficial interest.[137] Furthermore, the limitation regarding a person having a power to add beneficiaries does not apply if the power (held by any person) would qualify as an exception to grantor trust status under §674(b)(3) (relating to powers exercisable by will).[138]

The power to add beneficiaries, if held by the grantor or any non-adverse party, would negate the exceptions above and result in grantor trust status. That power is often discussed as a means of intentionally creating grantor trust treatment (that also can be "turned off"). I have not relied on that approach very much, if at all, for three primary reasons: (i) it does not work well for estate tax purposes if held by the grantor due to §2036, (ii) it places any other power holder in a tricky situation in that it may be difficult to add or not add beneficiaries, and to release the power, and it may create questions about fiduciary duties depending on the circumstances, and (iii) it likely gives more power to others than most clients would want to give them.

(vi) Power to withhold ordinary income temporarily - §674(b)(6)

In general, section 674(b)(6) of the Code excepts from the general rule of §674(a) a power that enables its holder merely to effect a postponement in the time when the ordinary income is enjoyed by a current beneficiary.[139] The exception does not apply if the power is, in substance, one to shift ordinary income from one beneficiary to another.[140] Accordingly, a power will not be excepted if ordinary income may be distributed to A or may be accumulated and added to corpus that ultimately is distributable to B, where B is a remainder beneficiary who is not a current income beneficiary.[141] On the other hand, the exception does permit a limited power to shift ordinary income among current income beneficiaries.[142]

Specifically, without triggering grantor trust treatment, any person can have a power to apply ordinary income to or for a current income beneficiary or to accumulate the income, as long as no person

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133 Treas. Reg. §1.674(b)-(1)(b)(5)(iii), Example (2).
134 Treas. Reg. §1.674(b)-(1)(b)(5)(iii), Example (3).
135 *Id*.
136 Treas. Reg. §1.674(d)-2(b).
137 *Id*.
138 *Id*.
139 Treas. Reg. §1.674(b)-1(b)(6).
140 Treas. Reg. §1.674(b)-1(b)(6)(i)(c).
141 *Id*.
142 *Id*.

has a power to add beneficiaries (except to provide for after-born or after-adopted children),[143] if any accumulated income ultimately must be payable:

* to the beneficiary from whom distribution or application is withheld, to the beneficiary's estate, or to the beneficiary's appointees (or takers in default) as long as the beneficiary has a power of appointment that does not exclude anyone as permissible appointees other than the beneficiary, the beneficiary's estate, the beneficiary's creditors, or the creditors of the beneficiary's estate (for purposes of this part of the rule, if the accumulated income is ultimately payable to the estate of the current income beneficiary, or to his or her appointees or takers in default, it need not be payable to the beneficiary from whom it was withheld under any circumstances);[144] or

* on termination of the trust, or in conjunction with a distribution of corpus that is augmented by such accumulated income, to the current income beneficiaries in shares that have been specified irrevocably in by the trust.[145]

For purposes of these rules, accumulated income is considered so payable even though, if any beneficiary does not survive a date of distribution that reasonably could be expected to occur within his or her lifetime, the share of the deceased beneficiary is to be paid to his or her appointees under any power of appointment (general or special) or to alternate takers (other than the grantor or grantor's estate) whose shares have been irrevocably specified.[146]

If a trust qualifies for the exception under the first bullet point above, then the trust income will not be taxable to the grantor under §677 by reason of the existence of the power of appointment referenced in that bullet point.[147] That provision of the regulations must relate to the possibility that the beneficiary would exercise his or her power of appointment over the trust in favor of the grantor or the grantor's spouse.

The regulations provide three examples in addition to the one discussed above.[148]

The first two examples share the following common facts. The trust provides for the income to be payable in equal shares to the grantor's two adult daughters, but the grantor reserves the power to withhold from either daughter any part of her share and add it to corpus until the younger daughter attains thirty years of age. At that time, the trust is to terminate, and the corpus is to be divided equally between the two daughters or their estates. In the first example, Treasury concludes that, although the exercise of the power may permit shifting of accumulated income from one daughter to the other, the power is excepted under Code §674(b)(6)(B).[149] In the second example, the only factual difference is that the grantor reserves the power to distribute accumulated income to the grantor's daughters in such shares as the grantor chooses. There, Treasury indicates that the combined powers are not excepted by §674(b)(6)(B) because income is neither required to be payable only in conjunction with a corpus payment nor required to be payable in shares specified by the trust.[150] For comparison, the regulations

143 Code §674(b)(6) (last sentence).
144 Code §674(b)(6)(A) and Treas. Reg. §1.674(b)-1(b)(6)(i)(a) and (c).
145 Code §674(b)(6)(B) and Treas. Reg. §1.674(b)-1(b)(6)(i)(c).
146 Code §674(b)(6) (penultimate sentence) and Treas. Reg. §1.674(b)-1(b)(6)(i)(b) and (c).
147 Treas. Reg. §1.674(b)-1(b)(6)(i)(c)
148 Treas. Reg. §1.674(b)-1(b)(6)(ii).
149 Treas. Reg. §1.674(b)-1(b)(6)(ii), Example (1).
150 Treas. Reg. §1.674(b)-1(b)(6)(ii), Example (2).

refer to §674(c) and Treas. Reg. §1.674(c)-1 for the effect of such a power if it is exercisable only by an independent trustee.[151]

In the third example, the trust provides for payment of income to the grantor's adult son, and the grantor has retained the power to accumulate the income until the grantor's death, at which time all accumulations are to be paid to the son unless the son has predeceased the grantor, in which event the payment is to the grantor's daughter or, if she is not living, to alternate takers (other than the grantor's estate) in specified shares. Here, Treasury concludes that the power is excepted under Code §674(b)(6)(A) because the distribution at the grantor's death reasonably may be expected to occur during the son's lifetime, and it is not necessary for the accumulations to be payable to the son's estate or the son's appointees if the son were to predecease the grantor.[152]

The limitation regarding a person having a power to add beneficiaries does not apply to a power held by a beneficiary to substitute other beneficiaries to succeed his or her interest (so that he or she would be an adverse party as to the exercise or non-exercise of that power).[153] As an example, the regulations indicate that the limitation on adding beneficiaries does not apply if a beneficiary of a non-spendthrift trust has a power to assign his or her beneficial interest.[154] Furthermore, the limitation regarding a person having a power to add beneficiaries does not apply if the power (held by any person) would qualify as an exception to grantor trust status under §674(b)(3) (relating to powers exercisable by will).[155]

(vii) Power to withhold income during disability of a beneficiary - §674(b)(7)

Section 674(b)(7) provides an exception for a power that, in general, will permit ordinary income to be withheld during the legal disability of an income beneficiary or while he or she is under twenty one years of age.[156] Specifically, without triggering grantor trust treatment, any person can have a power to distribute or apply ordinary income to or for a current income beneficiary or to accumulate the income and add it to corpus if the power is exercisable only during that beneficiary's legal disability or during the time when that beneficiary is under twenty one years of age, but only as long as no person has a power to add beneficiaries (except to provide for after-born or after-adopted children).[157]

To qualify for this exception, it is not necessary for the income ultimately to be payable to the income beneficiary from whom it was withheld, his or her estate, or his or her appointees; instead, the accumulated income may be added to corpus and ultimately distributed to others.[158] As an example, the regulations indicate that the grantor is not treated as the owner of a trust under §674(a) if the income of the trust is payable to the grantor's son for life, and then to the grantor's grandchildren, even though the grantor reserves the power to accumulate income and add it to corpus while the grantor's son is under twenty one years of age.[159]

The limitation regarding a person having a power to add beneficiaries does not apply to a power held by a beneficiary to substitute other beneficiaries to succeed his or her interest (so that he or she would be an adverse party as to the exercise or non-exercise of that power).[160] As an example, the regulations

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[151] *Id*.
[152] Treas. Reg. §1.674(b)-1(b)(6)(ii), Example, (3).
[153] Treas. Reg. §1.674(d)-2(b).
[154] *Id*.
[155] *Id*.
[156] Treas. Reg. §1.674(b)-1(b)(7).
[157] Code §674(b)(7) and Treas. Reg. §1.674(b)-1(b)(7).
[158] Treas. Reg. §1.674(b)-1(b)(7).
[159] *Id*.
[160] Treas. Reg. §1.674(d)-2(b).

indicate that the limitation on adding beneficiaries does not apply if a beneficiary of a non-spendthrift trust has a power to assign his or her beneficial interest.[161] Furthermore, the limitation regarding a person having a power to add beneficiaries does not apply if the power (held by any person) would qualify as an exception to grantor trust status under §674(b)(3) (relating to powers exercisable by will).[162]

(viii) Power to allocate between income and corpus - §674(b)(8)

Without triggering grantor trust treatment, any person can have a power to allocate receipts and disbursements to corpus or income, even if expressed in broad language.[163]

C. Exception -- powers held by independent trustee - §674(c)

Section 674(c) provides an exception to the general rule of §674(a) for certain powers exercisable by independent trustees that are in addition to the various powers under §674(b) that may be held by any person (including independent trustees) without triggering grantor trust status.[164] As long as no person has a power to add beneficiaries (except to provide for after-born or after-adopted children),[165] the excepted powers for independent trustees 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;[166] or

* pay out corpus to or for a beneficiary or beneficiaries or to or for a class of beneficiaries (whether or not income beneficiaries).[167]

In order for any of those powers to fall within the exception, it must be exercisable solely, without the approval or consent of any other person, by a trustee or trustees none of whom is the grantor (or grantor's spouse) and no more than half of whom are related or subordinate parties who are subservient to the wishes of the grantor (or grantor's spouse).[168] For purposes of this provision, section 672(c) indicates that a related or subordinate party is presumed to be subservient to the grantor in the exercise or non-exercise of the powers "conferred upon him" or her unless a preponderance of the evidence shows otherwise.[169] As noted previously, the use of the word "him" must refer to powers held by the related or subordinate party, rather than powers held by the grantor. The regulations under §672 clarify who is the relevant person that might exercise or not exercise a power. After identifying all of the different relatives, corporations, and employees who would be related or subordinate parties, the regulations indicate that "these persons" are presumed to be subservient to the grantor in respect to the exercise or non-exercise of powers "conferred on them."[170]

An example from the regulations of a trust that qualifies for the independent trustee exception (and thus is not a grantor trust) is a trust the income of which is payable to the grantor's three adult sons with a power held by an independent trustee to allocate without restriction the amounts of income paid to each

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161 *Id*.
162 *Id*.
163 Code §674(b)(8) and Treas. Reg. §1.674(b)-1(b)(8).
164 Treas. Reg. §1.674(c)-1.
165 Code §674(c) (penultimate sentence). The regulations do not include this restriction for some reason.
166 Code §674(c)(1) and Treas. Reg. §1.674(c)-1.
167 Code §674(c)(2) and Treas. Reg. §1.674(c)-1.
168 Code §674(c) (lead-in) and Treas. Reg. §1.674(c)-1.
169 Code §672(c) (last sentence).
170 Treas. Reg. §1.672(c)-1.

son in each year, but subject to the limitations in Treas. Reg. §1.674(d)-2.[171] Those limitations are discussed below and relate to powers to remove trustees and powers to add beneficiaries.

The exception for independent trustees provided by §674(c) also contains a special provision relating to the grantor's spouse. Specifically, the last sentence of §674(c) indicates that, for periods when a person is the spouse of the grantor, any reference in §674(c) to the grantor shall be treated as including a reference to such spouse.[172] Accordingly, the applicable language above in this portion of the outline (after the two bullet points) includes references in parentheses to the grantor's spouse. This particular treatment of spouses is different than the attribution of powers between spouses under §672(e) because, here in §674(c), the focus is not on powers held by the grantor (or spouse) but rather that no trustee can be the grantor (or spouse) and no more than half of the trustees can be someone related or subordinate to the grantor (or spouse). Remember also from §672(e)(2) that there is no marriage during a time of legal separation under a decree of divorce or of separate maintenance.[173]

It is important to keep in mind that a grantor's power to remove and replace trustees can attribute to the grantor any trustee's powers that are not expressly retained by the grantor. For purposes of the §674(c) exception to the grantor trust rules, a grantor's powers to remove, substitute, or add trustees can alter the situation relating to grantor trust status unless (i) the powers are exercisable only upon limited conditions that do not exist during the applicable tax year, such as the death or resignation of a trustee or the breach of fiduciary duty by a trustee, or (ii) the powers are limited so that their exercise could not alter the trust in a manner that would disqualify it for purposes of §674(c).[174] Specifically, the regulations indicate that a grantor's unrestricted power to remove an independent trustee and substitute any person, including the grantor, as trustee will disqualify an otherwise satisfactory trust for purposes of §674(c).[175] On the other hand, the regulations also indicate that a grantor's power to remove or discharge an independent trustee on the condition that the grantor must substitute another independent trustee will not disqualify a trust under §674(c).[176]

The limitation regarding a person having a power to add beneficiaries does not apply to a power held by a beneficiary to substitute other beneficiaries to succeed his or her interest (so that he or she would be an adverse party as to the exercise or non-exercise of that power).[177] As an example, the regulations indicate that the limitation on adding beneficiaries does not apply if a beneficiary of a non-spendthrift trust has a power to assign his or her beneficial interest.[178] Furthermore, the limitation regarding a person having a power to add beneficiaries does not apply if the power (held by any person) would qualify as an exception to grantor trust status under Code §674(b)(3) (relating to powers exercisable by will).[179]

D. Exception -- power to allocate income limited by a standard (not grantor or spouse) - §674(d)

Without triggering grantor trust treatment, as long as no person has a power to add beneficiaries (except to provide for after-born or after-adopted children), the grantor can grant a power that is solely exercisable (without the approval or consent of any other person) by a trustee or trustees, none of whom is the grantor or spouse living with the grantor, to distribute, apportion, or accumulate income to or for a

171 Treas. Reg. §1.674(c)-1.
172 Code §674(c) (last sentence). The regulations do not include this provision.
173 Code §672(e)(2).
174 Treas. Reg. §1.674(d)-2(a).
175 *Id*.
176 *Id*.
177 Treas. Reg. §1.674(d)-2(b).
178 *Id*.
179 *Id*.

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.[180]

The regulations under §674(d) refer to the regulations under §674(b)(5) for what constitutes a reasonably definite standard.[181] As noted above in this outline, the regulations are somewhat similar to the approach under §2041, looking for a "clearly measurable standard under which the holder of a power is legally accountable" given the "entire context" of a trust instrument.[182] Listed as acceptable powers are those allowing distributions for a beneficiary's health, education, maintenance, or support; for his or her reasonable support and comfort; to enable maintenance of an accustomed standard of living; or to meet an emergency.[183] Not satisfactory are powers referring to pleasure, desire, or happiness.[184] If a trust instrument provides that the trustee's determination with respect to the exercise or non-exercise of a power is conclusive, then the power is not sufficiently limited, but a trust instrument that is phrased in discretionary terms is not in itself determinative.[185] An example from the regulations of a satisfactory power involves a power to distribute for medical expenses,[186] and an example of an unsatisfactory power involves a power to distribute for happiness.[187]

As mentioned above in connection with powers held by independent trustees, it is important to keep in mind that a grantor's power to remove and replace trustees can attribute to the grantor any trustee's powers that are not expressly retained by the grantor. For purposes of the §674(d) exception to the grantor trust rules, a grantor's powers to remove, substitute, or add trustees can alter the situation relating to grantor trust status unless (i) the powers are exercisable only upon limited conditions that do not exist during the applicable tax year, such as the death or resignation of a trustee or the breach of fiduciary duty by a trustee, or (ii) the powers are limited so that their exercise could not alter the trust in a manner that would disqualify it for purposes of §674(d).[188] Specifically, the regulations indicate that a grantor's unrestricted power to remove an independent trustee and substitute any person, including the grantor, as trustee will disqualify an otherwise satisfactory trust for purposes of §674(d).[189] On the other hand, the regulations also indicate that a grantor's power to remove or discharge an independent trustee on the condition that the grantor must substitute another independent trustee will not disqualify a trust under §674(c).[190] That latter example should apply equally to §674(d) even though it is not so stated in the regulations. Likewise, for purposes of §674(d), because an independent trustee is not required, the grantor conceivably could have broader trustee removal and replacement powers as long as neither the grantor nor his or her spouse can be substituted as a trustee.

I have no idea why it would be okay for a spouse who is not living with the grantor to have this power to allocate income. The Code includes this odd proviso here but not elsewhere.[191]

As noted above, section 674(b)(5) allows any trustee to have a power to distribute corpus if limited by a reasonably definite standard as long as nobody can add beneficiaries. Accordingly, when §674(b)(5) is read together with §674(d), we have the authority to avoid grantor trust treatment for trusts that limit all

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180 Code §674(d) and Treas. Reg. §1.674(d)-1.
181 Treas. Reg. §1.674(d)-1 refers to Treas. Reg. §1.674(b)-1(b)(5).
182 Treas. Reg. §1.674(b)-(1)(b)(5)(i).
183 *Id*.
184 *Id*.
185 *Id*.
186 Treas. Reg. §1.674(b)-(1)(b)(5)(iii), Example (1).
187 Treas. Reg. §1.674(b)-(1)(b)(5)(iii), Example (2).
188 Treas. Reg. §1.674(d)-2(a).
189 *Id*.
190 *Id*.
191 Compare §674(d) to §672(e) and §674(c) (last sentence).

distributions (income or corpus) to a standard as long as neither the grantor nor the grantor's spouse (if living with the grantor) has any power to make distributions and nobody has a power to add beneficiaries. In those circumstances, anyone else can be a trustee with distribution powers limited to a standard, including related or subordinate parties (*i.e.*, not just independent trustees), without triggering the grantor trust rules.

The limitation regarding a person having a power to add beneficiaries does not apply to a power held by a beneficiary to substitute other beneficiaries to succeed his or her interest (so that he or she would be an adverse party as to the exercise or non-exercise of that power).[192] As an example, the regulations indicate that the limitation on adding beneficiaries does not apply if a beneficiary of a non-spendthrift trust has a power to assign his or her beneficial interest.[193] Furthermore, the limitation regarding a person having a power to add beneficiaries does not apply if the power (held by any person) would qualify as an exception to grantor trust status under Code §674(b)(3) (relating to powers exercisable by will).[194]

VIII. ADMINISTRATIVE POWERS -- §675

Section 675 of the Code provides a laundry list of powers that can trigger grantor trust status, grouped into four categories. In general, section 675 provides that the grantor is treated as the owner of any portion of a trust if, under the terms of the trust instrument or circumstances attendant to its operation, administrative control is exercisable primarily for the benefit of the grantor rather than the beneficiaries.[195] If a grantor retains a power to amend the administrative provisions of a trust instrument that is broad enough to permit an amendment causing the grantor to be treated as the owner under §675, then the grantor will be treated as the owner from the inception of the trust.[196]

A. Power to deal for less than adequate and full consideration -- §675(1)

The grantor is treated as the owner of any portion of a trust in respect of which a power, exercisable by the grantor or a non-adverse party (or both) without the approval or consent of an adverse party, enables the grantor or any person to purchase, exchange, or otherwise deal with or dispose of the corpus or income for less than an adequate consideration in money or money's worth.[197] Whether the existence of the power will result in the holder of the power being considered an adverse party depends on the circumstances.[198]

The mere fact that a power exercisable by a trustee is described in broad language in the trust instrument does not indicate that the trustee is authorized to purchase, exchange, or otherwise deal with or dispose of the trust property or income for less than an adequate and full consideration in money or money's worth.[199] On the other hand, such authority may be indicated by the actual administration of the trust.[200]

This power is of little utility in planning with grantor trusts. Given the boundaries of fiduciary duties and the estate and gift tax system, it is hard to imagine a trust that allows such a power to exist.

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192 Treas. Reg. §1.674(d)-2(b).
193 *Id*.
194 *Id*.
195 Treas. Reg. §1.675-1(a).
196 *Id*.
197 Code §675(1) and Treas. Reg. §1.675-1(b)(1).
198 Treas. Reg. §1.675-1(b)(1).
199 Treas. Reg. §1.675-1(c).
200 *Id*.

B. Power to borrow without adequate interest or security -- §675(2)

The grantor is treated as the owner of any portion of a trust in respect of which a power, exercisable by the grantor or a non-adverse party (or both), enables the grantor to borrow the corpus or income, directly or indirectly, without adequate interest or without adequate security, except in the case when a trustee (other than the grantor acting alone) is authorized under a general lending power to make loans to any person without regard to interest or security.[201] Furthermore, a general lending power held by the grantor, acting alone as trustee, under which the grantor has the power to determine interest rates and the adequacy of security is not, by itself, an indication that the grantor has to power to borrow corpus or income without adequate interest or security.[202]

It is interesting to note that, as compared to the power to deal for less than adequate and full consideration (where required approval or consent of an adverse party avoids grantor trust status), there is no similar savings provision relating to adverse party consent in regard to the power to borrow without adequate interest or security.

As in the case of the power to deal for less than adequate and full consideration, the mere fact that a power exercisable by a trustee is described in broad language in the trust instrument does not indicate that the trustee is authorized to lend the trust property or income to the grantor without adequate interest.[203] On the other hand, such authority may be indicated by the actual administration of the trust.[204]

C. Borrowing of the trust funds -- §675(3)

The grantor is treated as the owner of any portion of a trust in respect of which the grantor or the grantor's spouse has directly or indirectly borrowed the corpus or income and has not completely repaid the loan, including any interest, before the beginning of the tax year.[205] However, the rule does not apply to a loan that provides for adequate interest and security if the loan is made by a trustee other than the grantor, the grantor's spouse, or a related or subordinate trustee who is subservient to the grantor or the grantor's spouse.[206]

For purposes of determining subservience in connection with §675(3), section 672(c) indicates that a related or subordinate trustee shall be presumed to be subservient to the grantor or the grantor's spouse in respect of the exercise or non-exercise of the "powers conferred on him" or her unless it can be shown otherwise by a preponderance of the evidence.[207] The use of the word "him" seems to refer to powers held by the related or subordinate party rather than powers held by the grantor. The regulations are more precise in referencing the use of the term "related or subordinate party" only in reference to §674(c) and §675(3).[208] Furthermore, the regulations more clearly indicate the relevant power holder. After identifying all of the different relatives, corporations, and employees who would be related or subordinate parties, the regulations indicate that "these persons" are presumed to be subservient to the grantor in the exercise or non-exercise of powers "conferred on them."[209]

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201 Code §675(2) and Treas. Reg. §1.675-1(b)(2).
202 Treas. Reg. §1.675-1(b)(2).
203 Treas. Reg. §1.675-1(c).
204 *Id*.
205 Code §675(3) and Treas. Reg. §1.675-1(b)(3).
206 *Id*.
207 Code §672(c) (last sentence).
208 Treas. Reg. §1.672(c)-1.
209 *Id*.

As in the case of the exception for independent trustees provided by §674(c), section 675(3) contains a special provision relating to the grantor's spouse. Specifically, the last sentence of §675(3) indicates that, for periods when a person is the spouse of the grantor, any reference in §675(3) to the grantor shall be treated as including a reference to such spouse.[210] Accordingly, the applicable language above in this portion of the outline includes references to the grantor's spouse. This particular treatment of spouses is different than the attribution of powers between spouses under §672(e) because, here in §675(3), the focus is not on powers held by the grantor (or spouse) but rather whether the grantor (or spouse) has borrowed from the trust for less than adequate interest or security under a loan made by a related or subordinate trustee. Remember also from §672(e)(2) that there is no marriage during a time of legal separation under a decree of divorce or of separate maintenance.[211]

Revenue Ruling 85-13[212] involved a trust created by a grantor for his child's benefit with his spouse as trustee. Neither the grantor nor any other person had a power over or interest in the trust that would cause the grantor to be treated as the owner of the trust under the grantor trust rules. However, after some time had elapsed, the trustee (grantor's spouse) transferred the trust's asset to the grantor in exchange for an unsecured promissory note bearing adequate interest. The grantor then sold the asset to a third party. The IRS held that "[the grantor's] receipt of the entire corpus of the trust in exchange for [the grantor's] unsecured promissory note constituted an indirect borrowing of the trust corpus which caused [the grantor] to be the owner of the entire trust under section 675(3)." In connection with that holding, the IRS pointed out that "[s]ection 675(3) differs from the other provisions of section 675 which provide rules for determining ownership of a trust, because it requires an affirmative act (borrowing) rather than a retained power, before it applies."

Section 675(3) is thus a good example of the potential to accidentally have grantor trust status. It also suggests one means of being able to "toggle" grantor trust status on and off.

D. General powers of administration -- §675(4)

Section 675(4) indicates that the grantor is treated as the owner of any portion of a trust in respect of which a "power of administration" is exercisable in a non-fiduciary capacity *by any person* without the approval or consent of any person in a fiduciary capacity.[213] By contrast, the regulations under §675(4) refer to powers of administration exercisable in a non-fiduciary capacity *by any non-adverse party* without the approval or consent of any person in a fiduciary capacity.[214] Accordingly, an otherwise offending power of administration held by an adverse party in a non-fiduciary capacity would not result in grantor trust status under the regulations.

The regulations add that if a power is exercisable by a person as trustee, it is presumed that the power is exercisable in a fiduciary capacity primarily in the interests of the beneficiaries, and the presumption can be rebutted only by clear and convincing evidence.[215] On the other hand, if a power is not exercisable by a person as trustee, the determination of whether the power is exercisable in a fiduciary or non-fiduciary capacity depends on all of the terms of the trust instrument and all of the circumstances surrounding the trust's creation and administration.[216]

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210 Code §675(3) (last sentence). The regulations do not include this provision.
211 Code §672(e)(2).
212 Rev. Rul. 1985-13, 1 C.B. 184.
213 Code §675(4) (emphasis added).
214 Treas. Reg. 1.675-1(b)(4) (emphasis added).
215 *Id*.
216 *Id*.

There are three categories of "powers of administration."

(i) Voting powers -- §675(4)(A)

The term "power of administration" includes a power to vote or direct the voting of stock or other securities of a corporation in which the holdings of the grantor and the trust are significant from the viewpoint of voting control.[217]

(ii) Investing powers -- §675(4)(B)

The term "power of administration" includes a power to control the investment of the trust funds, either by directing investments or reinvestments or vetoing proposed investments or reinvestments, to the extent that the trust funds consist of socks or securities of corporations in which the holdings of the grantor and the trust are significant from the viewpoint of voting control.[218]

(iii) Substitution power - §675(4)(C)

The term "power of administration" includes a power to reacquire the trust corpus by substituting other property of an equivalent value.[219] This power appears to be the most widely used grantor trust power in planning with "intentionally defective grantor trusts."[220]

Parsing the language of the statute, the rule states that "[t]he grantor is treated as the owner of any portion of a trust in respect of which...a power to reacquire the trust corpus by substituting other property of an equivalent value...is exercisable in a non-fiduciary capacity by any person without the approval or consent of any person in a fiduciary capacity."[221] By contrast, as noted above, the regulations refer to a power exercisable in a non-fiduciary capacity *by any non-adverse party* without the approval or consent of any person in a fiduciary capacity.[222] Whether that distinction matters in planning for grantor trusts can be discussed by others. It appears to me that most practitioners give the power to the grantor due to the fact that the statute speaks in terms of re-acquiring the trust corpus, such that only the grantor can reacquire anything. In other words, giving the substitution power to any other person, which seems plausible under certain language in the statute, does not tie with the word "reacquire." By contrast, some other person having voting or investment powers under §675(4)(A) or (B) makes more sense.

As indicated above in this outline, the power of substitution over corpus results in grantor trust status as to both ordinary income and other income allocable to corpus (*e.g.*, capital gains and losses) by reason of an interest in or power over corpus alone that does not come within the rules of Treas. Reg. §1.671-3(b)(2).[223] An example from the regulations provides that if a grantor or other person is treated as an owner under §675 or §678 because of a power over corpus, then he or she includes both ordinary income and other income allocable to corpus in the portion he or she is treated as owning.[224]

Revenue Ruling 2008-22[225] provided a great amount of comfort to practitioners who make use of the power of substitution to trigger grantor trust status intentionally.[226] In that ruling, the IRS tackled the

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217 Code §675(4)(A) and Treas. Reg. §1.675-1(b)(4)(i).
218 Code §675(4)(B) and Treas. Reg. §1.675-1(b)(4)(ii).
219 Code §675(4)(C) and Treas. Reg. §1.675-1(b)(4)(iii).
220 *See* Rev. Rul 2008-22, 16 I.R.B. 796.
221 *See* Code §675 (lead-in language) and §675(4) (first sentence) and §675(4)(C).
222 Treas. Reg. 1.675-1(b)(4).
223 Treas. Reg. §1.671-3(b)(3).
224 Treas. Reg. §1.671-3(b)(3).
225 16 I.R.B. 796.

issue of whether the corpus of an inter vivos trust is includible in the grantor's gross estate under §2036 or §2038 if the grantor retained the power, exercisable in a non-fiduciary capacity, to "acquire" property held in the trust by substituting other property of equivalent value.[227] Under the facts presented by the IRS in the revenue ruling, the decedent was prohibited from serving as trustee but had the power at any time to "acquire" any property held in the trust by substituting other property of equivalent value (exercisable in a non-fiduciary capacity without the approval or consent of any person acting in a fiduciary capacity, except that under local law the trustee had a fiduciary duty to ensure that the properties being exchanged were of equivalent value).[228] The IRS also stated as fact that local law required a trustee to act impartially, taking into account any differing interests among beneficiaries.[229]

Before turning to its analysis and holding, the IRS discussed the Tax Court's decision in the *Jordahl* case.[230] In that case, as summarized by the IRS in the revenue ruling, the decedent reserved a power of substitution, but the Service had argued for inclusion in the gross estate under §2038 based on the argument that the power of substitution could be exercised to alter the beneficial interests in the trust.[231] As explained by the IRS in the revenue ruling, the Tax Court determined that the decedent was bound by fiduciary standards and therefore was accountable to succeeding beneficiaries, such that the decedent could not exercise the power "to deplete the trust or to shift trust benefits among the beneficiaries."[232] The IRS drew a distinction in the revenue ruling, as compared to *Jordahl*, because under the facts of the revenue ruling the trust instrument prohibited the decedent from serving as trustee (unlike *Jordahl*) and stated that the power of substitution was held in a non-fiduciary capacity, such that the decedent in the ruling was not subject to "the rigorous standards attendant to a power held in a fiduciary capacity."[233] However, the IRS pointed out that any swapped assets in the case of the revenue ruling were required to be of equivalent value and that the trustee had a fiduciary duty to ensure the same, such that the power could not be exercised to reduce the value of the trust or increase the decedent's net worth.[234] The IRS also emphasized the trustee's duty to prevent any shifting of benefits among the beneficiaries.[235]

The holding of the revenue ruling bears repeating in toto:

A grantor's retained power, exercisable in a non-fiduciary 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 §2036 or §2038, provided the trustee has a fiduciary obligation (under local law or the trust instrument) to ensure the grantor's compliance with the terms of this power by satisfying itself that the properties acquired and substituted by the grantor are in fact of equivalent value, and further provided that the substitution power cannot be exercised in a manner that can shift benefits among the trust beneficiaries. A substitution power cannot be exercised in a manner that can shift benefits if: (a) the trustee has both the power (under local law or the trust instrument) to reinvest the trust corpus and a duty of impartiality with respect to the trust beneficiaries; or (b) the nature of the trust's investments or the level of income produced by any or all of the trust's investments does not impact the respective interests of the beneficiaries, such as when the trust is administered as a unitrust

226 *But see* Craig L. Janes & Bernadette M. Kelly, *When Using a Power of Substitution — Take Nothing for Granted*, 34 EST. PLAN. (NO. 8) 3, 3-10 (Aug. 2007).
227 Rev. Rul 2008-22, 16 I.R.B. 796.
228 *Id*.
229 *Id*.
230 *Estate of Jordahl v. Commissioner*, 65 T.C. 92 (1975).
231 Rev. Rul 2008-22, 16 I.R.B. 796.
232 *Id*.
233 *Id*.
234 *Id*.
235 *Id*.

(under local law or the trust instrument) or when distributions from the trust are limited to discretionary distributions of principal and income. [236]

IX. POWER TO REVOKE -- §676

Section 676(a) provides the general and rather obvious general rule that the grantor is treated as the owner of any portion of a trust, whether or not the grantor is treated as an owner under any provision of the Code from §641 through §685, where at any time the power to "revest...title" to such portion in the grantor is exercisable by the grantor or a non-adverse party (or both).[237] To that rule, the regulations add the proviso "without the approval or consent of an adverse party."[238] The regulations also elaborate on the power to "revest" title, indicating that if title to a portion of a trust will revest in the grantor upon the exercise of a power by the grantor or a non-adverse party (or both), then the grantor is treated as the owner of that portion "regardless of whether the power is a power to revoke, to terminate, to alter or amend, or to appoint."[239]

The general rule does not apply to a power the exercise of which can only affect the beneficial enjoyment of the income for a period commencing after the occurrence of an event such that the grantor would not be treated as the owner under §673 if the power were a reversionary interest, but the grantor may be treated as the owner after the occurrence of the event unless the power is relinquished.[240] The regulations add that if the beginning of the period during which the grantor may revest title is postponed, the rules set forth in Treas. Reg. §1.673(d)-1 are applicable to determine whether the grantor should be treated as an owner during the period following the postponement.[241] As noted in connection with §673 and reversionary interests, if there is any postponement of the grantor's reversion, then that postponement is treated as a new transfer in trust by the grantor, starting with the date of the postponement and ending with the date specified in the postponement, but income for any period is not included in the grantor's income just because of such a postponement if the income otherwise would not be included absent the postponement.[242] This provision perhaps had more meaning before the 1986 changes to §673 that left us with the 5% rule (and eliminated the 10-year rule).[243]

The rules of §676 are referenced in several portion of the regulations under §671 and §672. For example, a grantor may have a power over corpus that treats the grantor as an owner under §676(a), but ordinary income will not be included in the portion if the grantor's power can affect only income received after a period of time such that the grantor would not be treated as an owner of the income if the power were a reversionary interest.[244] On the other hand, a grantor includes both ordinary income and other income allocable to corpus in the portion the grantor is treated as owning if the grantor is treated under §676 as an owner because of a power over corpus that can affect income received within a period such that the grantor would be treated as an owner under §673 if the power were a reversionary interest.[245]

Regarding the definition of adverse party, the regulations under §672 provide that, while a beneficiary ordinarily will be an adverse party, if the beneficiary's right to share in income or corpus is

236 *Id*. (emphasis added).
237 Code §676(a).
238 Treas. Reg. §1.676(a)-1.
239 *Id*.
240 Code §676(b) and Treas. Reg. §1.676(b)-1.
241 Treas. Reg. §1.676(b)-1.
242 Code §673(d) and Treas. Reg. §1.673(d)-1.
243 *See* the example in Treas. Reg. §1.673(d)-1.
244 Treas. Reg. §1.671-3(b)(2).
245 Treas. Reg. §1.671-3(b)(3).

limited to only a part, then he or she may be an adverse party only as to that part.[246] As an example, the regulations indicate that a trust with four equal income beneficiaries that is revocable by the grantor, but only with the consent of one of those income beneficiaries, results in the grantor being treated as the owner of three-fourths of the trust.[247]

Also from those regulations, we know that the interest of a beneficiary in the ordinary income of a trust may or may not be adverse with respect to the exercise of a power over corpus.[248] Similarly, the interest of a contingent income beneficiary is adverse to a return of corpus to the grantor before the termination of the contingent beneficiary's interest but not after.[249] As an example, the regulations indicate that if the income of a trust is payable to the income beneficiary for life, and if the income beneficiary has a non-general lifetime and testamentary power to appoint trust corpus to the grantor, then the income beneficiary's interest is adverse to the return of corpus to the grantor during the income beneficiary's life but not after his or her death.[250] Said differently, the income beneficiary's interest is "adverse as to ordinary income but is not adverse as to income allocable to corpus."[251] Based on that example, the regulations indicate that, absent no other relevant facts, the grantor would not be taxable on ordinary income under §676 (or §674 or §677) but would be taxable under §677 on income allocable to corpus (*e.g.*, capital gains or losses) because income allocable to corpus may, in the discretion of a non-adverse party, be accumulated for future distribution to the grantor.[252]

X. INCOME FOR BENEFIT OF GRANTOR OR SPOUSE -- §677

Section 677 deals with the treatment of the grantor of a trust as the owner of a portion of the trust because the grantor has retained an interest in the income from that portion.[253] It also deals with the treatment of the grantor of a trust as the owner of a portion of the trust because the income from property transferred in trust after October 9, 1969, is or may be distributed to the grantor's spouse or applied to the payment of premiums on policies of insurance on the life of the grantor's spouse.[254] However, section 677 does not apply when the income of a trust is taxable to a grantor's spouse under section 71 (relating to alimony and separate maintenance payments) or section 682 (relating to income of an estate or trust in the case of divorce, etc.),[255] but §682 was repealed by the 2017 tax act.

A. General rules

Subject to the two exceptions discussed below relating to reversionary interests (§673) and obligations of support, section 677(a) provides that the grantor shall be treated as the owner of any portion of a trust, whether §674 applies or not, if the income of the trust, without the approval or consent of any adverse party (other than the grantor's spouse), is or in the discretion of the grantor, the grantor's spouse, or a non-adverse party (or any combination thereof) may be:

* distributed to the grantor or the grantor's spouse;

* held or accumulated for future distribution to the grantor or the grantor's spouse; or

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246 Treas. Reg. §1.672(a)-1(b).
247 *Id*.
248 Treas. Reg. §1.672 (a)-1(c).
249 *Id*.
250 *Id*.
251 *Id*.
252 *Id*.
253 Treas. Reg. §1.677(a)-1(a)(1).
254 *Id*.
255 *Id*.

* applied to the payment of premiums on policies of insurance on the life of the grantor or the grantor's spouse (except policies irrevocably payable to charity).[256]

The provisions relating to the grantor's spouse were added by the Tax Reform Act of 1969, such that transfers in trust prior to October 10, 1969, are governed by a different set of rules.[257] The regulations add that, with respect to the treatment of the grantor as the owner of a portion of a trust because its income is or may be distributed or accumulated for future distribution to the grantor's spouse or applied to premiums of life insurance on the spouse's life, the general rules apply solely during the period of the marriage, and sections 71 and 682 apply in the case of divorce or separation (apparently in lieu of §672(e),[258] but now §682 has been repealed by the 2017 tax act.

The general rules do not apply to a power the exercise of which can only affect the beneficial enjoyment of the income for a period commencing after the occurrence of an event such that the grantor would not be treated as the owner under §673 if the power were a reversionary interest, but the grantor may be treated as the owner after the occurrence of the event unless the power is relinquished.[259] The regulations add that if the beginning of the period is postponed, the rules set forth in Treas. Reg. §1.673(d)-1 are applicable to determine whether the grantor should be treated as an owner during the period following the postponement.[260] As noted above in connection with §673 and reversionary interests, if there is any postponement of the grantor's reversion, then that postponement is treated as a new transfer in trust by the grantor, starting with the date of the postponement and ending with the date specified in the postponement, but income for any period is not included in the grantor's income just because of such a postponement if the income otherwise would not be included absent the postponement.[261] This provision perhaps had more meaning before the 1986 changes to §673 that left us with the 5% rule (and eliminated the 10-year rule).[262]

Bear in mind some examples of what adverse party means from the regulations under §672. From those regulations, we know that the interest of a beneficiary in the ordinary income of a trust may or may not be adverse with respect to the exercise of a power over corpus.[263] Similarly, the interest of a contingent income beneficiary is adverse to a return of corpus to the grantor before the termination of the contingent beneficiary's interest but not after.[264] As an example, the regulations indicate that if the income of a trust is payable to the income beneficiary for life, and if the income beneficiary has a non-general lifetime and testamentary power to appoint trust corpus to the grantor, then the income beneficiary's interest is adverse to the return of corpus to the grantor during the income beneficiary's life but not after his or her death.[265] Said differently, the income beneficiary's interest is "adverse as to ordinary income but is not adverse as to income allocable to corpus."[266] Based on that example, the regulations indicate that, absent no other relevant facts, the grantor would not be taxable on ordinary income under §677 (or §674 or §676) but would be taxable under §677 on income allocable to corpus

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256 Code §677(a) and Treas. Reg. §1.677(a)-1(b)(2).

257 Treas. Reg. §1.677(a)-1(b)(1); Tax Reform Act of 1969 (P.L. 91-172, §332(a)(1).

258 Treas. Reg. §1.677(a)-1(b)(2). *See also* Robert T. Danforth & Howard M. Zaritsky, *Grantor Trusts: Income Taxation Under Subpart E,* 819 TAX MGMT. (BNA) ESTATES, GIFTS, AND TRUSTS, at A-60-61 (Oct. 6, 2014) (citing Treas. Reg. §1.1361-1(k)(1), Ex. 10(ii)).

259 Code §677(a).

260 Treas. Reg. §1.677(a)-1(e).

261 Code §673(d) and Treas. Reg. §1.673(d)-1.

262 *See* the example in Treas. Reg. §1.673(d)-1.

263 Treas. Reg. §1.672 (a)-1(c).

264 *Id*.

265 *Id*.

266 *Id*.

(*e.g.*, capital gains or losses) because income allocable to corpus may, in the discretion of a non-adverse party, be accumulated for future distribution to the grantor.[267]

B. Constructive distribution; cessation of interest

The regulations indicate that the grantor is treated under §677 as the owner of a portion of a trust if the grantor has retained any interest that might enable the grantor (without the approval or consent of an adverse party) to have the income from that portion distributed to the grantor at some time either actually or constructively (subject to the exception noted above that ties into §673).[268] In the case of a transfer in trust after October 9, 1969, the grantor is also treated under §677 as the owner of a portion of a trust if the grantor has granted or retained any interest that might enable the grantor's spouse (without the approval or consent of an adverse party other than the grantor's spouse) to have the income from that portion distributed to the spouse at some time either actually or constructively (whether or not within the grantor's lifetime).[269] Constructive distribution includes payment to a person on behalf of the grantor or the grantor's spouse in obedience to his or her direction and payment of life insurance premiums relating to policies insuring the life of the grantor or the grantor's spouse (unless irrevocably payable to charity).[270] If the grantor (in the case of property transferred in trust prior to October 10, 1969) or the grantor and the grantor's spouse (in the case of property transferred in trust after October 9, 1969) are divested permanently and completely of every interest described in the previous three sentences, the grantor is not treated as an owner under §677 after that divesting.[271]

The word "interest" as used in these provisions of the regulations does not include the possibility that the grantor or the grantor's spouse might receive back from a beneficiary an interest in a trust by inheritance.[272] Further, with respect to transfers in trust prior to October 10, 1969, the word "interest" does not include the possibility that the grantor might receive back from a beneficiary an interest in a trust as a surviving spouse under a statutory right of election or similar right.[273]

C. Discharge of legal obligation v. trusts for support

In general, a grantor is treated under §677(a) as the owner of a portion of a trust whose income is or in the discretion of the grantor or a non-adverse party (or both) may be applied in discharge of a legal obligation of the grantor (or the grantor's spouse in the case of property transferred in trust after October 9, 1969), such as rent or other household expenses.[274] However, as an exception to that general rule, section 677(b) provides that the income of a trust shall not be considered taxable to the grantor under §677(a) (or any other provision of Chapter 1 of the Code) merely because the income, in the discretion of another person, the trustee, or the grantor acting as the trustee or a co-trustee, may be applied or distributed for the support or maintenance of a beneficiary (other than the grantor's spouse in the case of income from property transferred in trust after October 9, 1969) whom the grantor or the grantor's spouse is legally obligated to support or maintain (such as a child), unless the income is so applied or

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267 *Id*.
268 Treas. Reg. §1.677(a)-1(c).
269 *Id*.
270 *Id*.
271 *Id*.
272 *Id*.
273 *Id*.
274 Treas. Reg. §§1.677(a)-1(d) and §1.677(b)-1(d).

distributed.[275] The exception applies solely to the discretionary satisfaction of the grantor's legal obligation to support or maintain a beneficiary, not any other obligations.[276]

Unless the grantor has discretion as a trustee or co-trustee, the general rule of §677(a) applies, not the exception of §677(b), if the discretion to apply or distribute trust income rests solely with the grantor (in some other capacity) or the grantor (in some other capacity) in conjunction with other persons.[277] In other words, if the grantor has no role in the discretion, then the exception applies, but if the grantor does have a role, the exception will not apply unless the grantor's role is serving as a trustee. Likewise, the general rule of §677(a) applies, not the exception of §677(b), to the extent that income is required (without any discretionary determination) to be applied or distributed to the satisfaction of the grantor's legal obligation to support or maintain a beneficiary.[278]

If income actually is so applied or distributed to the satisfaction of the grantor's legal obligation to support or maintain a beneficiary, then the grantor may be treated as the owner of any portion of the trust under §677 to that extent, even though it might have been applied or distributed for other purposes.[279] In the case of property transferred in trust for the benefit of the grantor's spouse before October 10, 1969, the grantor may be treated as the owner to the extent income is actually applied for the support or maintenance of the grantor's spouse.[280]

In cases where the amounts so applied or distributed are paid out of corpus (or out of income other than income for the current year), the grantor is treated as a beneficiary of the trust for purposes of §641 through §668, and such amounts are deductible under §661(a)(2) and taxed to the grantor under §662.[281]

The regulations provide an ordering mechanism to determine the items of income, deduction, and credit of a trust to be included in computing the grantor's tax liability under these principles. Specifically, the income of the trust for the taxable year of distribution is deemed to have been distributed first.[282] As an example, the regulations indicate that a distribution of $10,000 to a dependent of the grantor on January 1st is deemed to have been made out of ordinary income for that year, to the extent of the income for that year, even though the trust had received no income as of January 1st.[283] The example goes on to say that if the trust receives dividends of $5,000 and incurs expenses of $1,000 during that year, the grantor will take both of those items into account when computing the grantor's tax liability, and furthermore the grantor will be treated as a beneficiary with respect to the $6,000 paid out of corpus or out of accumulated income from a year other than the current year.[284]

D. Accumulation of income

The regulations expand on §677(a)(2)'s treatment of the grantor as an owner for any taxable year if income is accumulated for future distribution to the grantor (or the grantor's spouse in the case of property transferred in trust after October 9, 1969). Specifically, the regulations indicate that the

[275] Code §677(b), Treas. Reg. §1.677(a)-1(d), and Treas. Reg. §1.677(b)-1(a).
[276] Treas. Reg. §1.677(b)-1(d).
[277] Treas. Reg. §1.677(b)-1(e).
[278] Treas. Reg. §1.677(b)-1(f).
[279] Treas. Reg. §1.677(b)-1(a).
[280] *Id*.
[281] Code §677(b) and Treas. Reg. §1.677(b)-1(b). The two sections of the Code referenced in the body of the outline at this footnote relate to trusts accumulating income or distributing corpus, §661 provides income tax deductions for such trusts, and §662 provides for the inclusion of applicable amounts in a beneficiary's income.
[282] Treas. Reg. §1.677(b)-1(c).
[283] *Id*.
[284] *Id*.

exception tied into the reversionary interest rules (§673) does not apply merely because the grantor (or the grantor's spouse in the case of property transferred in trust after October 9, 1969) must await the expiration of a period of time before he or she can receive or exercise discretion over accumulated income, even though the period is such that the grantor would not be treated as an owner under §673 if a reversionary interest were involved.[285]

The regulations provide an example using the obsolete 10-year rule of §673 that, updated for the 5% rule adopted in 1986, indicates that if the income of a trust (including capital gains) is to be accumulated for a period of time covering less than 95% of the trust's value (such that a reversionary interest would exceed 5%) but then after that time will be or in the discretion of the grantor or the grantor's spouse (in the case of property transferred in trust after October 9, 1969) or a non-adverse party may be distributed to the grantor (or the grantor's spouse in the case of property transferred in trust after October 9, 1969), then the grantor is treated as the owner of the trust from its inception.[286] With regard to transfers after October 9, 1969, the regulations add that if income is accumulated in any taxable year during the grantor's lifetime for future distribution to the grantor's spouse, section 677(a)(2) treats the grantor as an owner for that taxable year even though the grantor's spouse may not receive or exercise discretion over that income prior to the grantor's death.[287]

E. Two examples from the regulations

Example (1).[288] The grantor creates an irrevocable trust with income payable to the grantor for life and the corpus payable at the grantor's death to an unrelated person. Except for the right to the income, the grantor retains no other powers that would trigger any of the grantor trust rules. Under local law, capital gains are allocated to corpus. During the year, the trust has the following items of income and deduction: $5,000 of dividends, $1,000 of capital gain, $200 of expenses allocable to income, and $100 of expenses allocable to corpus. Section 677(a) applies because of the grantor's right to receive trust income. Treasury indicates that the grantor should include the $5,000 of dividends, $200 of expenses allocable to income, and $100 of expenses allocable to corpus in the computation of the grantor's tax for that year, but not the $1,000 of capital gain because it is not attributable to the portion of the trust that the grantor owns. The example goes on to say that capital loss likewise would not be included in the computation of the grantor's taxable income. Instead, the capital gain and loss would be governed by §641 through §668. The example cross-references Treas. Reg. §1.671-3(b) for the rules applicable to the portion deemed owned by the grantor.

Example (2).[289] The grantor creates an irrevocable trust with ordinary income payable to the grantor's adult son. Corpus reverts to the grantor on the earlier of the death of the son or ten years and one day after the creation of the trust. The grantor also reserves a discretionary right to receive $5,000 of ordinary income each year (all other ordinary income is payable to the son). The grantor retains no other powers that would trigger any of the grantor trust rules. Under the terms of the trust instrument and local law, capital gains must be applied to corpus. During the year, the trust has the following items of income and deduction: $10,000 of dividends, $2,000 of capital gain, $400 of expenses allocable to income, and $200 of expenses allocable to corpus. Section 677(a)(2) applies because the capital gain is held or accumulated for future distribution to the grantor. The grantor therefore is "treated under section 677(a)(2) as an owner of a portion of the trust to which the gain is attributable." The example cross-references Treas. Reg. §1.671-3(b) for the rules applicable to the portion deemed owned by the grantor.

285 Treas. Reg. §1.677(a)-1(f).
286 *Id.*
287 *Id.*
288 Treas. Reg. §1.677(a)-1(g), Example (1).
289 Treas. Reg. §1.677(a)-1(g), Example (2).

Treasury indicates that the grantor must include the $2,000 capital gain in the computation of the grantor's income, and likewise would include a capital loss if one had been incurred. In addition, because of the grantor's retained discretionary right to receive $5,000 of ordinary income each year (whether exercised or not), the grantor is treated as the owner of a portion of the trust that will permit a distribution of income to the grantor of $5,000 and must include dividends of $5,208.33 and income expenses of $208.33 in computing the grantor's taxable income. Those amounts are computed by reference to the ratio of the $5,000 discretionary amount to the trust's DNI of $9,600 (dividends of $10,000 minus $400 of expenses allocable to income), as applied to the trust's dividend total of $10,000 and expenses allocable to income of $400 (*i.e.*, 5,000/9,600 x $10,000 = $5,208.33 and 5,000/9,600 x $400 = $208.33). The example adds that, in accordance with Treas. Reg. §1.671-3(c), the grantor also takes into account $104.17 of expenses allocable to corpus in computing the grantor's tax liability (5,000/9,600 x 200 = $104.17). Finally, the example concludes by stating that the portion of the dividends and expenses of the trust not attributable to the grantor are governed by §641 through §668.

XI. PERSON OTHER THAN GRANTOR TREATED AS SUBSTANTIAL OWNER -- §678

Section 678 deals with the situation when someone other than the grantor is treated as the owner of a trust. In general, under §678, income of a trust is taxed to a person other than the grantor to the extent that that other person has the sole power to vest the corpus or income in himself or herself.[290]

A. General rule

Section 678(a) provides the general rule that a person other than the grantor will be treated as the owner of any portion of a trust with respect to which that other person either (i) has a power exercisable solely by himself or herself to vest the trust's corpus or income in himself or herself or (ii) has previously partially released or otherwise modified such a power (so that he or she no longer can vest the corpus or income in himself or herself) after which release or modification he or she retains sufficient controls that would subject a grantor to treatment as the owner of that portion of the trust under §671 through §677.[291] The regulations add that the rule applies with respect to a testamentary or inter vivos trust.[292] The regulations also indicate that §678 does not apply if the power is not exercisable solely by the power holder himself or herself (*i.e.*, a shared or jointly held power is not covered, whether the other power holder is adverse or not).[293]

Following is an example from Treas. Reg. §1.671-2(e) that illustrates the general rule of §678(a):

A creates and funds a trust, T. A does not retain any power or interest in T that would cause A to be treated as an owner of any portion of the trust under sections 671 through 677. B holds an unrestricted power, exercisable solely by B, to withdraw certain amounts contributed to the trust before the end of the calendar year and to vest those amounts in B. B is treated as an owner of the portion of T that is subject to the withdrawal power under section 678(a)(1). However, B is not a grantor of T under paragraph (e)(1) of this section because B neither created T nor made a gratuitous transfer to T.[294]

Other than a special exception regarding distribution powers held as a trustee tied to the satisfaction of obligations of support (discussed below), section 678(a) treats a person as an owner of a trust if he or she has a power exercisable solely by himself or herself to apply the income or corpus to the satisfaction

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290 Treas. Reg. §1.671-1(a) (last sentence). See also *Mallinckrodt v. Nunan*, 146 F.2d 1 (8th Cir. 1945) for a similar approach that pre-dated and most likely led to the adoption of Code §678 in 1954.

291 Code §678(a)(1) and (2) and Treas. Reg. §1.678(a)-1(a).

292 Treas. Reg. §1.678(a)-1(a).

293 Treas. Reg. §1.678(a)-1(b).

294 Treas. Reg. §1.671-2(e)(6), Example 4.

of his or her legal obligations.[295] Said another way, the general rule of §678(a) applies, not the exception, in any case in which the holder of a power exercisable solely by himself or herself is able, in any capacity other than that of a trustee or co-trustee, to apply the income of a trust in discharge of his or her obligation of support or maintenance.[296]

By contrast, the regulations under §662 deal with income of a trust that, pursuant to the terms of the trust, is used to satisfy the obligations of a person other than the grantor. Specifically, that part of the regulations provides that any amount that, pursuant to the terms of a will or trust instrument, is used in full or partial discharge or satisfaction of a legal obligation of any person is included in the gross income of that person under §662(a)(1) or (2), whichever is applicable, as though directly distributed to that person as a beneficiary (except in cases relating to alimony under §71 or divorce under §682).[297] The amount included in the income of that person is limited by the extent of his or her legal obligation under local law.[298] For purposes of these rules, a legal obligation includes a legal obligation to support another person if, and only if, the obligation is not affected by the adequacy of the dependent's own resources.[299] Specifically, if local law allows a parent to utilize resources owned by a minor child for the child's support, in lieu of utilizing the parent's own resources, then no obligation of support exists for purposes of these rules, whether or not the trust income is actually used for support purposes.[300] Similarly, if local law provides that a child is obligated to support a parent only when the parent's resources are lacking, then no obligation exists for purposes of these rules regardless of what the parent's resources actually might be.[301] Finally, if a parent's obligation to support a child (including education) is determined under local law by reference the family's station in life and the means of the parent, then those reference points are to be determined without consideration of the trust income in question.

B. Exception if grantor is taxable

The general rule of §678(a) does not apply with respect to a power over "income," as originally granted or thereafter modified, if the grantor of the trust is otherwise treated as the owner under §671 through §677.[302] Note that this exception does not refer to a power over corpus. Accordingly, if the grantor otherwise is treated as the owner under §671 through §677 and someone else has a power over corpus that would invoke §678(a), then this exception does not apply. Unfortunately, the consequences are not terribly clear. Conveniently, the IRS seems to favor the position that the grantor is the deemed owner in spite of a third person's power over corpus.[303]

C. Powers held as trustee relating to obligations of support

The general rule of §678(a) also does not apply to a power that enables that other person (person other than the grantor), in the capacity of trustee or co-trustee, merely to apply the income of the trust to the support or maintenance of a person that he or she is obligated to support or maintain, except to the

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295 Treas. Reg. §1.678(a)-1(b).
296 Treas. Reg. §1.678(c)-1(b).
297 Treas. Reg. §1.662(a)-4.
298 *Id*.
299 *Id*.
300 *Id*.
301 *Id*.
302 Code §678(b) and Treas. Reg. §1.678(b)-1. Note that this outline does not comment on the references to Code §679 (dealing with foreign trusts) that are found in Code §678(b).
303 *See* Robert T. Danforth & Howard M. Zaritsky, *Grantor Trusts: Income Taxation Under Subpart E*, 819 TAX MGMT. (BNA) ESTATES, GIFTS, AND TRUSTS, at A-66 n. 497 (Oct. 6, 2014). *See also* Treas. Reg. §1.671-2(b) regarding the meaning of "income." *See also* Treas. Reg. §1.671-3(b)(3).

extent that the income is so applied.[304] If the amounts so applied or distributed are paid out of corpus or out of "other than income of the taxable year," the amounts are taxed to the power holder under §662.[305]

This exception is concerned with the taxability of income subject to a power described in §678(a), but it has no application to the taxability of income that is either required to be applied pursuant to the terms of a trust instrument (see above for discussion of §662) or is applied pursuant to a power that is not described in §678(a).[306]

Treas. Reg. §1.677(b)-1(a), (b), and (c) provides the guiding principles when any amount is applied for the support or maintenance of a person whom the power holder is obligated to support.[307] Recall from that portion of the outline that if income actually is so applied or distributed to the satisfaction of a legal obligation to support or maintain a beneficiary, then the power holder may be treated as the owner of any portion of the trust to that extent, even though it might have been applied or distributed for other purposes.[308] In cases where the amounts so applied or distributed are paid out of corpus (or out of income other than income for the current year), the power holder is treated as a beneficiary of the trust for purposes of §641 through §668, and such amounts are deductible under §661(a)(2) and taxed under §662.[309] The regulations provide an ordering mechanism to determine the items of income, deduction, and credit of a trust to be included in computing the tax liability under these principles. Specifically, the income of the trust for the taxable year of distribution is deemed to have been distributed first.[310] As an example, the regulations indicate that a distribution of $10,000 to a dependent on January 1st is deemed to have been made out of ordinary income for that year, to the extent of the income for that year, even though the trust had received no income as of January 1st.[311] The example goes on to say that if the trust receives dividends of $5,000 and incurs expenses of $1,000 during that year, the power holder will take both of those items into account when computing the tax liability, and furthermore will be treated as a beneficiary with respect to the $6,000 paid out of corpus or out of accumulated income from a year other than the current year.[312]

D. Effect of renunciation or disclaimer

Finally, the general rule of §678(a) does not apply with respect to a power that has been renounced or disclaimed within a reasonable period of time after the holder of the power first becomes aware of its existence.[313]

E. Qualified subchapter S trust

Section §678(e) makes reference to §1361(d) (the rules relating to a qualified subchapter S trust or "QSST"). Section 1361(d)(1)(B) indicates that, for purposes of §678(a), the beneficiary of a QSST will be treated as the owner of that portion of the QSST that consists of stock in an S corporation with respect to which the QSST election has been made under §1361(d)(2).

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304 Code §678(c) and Treas. Reg. §1.678(c)-1(a).
305 Code §678(c).
306 Treas. Reg. §1.678(c)-1(c).
307 Treas. Reg. §1.678(c)-1(a).
308 Treas. Reg. §1.677(b)-1(a).
309 Treas. Reg. §1.677(b)-1(b). The two sections of the Code referenced in the body of the outline at this footnote relate to trusts accumulating income or distributing corpus, §661 provides income tax deductions for such trusts, and §662 provides for the inclusion of applicable amounts in a beneficiary's income.
310 Treas. Reg. §1.677(b)-1(c).
311 *Id.*
312 *Id.*
313 Code §678(d) and Treas. Reg. §1.678(d)-1.

XII. SELECTED TOPICS OF INTEREST

The preceding portions of this outline cover the grantor trust rules in detail as they are presented to us by the Code and the regulations, with a few references to judicial opinions, IRS rulings, and commentators along the way. Needless to say, there is a lot of detail in the grantor trust rules as presented by the Code and regulations, to the end that it would be easy to accidentally trigger grantor trust status (or to accidentally fail to trigger grantor trust status). It also is very hard to keep in mind all of the details all of the time. As a consequence, it appears that most practitioners tend to repeat the same or similar patterns in their own approaches to grantor trust issues. For example, it is common to have some boiler plate language that turns off all of the grantor trust rules so as not to accidentally trigger grantor trust status when it is not wanted. Likewise, it is common to use the same power or powers repeatedly to trigger grantor trust status deliberately.

But not everyone practices law in the same way. Further, there are numerous commentators (lawyers and accountants) who have written on various topics related to the grantor trust rules. The result is that finding different points of view on lots of topics is easy. Against that backdrop, what follows is a list of topics for discussion with sometimes little, if any, meaningful commentary from me, but with several references to written materials prepared by others.

A. Benefits of having grantor trust status

Chief among the benefits of grantor trusts in estate planning is that payment of income taxes by the grantor is not a gift to the trust beneficiaries. In effect, the grantor is able to make a tax-free gift to the trust for each year that the trust is a grantor trust and has taxable income. The result is better growth potential for the trust (no income tax burden), as well as continuous depletion of the grantor's estate. Similarly, there are lots of benefits to be had in connection with the grantor selling assets to the trust (*e.g.*, sales for promissory notes) or exchanging assets with the trust (*e.g.*, substituting high basis property for low basis property prior to death).

(i) Income tax payment is not a gift -- Rev. Rul. 2004-64

It has been understood by most practitioners for a long time that, when a grantor pays the income tax associated with income earned by a trust that the grantor created for the benefit of others, there is no taxable gift by the grantor because the income tax burden falls squarely on the grantor pursuant to the grantor trust rules.[314] In a very helpful revenue ruling issued in 2004, the IRS confirmed the widely held understanding of practitioners.[315]

In that revenue ruling, the hypothetical taxpayer established a trust for descendants that, by its terms, provided no retained beneficial interest or power in favor of the grantor that would cause a gratuitous transfer to be incomplete for federal gift tax purposes, or that would cause the trust corpus to be included in the grantor's gross estate for federal estate tax purposes, even though the grantor retained sufficient powers to be treated as the owner for income tax purposes under the grantor trust rules. In other words, the hypothetical trust was a classic intentionally defective grantor trust (and that alone was a great thing to see from the IRS).

In its holding, the IRS says that "[w]hen the grantor of a trust, who is treated as the owner of the trust under subpart E, pays the income tax attributable to the inclusion of the trust's income in the grantor's taxable income, the grantor is not treated as making a gift of the amount of the tax to the trust

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314 David A. Handler, *The Power of Grantor Trusts*, TR. & EST., Mar. 2006, at 24, 24-29.
315 Rev. Rul 2004-64, 2004-2 C.B. 7.

beneficiaries."[316] The reasoning, as stated in the analysis portion of the ruling, is that "even though [the grantor] is not a Trust beneficiary, any income tax [the grantor] pays that is attributable to Trust's income is paid in discharge of [the grantor's] own liability, imposed on [the grantor] by §671."[317]

(ii) Tax-free exchange of property -- Rev. Rul. 85-13

An additional benefit of grantor trust status is the ability to make transactions between the grantor and the grantor trust without having income tax concerns, principally without triggering any gain. Avoidance of gain recognition in a sale to a defective trust is a key feature of that technique. Furthermore, the ability to exchange assets with a grantor trust allows an exchange just prior to death of low basis trust assets with high basis personal assets so as to take advantage of a step-up in basis at death under §1014.

The logic in support of those sorts of transactions comes from Revenue Ruling 85-13.[318] That ruling indicates the IRS position, now unchanged for over thirty years, that the *Rothstein*[319] decision from the Second Circuit makes no sense ("[t]he Service will not follow the *Rothstein* decision") and that a grantor trust will not be recognized as a separate taxpayer capable of entering into a sales transaction with the grantor.[320]

Under the facts of the revenue ruling, the grantor created a trust for his child's benefit with his spouse as trustee. Neither the grantor nor any other person had a power over or interest in the trust that would cause the grantor to be treated as the owner of the trust under the grantor trust rules. However, after some time had elapsed, the trustee transferred the trust's asset to the grantor in exchange for an unsecured promissory note bearing adequate interest. The grantor then sold the asset to a third party.

The IRS held that "[the grantor's] receipt of the entire corpus of the trust in exchange for [the grantor's] unsecured promissory note constituted an indirect borrowing of the trust corpus which caused [the grantor] to be the owner of the entire trust under section 675(3)."[321] In connection with that holding, the IRS pointed out that "[s]ection 675(3) differs from the other provisions of section 675 which provide rules for determining ownership of a trust, because it requires an affirmative act (borrowing) rather than a retained power, before it applies."[322]

The IRS also held that the sale of the trust asset (stock) to the grantor for the unsecured promissory note should not be recognized for income tax purposes, as follows:

"At the time [the grantor] became the owner of the trust, [the grantor] became the owner of the trust property. As a result, the transfer of trust assets to [the grantor] was not a sale for federal income tax purposes and [the grantor] did not acquire a cost basis in those assets. Accordingly, when [the grantor] sold the . . . stock . . . , [the grantor] recognized gain . . . Further, this holding would apply even if the trust held other assets in addition to [the grantor's] promissory note if [the grantor], under any of the grantor trust provisions, was treated as the owner of the portion of the trust represented by the promissory

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316 *Id*.
317 *Id*.
318 Rev. Rul. 1985-13, 1 C.B. 184.
319 *Rothstein v. U.S.*, 735 F.2d 704 (2d Cir. 1984).
320 Rev. Rul. 1985-13, 1 C.B. 184.
321 Rev. Rul. 1985-13, 1 C.B. 184.
322 *Id*.

note because [the grantor] would be treated as the owner of the purported consideration (the promissory note) both before and after the transaction."[323]

In the analysis portion of the ruling supporting that later holding, the IRS indicated that "because [the grantor] is treated as the owner of the entire trust, [the grantor] is considered to be the owner of the trust assets for federal income tax purposes."[324] As a result, the IRS determined that the grantor is considered to be the owner of the promissory note held by the trust.[325] The IRS then concluded that the transfer of the stock to the grantor "is not recognized as a sale for federal income tax purposes because [the grantor] is both the maker and the owner of the promissory note[,]" adding that "[a] transaction cannot be recognized as a sale for federal income tax purposes if the same person is treated as owning the purported consideration both before and after the transaction."[326]

After reviewing the opposite result determined by the Second Circuit in *Rothstein*, the IRS provides the following contrary rationale:

"It is anomalous to suggest that Congress, in enacting the grantor trust provisions of the Code, intended that the existence of a trust would be ignored for purposes of attribution of income, deduction, and credit, and yet, retain a vitality as a separate entity capable of entering into a sales transaction with the grantor. The reason for attributing items of income, deduction, and credit to the grantor under section 671 is that, by exercising dominion and control over a trust, either by retaining a power over or an interest in the trust, or, as in this case, by dealing with the trust property for the grantor's benefit, the grantor has treated the trust property as though it were the grantor's property. The Service position of treating the owner of an entire trust as the owner of the trust's assets is, therefore, consistent with and supported by the rationale for attributing items of income, deduction, and credit to the grantor."[327]

B. Which power(s) to use for intentional grantor trust status

The power of substitution under §675(4)(C) seems to be the most widely used power to create grantor trust status intentionally.[328] It is relatively simple to draft and has been cited favorably by the IRS in Revenue Ruling 2008-22, as noted above in this outline.[329] The power of substitution also is handy because it is easy for the grantor, himself or herself, to release the power of substitution when grantor trust status is no longer desirable.

Some practitioners believe strongly that the power of substitution should not be used alone but rather should be paired with another power.[330]

Of the other available powers, the most common alternative that I have seen practitioners use around the country is a power, exercisable by the grantor or a non-adverse party (or both), that enables the grantor to borrow the corpus or income, directly or indirectly, without security.[331] Care must be taken in

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323 *Id*.
324 *Id*. (citing several judicial opinions and revenue rulings, as well as Treas. Reg. §1.1001-2(c), Example 5.
325 *Id*.
326 *Id*.
327 *Id*.
328 *See, e.g.*, *Estate of Jordahl v. Commissioner*, 65 T.C. 92 (1975); Rev. Rul 2008-22, 16 I.R.B. 796.
329 16 I.R.B. 796.
330 *See* Craig L. Janes & Bernadette M. Kelly, *When Using a Power of Substitution — Take Nothing for Granted*, 34 EST. PLAN. (NO. 8) 3, 3-10 (Aug. 2007) (analyzing the historical development of the grantor trust rules and particularly the difference between fiduciary powers and non-fiduciary powers).
331 Code §675(2) and Treas. Reg. §1.675-1(b)(2).

drafting such a power to build in the ability to terminate grantor trust status when that status is no longer desirable.

Another fairly common power appears to be a power held by a non-adverse party in a non-fiduciary capacity to add beneficiaries (often charities). I personally do not favor this approach.

C. Toggling off (and on?)

It is common to turn off grantor trust status when the grantor no longer wants to report trust income as his own and therefore wants to stop paying the income tax. Indeed, building in grantor trust powers that can be turned off is important order to avoid undesirable consequences.

Can grantor trust status be turned back on after it has been turned off?[332] This outline considers these issue only briefly.

At the very least, it should be noted that certain transactions that involved toggling have been treated by the IRS as "transactions of interest."[333] In Notice 2007-73, the IRS described complex transactions that included a grantor trust, options, unitrust interests, and non-contingent remainder interests in an effort to create losses, in reaction to which the Service suggested that turning off grantor trust status is okay but turning it back on is a concern. Whether that concern translates to other situations, like more typical estate planning trusts, is open to interpretation.

Even without regard to Notice 2007-73, turning grantor trust status on after it has been turned off requires thoughtful consideration. In particular, the regulations provide that if a grantor retains a power to amend a trust agreement that is broad enough to permit an amendment that would cause grantor trust status under §675, then the grantor trust status will apply from its inception.[334] Given that rule and the spousal attribution rules discussed at various points in this outline, the ability to turn grantor trust status back on once it has been turned off should be held by someone other than the grantor and the grantor's spouse. Who else might have those types of powers depends on the powers themselves and the grantor's tolerance for allowing specific powers to be held by specific persons.

(i) Borrowing from the trust

As noted above, the grantor is treated as the owner of any portion of a trust in respect of which the grantor or the grantor's spouse has directly or indirectly borrowed the corpus or income and has not completely repaid the loan, including any interest, before the beginning of the tax year.[335] However, the rule does not apply to a loan that provides for adequate interest and security if the loan is made by a trustee other than the grantor, the grantor's spouse, or a related or subordinate trustee who is subservient to the grantor or the grantor's spouse.[336]

Accordingly, as was the case in Revenue Ruling 85-13,[337] at any time it is possible, unless prohibited by the trust instrument, for a grantor to create grantor trust status under §675(3) by borrowing trust corpus if the loan does not bear adequate interest, is not adequately secured, or is made by a trustee who is the grantor or a related or subordinate trustee subservient to the grantor. Because we almost always need to

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332 *See* Brian D. Cororve & Emily M. Radke, *It Toggles the Mind: Thoughts on Grantor Trusts and How to Turn Them On and Off*, State Bar of Texas 26th Annual Advanced Planning and Probate Drafting Course (Oct. 2015).

333 Notice 2007-73, 36 I.R.B. 545.

334 Treas. Reg. §1.675-1(a).

335 Code §675(3) and Treas. Reg. §1.675-1(b)(3).

336 *Id*.

337 Rev. Rul. 1985-13, 1 C.B. 184.

pay sufficient interest to avoid estate and gift tax problems, the use of an unsecured loan is really all that is needed when paired with the right trustee, ignoring fiduciary issues.

In *Mau vs. U.S.*,[338] the court held that borrowing at any time during the year caused grantor trust status for the entire year. The IRS followed that result in Revenue Ruling 86-82,[339] in which the grantor borrowed trust assets and then repaid the loan during the same year. Citing *Mau*, the IRS held that §675(3) applies for the entire year once the loan is made during the year, regardless of whether the loan is repaid before year's end.[340]

(ii) Trustee's power to loan without security

As noted above, one widely used grantor trust power is a power, exercisable by the grantor or a non-adverse party (or both), that enables the grantor to borrow the corpus or income, directly or indirectly, without security.[341] While we probably can figure out how to have the grantor or trustee (or trust protector) turn off this power, some other person (like a trust protector) might have the ability to toggle it back on. Indeed, an independent person who is not the trustee (like a trust protector) might hold both the power to enable such loans and the power to not enable such loans.

(iii) Power of substitution

The substitution power is probably the most widely used grantor trust power, as noted elsewhere in this outline. My approach is for the grantor to have the substitution power (not someone else) and for the grantor to be able to release it at any time. For me, once it is turned off, it is turned off. But perhaps it would be possible to designate someone else (like a trust protector) who could have the ability to turn that power back on.

(iv) Decanting, merging, etc.

Decanting is all the rage in some parts of the country, particularly the Northeast, but it is fairly limited under the Texas statute. Under the right circumstances, perhaps a grantor trust power could be toggled "on" and "off" by decanting. In particular, decanting might allow for the creation of grantor trust status if a trust is not already a grantor trust.[342] For example, in PLR 200848017,[343] a decanting was used to modify a trust in order to add a power of substitution for the grantor, and the IRS agreed that the trust became a grantor trust. Of course, that approach favors the trust beneficiaries, but going the other way might prove tricky for the trustee.

D. Income tax treatment upon termination of grantor trust status (particularly when the grantor holds notes receivable from the trust)

When the grantor trust status of a trust is "toggled off" -- often the grantor or someone else is said to "undefect" the trust -- the income tax ramifications to the grantor (or the grantor's estate) and to the trust itself need to be considered. Does the grantor (or the grantor's estate) recognize income, and what happens to the basis of the trust assets? The appropriate treatment can be somewhat unclear.

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338 355 F. Supp. 909 (D. Hawaii 1973).
339 1986-1 C.B. 253.
340 *Id*.
341 Code §675(2) and Treas. Reg. §1.675-1(b)(2).
342 *See* Amy M. Heller, *Grantor Trusts: Take Nothing for Granted*, 46 ANN. HECKERLING INST. ON EST. PLAN. 3-3 (2012).
343 Priv. Ltr. Rul. 2008-48017 (Nov. 28, 2008).

As noted multiple times in this outline, sales between a grantor and a grantor trust generally are ignored for income tax purposes. This approach stems from Revenue Ruling 85-13 because a transaction "cannot be recognized as a sale for federal income tax purposes if the same person is treated as owning the purported consideration both before and after the transaction."[344]

On the other hand, the lapse in a trust's status as a grantor trust can cause a deemed transfer to occur for income tax purposes. In particular, if the lapse occurs during the grantor's lifetime, it is reasonably well established that the transfer is treated as a deemed sale or exchange (and that is particularly important if there is consideration running from the trust to the grantor in the form of a promissory note).[345]

But if the lapse occurs because of the grantor's death, there is arguably no direct authority, and competing approaches are supported by different commentators.[346] In general, commentators have tended toward two approaches to collections on the note, being (i) tax on gain as collected under §691 (income in respect of a decedent) or (ii) no tax under §691 because the grantor would not have recognized that income himself or herself, and three approaches to determining the trust's basis, being (i) the carryover basis approach, (ii) the deemed sale basis approach, and (iii) the §1014(a) stepped-up basis approach.[347] The discussion that follows is organized around the three approaches to basis, with commentary mixed in that relates to the income side for collections on the note.

(i) Carryover basis approach

The carryover basis approach treats the situation as a "transfer in trust," leaving the trust with carryover basis under §1015(b). The approach is consistent with the principle that transfers caused by death generally do not result in an income tax event unless the Code specifically requires otherwise.[348] That principle is not statutory, but courts and the IRS recognize its existence.[349] The carryover basis approach also is consistent with the view that there is no gain to be recognized to the grantor before death (because of Revenue Ruling 85-13[350]), nor to the grantor's estate as income in respect of a decedent under §691 (because there would have been no income recognition to the grantor if he had lived). In simple terms, failing to tax the inherent gain at death is appropriate because the low basis in the trust assets is preserved under §1015 for taxation upon later sale.

As pointed out by one commentator rather persuasively,[351] the analysis of the carryover basis approach actually begins by looking at the statutory provisions relating to cost basis in §1012. There, the

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344 Rev. Rul. 85-13, 1985-1 C.B. 184.
345 *Madorin v. Comm'r*, 84 T.C. 667, 677–80 (1985); Treas. Reg. §1.1001-2(c), Example 5; Rev. Rul. 77-402, 1977-2 C.B. 222.
346 *See, e.g.*, David Handler and Deborah V. Dunn, *Tax Consequences of Outstanding Trust Liabilities when Grantor Trust Status Terminates*, 95 J. TAX'N 49 (July 2001); Jonathan G. Blattmachr, Mitchell M. Gans & Hugh H. Jacobson, *Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor's Death*, 97 J. TAX'N (NO. 3) 149, 149-59 (Sept. 2002); Mitchell M. Gans & Jonathan Blattmachr, *No Gain at Death*, TR. & EST., Feb. 2010, at 34, 34-37; Carol A. Cantrell, *Gain is Realized at Death*, TR. & EST., Feb. 2010, at 20, 20-33; Laura H. Peebles, *Death of an IDIT Noteholder*, TR. & EST., Aug. 2005; H. Allan Shore & Craig T. McClung, *Beyond the Basic SUPERFREEZE—An Update and Additional Planning*, 75 TAXES 41, 51 (1997); Mark L. Ascher, *The Grantor Trust Rules Should Be Repealed*, 96 IOWA L. REV. 885, 923 n.200 (2011).
347 Laura H. Peebles, *Death of an IDIT Noteholder*, TR. & EST., Aug. 2005, at 29.
348 *Id*. at 33 (lists five examples from the Code and regulations).
349 *See, e.g.*, *Crane v. Comm'r*, 331 U.S. 1, 5–6, 11 (1947); Rev. Rul. 73-183, 1973-1 C.B. 364 (ruling that §1001 did not apply to transfers from a taxpayer to his executor); I.R.S. Chief Couns. Mem. 2009-23024 (June 5, 2009).
350 1985-1 C.B. 184.
351 Laura H. Peebles, *Death of an IDIT Noteholder*, TR. & EST., Aug. 2005, at 29.

Code indicates that the basis of property equals its cost, "except as otherwise provided in this subchapter."[352] Section 1015 is part of the subchapter that provides otherwise.

Most estate planners are familiar with §1015(a) and its provisions regarding carryover basis for property that is transferred by gift. Perhaps less familiar are the provisions of §1015(b). That part of the statute addresses the basis of property that is "transferred in trust" and provides as follows:

> If the property was acquired after December 31, 1920, by a transfer in trust (other than by a transfer in trust by a gift, bequest, or devise), the basis shall be the same as it would be in the hands of the grantor increased in the amount of gain or decreased in the amount of loss recognized to the grantor on such transfer under the law applicable to the year in which the transfer was made.[353]

Section 1015(b) very clearly applies to any transfer in trust that is not a gift, bequest, or devise. A sale to a grantor trust for a note is not a gift, bequest, or devise. It is a sale, albeit not recognized because of Revenue Ruling 85-13.[354] Accordingly, it follows that a "transfer in trust" under §1015(b) is considered to have occurred at the date of the original, unrecognized purchase and sale transaction, and that the trust's basis in the purchased asset under §1015(b) would be the same as the grantor's basis (carryover basis). It also fits with the theory that the grantor cannot have income tax at any time prior to death under any deemed sale caused by death because of Revenue Ruling 85-13.[355]

(ii) Deemed sale approach

The deemed sale approach is based on the assumption that a sale or exchange occurs for income tax purposes at the time of the grantor's death, when grantor trust status terminates, rather than at the time of the original transfer to the trust.[356] Although there is no definitive authority on this issue, commentators typically adopt one of two views for determining who recognizes the gain occurring under the deemed sale approach: (1) the moment-before approach; or (2) the moment-after approach.[357] That view also affects the approach to basis.

As noted above, Revenue Ruling 85-13[358] defers the recognition event associated with a transfer to a grantor trust to the time of the termination of the trust's grantor status. At that point, at least during the grantor's lifetime, a sale is deemed to occur.[359] There is no similar direct authority for applying the same rule to the termination of grantor trust status caused by the death of the grantor. However, arguments do exist for this treatment. First, the lifetime lapse authorities cited above focus on the termination of grantor status without placing significance on the lifetime nature of the event causing the termination, suggesting

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352 §1012(a).

353 §1015(b). Note that §1015(b) comes to the same result as cost basis under §1012, such that its existence as a separate statute may be questioned, but it has resulted in at least one ruling that points out a key difference in terms of allowing the tacking of the transferor's holding period. *See Citizen's Natl. Bank of Waco v. U.S.*, 417 F.2d 675 (5th Cir. 1969). *See also* James J. Freeland et al., *Part Gift-Part Sale: An Income Tax Analysis with Policy Considerations*, 47 TAX. L. REV. 407 (Winter 1992).

354 1985-1 C.B. 184.

355 *Id*.

356 Carol A. Cantrell, *Gain Is Realized at Death*, TR. & EST., Feb. 2010, 20, at 20–21.

357 *See, e.g.*, Mark L. Ascher, *The Grantor Trust Rules Should Be Repealed*, 96 IOWA L. REV. 885, 923 n.200 (2011).

358 1985-1 C.B. 184.

359 *See Madorin v. Comm'r*, 84 T.C. 667, 668, 677–80 (1985); Treas. Reg. §1.1001-2(c), Example 5; Rev. Rul. 77-402, 1977-2 C.B. 222.

that these authorities could apply with equal force to a termination caused by the grantor's death.[360] Second, applying the lifetime termination authorities to a termination caused by the grantor's death would be analogous to the treatment of the termination of ownership of a foreign trust by a U.S. person under Treas. Reg. §1.684-2(e)(1), Example 2 (the transfer occurring at the death of the grantor of a foreign grantor trust is treated as a deemed purchase and sale at the moment before the grantor's death).

The most significant issue with the deemed sale basis approach is that it ignores the established principle, noted above, that a transfer caused by death does not cause a recognition event for income tax purposes unless the Code requires otherwise.[361] The Office of Chief Counsel at the IRS made that very point in Chief Counsel Memorandum 2009-23024, in which it stated that "the rule . . . is narrow, insofar as it only affects inter vivos lapses of grantor trust status, not [a lapse] caused by the death of the owner[,] which is generally not treated as an income tax event."[362] While the position of the Chief Counsel is difficult to reconcile with the regulations dealing with the death of the grantor of a foreign grantor trust (noted above),[363] it would appear that the IRS opposes the deemed sale basis approach.

The moment-before approach assumes that the deemed sale happens the moment before the grantor dies. One commentator notably places particular emphasis on the fact that the entire day of death is reported on the taxpayer's final income tax return.[364] In any event, if the gain is triggered before death (or at death but in the taxpayer's final year), then gain would be recognized on the decedent's final income tax return, unless the gain can be reported on the installment basis over time as income in respect of a decedent. In turn, the trust's basis would be equal to the sum of (1) the greater of the principal balance of the notes or the grantor's adjusted basis in the property at death and (2) any gift tax paid.[365]

The Code defines an installment sale as a sale in which at least one payment is to be received after the close of the taxable year in which the disposition occurs.[366] Income from an installment sale is recognized using the "installment method" as payments are received.[367] If the decedent's notes receivable provide for interest annually and principal on some date after death, then it seems that installment sale treatment should apply.

The installment method applies automatically, absent a timely election out of the installment method by the taxpayer.[368] The Code specifically addresses how to elect out of the installment method. An election out must be made on or before the due date of the taxpayer's return (including extension) by the taxpayer either (1) reporting "an amount realized equal to the selling price including the full face amount of any installment obligation on the tax return filed for the taxable year in which the installment sale occurs;" or (2) reporting the gain on a Form 8949 or Form 4797, instead of reporting as an installment

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360 *See Madorin*, 84 T.C. at 676 ("Here, we must decide what are the tax consequences when a grantor trust is terminated as such."); Treas. Reg. §1.1001-2(c), Example 5 ("Consequently, at that time, C is considered to have transferred ownership of the interest in P to T, now a separate taxable entity."); I.R.S. Gen. Couns. Mem. 37,228 (Aug. 23, 1977) ("Consequently, at that time, A will have in effect transferred ownership of the interest in P partnership to the N trust, which has become a separate and independent taxable entity from the grantor, A.").

361 *See, e.g.*, *Crane v. Comm'r*, 331 U.S. 1, 5–6, 11 (1947); Rev. Rul. 73-183, 1973-1 C.B. 364 (ruling that §1001 did not apply to transfers from a taxpayer to his executor); I.R.S. Chief Couns. Mem. 2009-23024 (June 5, 2009). *See also* Laura H. Peebles, *Death of an IDIT Noteholder*, TR. & EST., Aug. 2005, at 33.

362 I.R.S. Chief Couns. Mem. 2009-23024 (June 5, 2009).

363 Treas. Reg. §1.684-2(e)(1), Example 2.

364 Carol A. Cantrell, *Gain Is Realized at Death*, TR. & EST., Feb. 2010.

365 Treas. Reg. §1.1015-4(a)(1)–(2).

366 Code §453(b)(1).

367 Code §453(a).

368 Code §453(d).

sale on a Form 6252.[369] The presumption in favor of the installment method is strong, based in part on §453's legislative history.[370]

If the moment-before approach is applied, the decedent's interest in the notes receivable is deemed to be transferred to the estate. Section 453B addresses the gain recognized from the disposition of an installment obligation, and § 453B(a) states as follows:

(a) If an installment obligation is satisfied at other than its face value or distributed, transmitted, sold, or otherwise disposed of, gain or loss shall result to the extent of the difference between the basis of the obligation and—

(1) the amount realized, in the case of satisfaction at other than face value or a sale or exchange, or

(2) the fair market value of the obligation at the time of distribution, transmission, or disposition, in the case of the distribution, transmission, or disposition otherwise than by sale or exchange.

any gain or loss so resulting shall be considered as resulting from the sale or exchange of the property in respect of which the installment obligation was received.

However, §453B(a)'s general recognition rule does not apply to the transmission of an installment obligation at death where the obligation passes from the decedent to the decedent's estate.[371] "No income is required to be reported in the return of [a] decedent by reason of the transmission at death of [an installment obligation owned by the decedent]."[372]

The amount of income in respect of a decedent arising from an installment obligation is "an amount equal to the excess of the face amount of such obligation over the basis of the obligation in the hands of the decedent (determined under section 453B)."[373]

As noted above, some commentators argue persuasively that §691 cannot apply because payments made to the grantor by the grantor trust would not constitute "items of gross income."[374] The logical conclusion from that argument is that, under the moment-before approach, any gain should be recognized on the deceased-grantor's final income tax return. While the latter might follow from the former, the problem is that, in order for the moment-before approach to apply coherently, the application of Revenue Ruling 85-13[375] must end the moment before the grantor's death and thus before the deemed sale.

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[369] *See* Code §453(d)(2); Temp. Treas. Reg. §15a.453-1(d)(3); I.R.S. PUBLICATION 537: INSTALLMENT SALES 4 (2016).

[370] *Bus. Ventures Int'l v. Olive*, 893 F.2d 641, 645–46 (3d Cir. 1990); *Estate of Wilkinson v. Comm'r*, 66 T.C.M. (CCH) 986 (1993); *Bolton v. Comm'r*, 92 T.C. 303, 305–06 (1989).

[371] Code §453B(c).

[372] Treas. Reg. §1.451-1(b)(2)*; see also Sun First Nat'l Bank of Orlando v. United States*, 607 F.2d 1347 (Ct. Cl. 1979) (holding that "[u]nder I.R.C. [§] 691(a)(1)(B), the gain reflected in the unpaid installment notes was gross income not properly includible in the decedent's final return because of the [§] 453 election. The trust 'acquired' the right to receive those amounts by reason of the death of the decedent."); *Estate of Kahn v. Comm'r,* 125 T.C. 227, 231–33 (2005) (reaching an analogous conclusion with respect to an individual retirement account).

[373] Code §691(a)(4).

[374] *See, e.g.,* H. Allan Shore & Craig T. McClung, *Beyond the Basic SUPERFREEZE—An Update and Additional Planning*, 75 TAXES 41, 51 (1997).

[375] 1985-1 C.B. 184.

If the moment-before approach applies, the IRS may take the position that recognition of gain should be on the decedent's final income tax return, as per the Tax Court's decision in the *Frane* case.[376] But the Tax Court's decision in *Frane* on this issue was reversed by the Eighth Circuit, holding that the moment-after death approach should apply.[377] The Eighth Circuit decision may not be binding precedent everywhere, but it is instructive, its reasoning is sound, and it is supported by other authorities.

The moment-after approach assumes that the deemed sale occurs the moment after the grantor dies. In that case, assuming no basis step-up under §1014(a) (that method is discussed below), the gain from the sale would be included on the estate's income tax return rather than the decedent's final income tax return. The Eighth Circuit's decision in *Frane* illustrates the moment-after approach.[378] *Frane* addressed the income tax consequences of self-cancelling installment notes that terminated at the maker's death.[379] The Tax Court held that the income resulting from the cancellation should be reported on the decedent's final income tax return instead of on the estate's income tax return.[380] The Eighth Circuit reversed and held that the taxable income should be reported on the estate's income tax return.[381] The Tax Court had reasoned that the cancellation triggered §453B(f),[382] resulting in §691 being inapplicable, but the Eighth Circuit concluded instead that the "cancellation [of the notes] occurring at the death of the obligee shall be treated as a transfer by the estate."[383] The Eighth Circuit also noted that the Tax Court's reasoning in applying § 453B(f) appeared "quite nebulous."[384]

The Eighth Circuit's decision in *Frane* is not an outlier. There is at least one revenue ruling and a general counsel memorandum reaching a similar conclusion.[385] The significant feature of these authorities is that the deemed transfer of a self-cancelling installment note must have occurred *after* the decedent died in order for the IRD rules of §691 rule to apply. In other words, the Eighth Circuit and the IRS have both reached the conclusion that the moment-after approach applies to the cancellation of a self-cancelling installment note.

(iii) The §1014(a) step-up approach

The §1014(a) stepped-up basis approach suggests that Revenue Ruling 85-13[386] makes the substance of the transfer occurring at the grantor's death equivalent to a bequest or devise within the meaning of §1014(b)(1). In other words, because the grantor is the deemed owner of the trust assets for income tax purposes under Revenue Ruling 85-13,[387] the grantor "owns" the trust assets at his or her death, such that

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376 *Frane v. Comm'r*, 98 T.C. 341 (1992), *aff'd in part, rev'd in pert. part*, 998 F.2d 567 (8th Cir. 1993).
377 *Frane v. Comm'r*, 998 F.2d 567 (8th Cir. 1993), *aff'g in part, rev'g in part*, 98 T.C. 341 (1992).
378 *Id*.
379 *Id.* at 568.
380 *Id*.
381 *Id.* at 572.
382 Section 453B(f) provides that if any installment obligation is canceled or otherwise becomes unenforceable then both (1) the obligation shall be treated as if it were disposed of in a transaction other than a sale or exchange, and (2) if the obligor and obligee are related persons (within the meaning of section 453(f)(1)), the fair market value of the obligation shall be treated as not less than its face amount.
383 *Id*.
384 *Id*.
385 Rev. Rul. 86-72, 1986-1 C.B. 253 (1986); I.R.S. Gen. Couns. Mem. 39,503 (May 7, 1986); *see also* Treas. Reg. §1.691(a)-2(b), Example 1.
386 1985-1 C.B. 184.
387 *Id*.

there should be a basis adjustment to the asset's fair market value at the date of the grantor's death under §1014(a).[388]

In most situations, the value of the assets held by an intentionally defective grantor trust is not included in a decedent's gross estate under Chapter 11 of the Code. As a consequence, consider whether the §1014(a) stepped-up basis approach is consistent with the purpose of §1014. The regulations indicate that the purpose of §1014 is to provide a basis for "property acquired from a decedent" that is equal to the value used "for purposes of the Federal estate tax."[389] Consider also the basis consistency rules and related reporting requirements under §6035.

In 2012, the IRS issued a private letter ruling that appears to give some support to the §1014(a) stepped-up basis approach.[390] In that ruling, a non-U.S. taxpayer contributed cash and stock to a grantor trust that, upon the taxpayer's death, would distribute its assets to the taxpayer's descendants.[391] The IRS ruled that the assets held by the trust received a stepped-up basis under §1014, reasoning that the taxpayer's descendants acquired assets from the trust at the taxpayer's death by bequest, devise, or inheritance.[392]

Other authorities have reached the opposite conclusion. In *Collins v. U.S.*, for example, a district court (later affirmed by the 9th Circuit) held that a taxpayer was not entitled to basis under §1014 for payments that she received from her late-husband's employment contract.[393] The court reasoned that, for property to be acquired by "bequest, devise, or inheritance" within the meaning of §1014(b)(1), it had to pass through probate, which had not occurred.[394] Similarly, the IRS issued a Chief Counsel Memorandum in 2009 stating that it "strongly disagreed" with the taxpayer's contention that assets transferred into a trust qualified for basis under §1014 because "it would seem that the general rule is that property transferred prior to death, even to a grantor trust, would not be subject to section 1014, unless the property is included in the gross estate for federal estate tax purposes as per section 1014(b)(9)."[395]

Some commentators addressing the conflict between Chief Counsel Memorandum 2009-37028 and Private Letter Ruling 2012-45-006 cast doubt on a taxpayer's ability to rely on the private letter ruling.[396] And finally, a recent article quoted Jonathan Blattmachr, the commentator who appears to have pioneered the §1014(a) stepped-up basis approach, saying that the IRS "doesn't like the result of stepped up basis, and isn't going to assist taxpayers in reducing their tax bill."[397]

E. Tax reimbursement clauses

In addition to providing us with confirmation of the rule that a grantor's payment of income tax under a grantor trust scenario is not a gift by the grantor to the trust's beneficiaries, Revenue Ruling 2004-

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388 *See* Johnathan G. Blattmachr et al., *Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor's Death*, 97 J. TAX'N 149 (2002).
389 Treas. Reg. §1.1014-1(a).
390 Priv. Ltr. Rul. 2012-45-006 (Nov. 9, 2012).
391 *Id*.
392 *Id*.
393 318 F. Supp. 382, 386 (C.D. Cal. 1970), *aff'd*, 448 F.2d 787 (9th Cir. 1971).
394 *Id*.
395 I.R.S. Chief Couns. Mem. 2009-37028 (Sept. 11, 2009).
396 *See* Paul S. Lee, *Venn Diagrams: Meet Me At The Intersection Of Estate & Income Tax (Planning For The Aftra-Math)* 49–51 (2014) ("[I]t appears the drafters of [Private Letter Ruling 2012-45-006] may have mistakenly referenced Section 1014(b)(1) . . . ."); FEDERAL TAX COORDINATOR ¶ P-4102 (2d. 2015) (arguing that Private Letter Ruling 2012-45-006 is not an authority on which heavy reliance should be placed).
397 Diane Freda, *IRS No-Rule on Basis in Grantor Trust Sales Reflects Clash of Opinions*, BNA DAILY TAX REPORT (June 19, 2015).

64 dealt with the estate tax result if the trust provided for reimbursement to the grantor for income tax paid.[398] The ruling considered three different scenarios.

In the first scenario, neither state law nor the governing instrument of the trust contained any provision requiring or permitting the trustee to distribute assets to the grantor or to reimburse the grantor for payment of his or her income tax attributable to the trust's income, and the IRS concluded that "no portion of the Trust is includible in [the grantor's] gross estate for federal estate tax purposes under §2036, because [the grantor] has not retained the right to have trust property expended in discharge of [the grantor's] legal obligation."[399]

In the second scenario, by contrast, the trustee was required by the trust instrument to distribute a sufficient amount to the grantor to satisfy the grantor's tax liability relating to the trust income, and the IRS concluded that the full value of the trust's assets is includible in the grantor's gross estate under §2036(a)(1) because the grantor retained the right to have trust property expended in discharge of the grantor's legal obligation.[400]

In the third scenario, whether to distribute funds to the grantor to cover tax obligations is left to the discretion of the trustee, and the IRS concluded that "the existence of that discretion, by itself (whether or not exercised), will not cause the value of the trust's assets to be includible in the grantor's gross estate."[401]

F. Spousal Attribution Rule and Divorce

As noted above in this outline, one problem with the spousal attribution rule of §672(e) is that there is no apparent "off switch" upon divorce. This can be a very serious issue in many divorces.

The rule states that the grantor is treated as holding any power or interest held by anyone who was the grantor's spouse <u>*at the time of the creation of that power or interest*</u>. It says nothing about the implications of a subsequent divorce. Consider the policy behind the rule: it makes no sense to have grantor trust status post-divorce due to a power or interest held by an ex-spouse. Nonetheless, most commentators believe that grantor trust status survives divorce in most situations. The commentary tends to evaluate the plain text of the statute. Because the statute focuses on the time when the spouse's power or interest is created, the conclusion is that divorce is of no consequence. The result is the unusual situation in which, after divorce, the grantor remains liable for tax on trust income because his or her ex-spouse holds a power or interest described in the grantor trust rules.

The repeal of §682 in the 2017 tax act only makes the situation worse. Section 682 at least provides some solace to the grantor by making the ex-spouse bear the tax on income that the ex-spouse is "entitled" to receive but that otherwise would be taxable to the grantor (e.g., under the grantor trust rules). It was not a perfect fix but did help matters. The silver lining, perhaps (and hopefully?), is that the attention to this situation that is created by the repeal of §682 might lead to a statutory fix.

What follows is a synopsis of some of the writings on this topic by notable commentators.

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398 Rev. Rul. 2004-64, 2004-2 C.B. 7. *See also* Keith Durkin, *Understanding Tax Payment/Reimbursement Clauses for Sales to Intentionally Defective Grantor Trusts*, 29 PROB. & PROP. (NO. 5), Sept./Oct. 2015, at 45, 45-49.

399 *Id*.

400 *Id*.

401 *Id*.

Jonathan Blattmachr and Ladson Boyle indicate that the "rule applies if the grantor was married to the spouse at the time the power or interest was created and is not affected by a subsequent divorce."[402]

Jeffrey Schoenblum describes the rule's application post-divorce as "far reaching" but accurate:

> [T]he application of § 672(e)(2) to § 672(e)(l)(A) means that, if a person was a spouse at the time of the creation of the power or interest, then he or she will be deemed a spouse thereafter, including following the parties' divorce. This far-reaching imposition of permanent status as a spouse means that there is no way to avoid attribution with respect to an interest or power of such former spouse.[403]

Howard Zaritsky and Norman Lane provide a more in-depth analysis. Their treatise starts with the same conclusion as others:

> Section 672(e) imputes powers held by one person to the grantor of the trust in two situations:
>
> 1. The parties were married on the date that the power or interest was created, and were not then legally separated; and
>
> 2. The parties became spouses after the creation of the power or interest, but only for periods after the marital relationship was established.
>
> It should be noted that if parties were married and not legally separated on the date of a trust transfer, a subsequent divorce does not terminate the imputation. The death of the grantor or grantor's spouse, however, will end the trust's grantor trust status.[404]

Zaritsky and Lane then analyze legislative history.[405] They conclude that §672(e) may apply only if a joint return can be filed in the year the power or interest is created:

> The legislative history . . . indicates that the spousal attribution rule applies "if the spouse and the grantor are eligible to file a joint income tax return for the relevant period." Arguably, the term "if" should be read as "only if;" i.e., eligibility to file a joint return is not merely a sufficient, but a necessary condition for application of the spousal attribution rule. If that is true, it would raise several issues, including a few which, in certain uncommon situations, can provide tax planning opportunities.[406]

Steve Akers states that the scope of § 672(e) post-divorce is "not clear."[407]

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[402] Jonathan G. Blattmachr & F. Ladson Boyle, *Blattmachr Income Taxation of Estates and Trusts* 5-32 (16th ed. 2013 & Supp. 2017).
[403] Jeffrey A. Schoenblum, *858 T.M, Family, Kinship, Descent, and Distribution* A-174 (2017).
[404] H. Zaritsky & N. Lane, *Federal Income Taxation of Estates and Trusts* 7.10 (Thomson Reuters/WG&L, 3d ed. 2001, with updates through October 2017) (online version accessed on Checkpoint (www.checkpoint.riag.com)).
[405] *Id.*
[406] *Id.* (citing S. Rep. No. 313, 99th Cong., 2d Sess. 871 (1986)).
[407] Steve R. Akers, *ACTEC 2016 Summer Meeting Musings (Including Fiduciary Income Tax Bootcamp) Bessemer* Trust, 21 (Sep. 2016)

Carlyn McCaffrey repeatedly states that nothing in the Code terminates the spousal attribution rule after divorce:

> I.R.C. §672(e) provides that he or she will be treated as holding any power or interest held by an individual to whom the grantor was married at the time of the creation of the power or interest or whom he or she married after such creation. There is no provision of the Code that causes this treatment to terminate if the spouses divorce.
>
> I.R.C. §672(e) is more difficult to avoid. It provides that a trust grantor will be treated as holding any trust interest or power held by an individual to whom the grantor was married at the time of the power's creation. Section 672(e) does not cease to operate after the grantor and spouse are divorced.[408]

Amy Heller also recognizes the principle:

> The legislative history of section §672(e) indicates that if the grantor and his spouse are married at the time the transfer to the trust occurs, the spouse's interests in and powers over the trust are attributed to the grantor even if the couple divorces. This means that if an ex-spouse remains a beneficiary of a trust created when the spouses were married, the spouse who created the trust may continue to be treated as deemed owner of the trust.409

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https://www.bessemertrust.com/portal/binary/com.epicentric.contentmanagement.servlet.ContentDeliveryServlet/Advisor/Presentation/Print%20PDFs/ACTEC%202016%20Summer%20Meeting%20Musings_FINAL%20WEB.pdf (Summary of author's observations from ACTEC 2016 Summer Meeting).

[408] Carlyn S. McCaffrey, *The Use of Trusts to Structure Divorce Settlements,* 27 J. Am. Acad. Matrimonial Law. 29, 38, 42 (2014).

[409] Amy E. Heller, *Grantor Trusts and the New Planning Landscape,* 19 ALI-CLE Est. Plan. Course Materials J. 25, 36 (2013).