# Planning with Grantor Trusts

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# Chapter 4
# Grantor Trusts

# Blattmachr on Income Taxation of Estates and Trusts*

**By: 2008 Jonathan G. Blattmachr and F. Ladson Boyle**

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*Chapter 4*

# Grantor Trusts


**§ 4:1 Introduction**
- **§ 4:1.1 Overview**
- **§ 4:1.2 History**

**§ 4:2 General Rules**
- **§ 4:2.1 Who Is a Grantor?**
- **§ 4:2.2 Portion Rule**
- **§ 4:2.3 Tax Year**
- **§ 4:2.4 Definitions**
  - **[A] Adverse Party and Non-Adverse Party**
  - **[B] Related or Subordinate Party**
  - **[C] Powers Subject to a Condition Precedent**
  - **[D] Powers and Interest of the Grantor's Spouse**
  - **[E] Foreign Trust Limitation**

**§ 4:3 Trust in Which the Grantor Has Retained a Beneficial Interest or Power—Sections 676 and 673— Revocable Trusts**

**§ 4:4 Revocable Trust Problems Common to Other Grantor Trusts—Computation of Taxable Income**

**§ 4:5 Trusts with Income for Benefit of Grantor or Spouse**
- **§ 4:5.1 Discretionary Distribution of Income to Grantor or Spouse**
- **§ 4:5.2 Accumulation of Income for Future Distribution to Grantor or Spouse**
- **§ 4:5.3 Satisfaction of Legal Obligations of Grantor or Spouse**
- **§ 4:5.4 Insurance Trusts**

**§ 4:6 Other Grantor Trusts**
- **§ 4:6.1 Reverter to Grantor**
- **§ 4:6.2 Control over Beneficial Interests**
- **§ 4:6.3 Administrative Control for Benefit of Grantor**
- **§ 4:6.4 Foreign Trust with U.S. Beneficiary**
- **§ 4:6.5 Taxability of Income to Person Other Than the Grantor**

**§ 4:7 Income Tax Reporting Requirements for Grantor Trusts**

**§ 4:8 The Termination of Grantor Trust Status**
- **§ 4:8.1 Termination of Grantor Trust Status During the Grantor's Lifetime**
  - **[A] Third-Party Indebtedness**

[B] Grantor Indebtedness
§ 4:8.2 Termination of Grantor Trust Status by Reason of the Grantor's Death
[A] Basic Rule of No Gain at Death
[B] Income in Respect of a Decedent
[C] Trustee's Basis

## § 4:1 Introduction

### *§ 4:1.1 Overview*

The taxation of trusts discussed in chapter 3 applies generally when the grantor has parted with all interests in the trust corpus and income, as well as control over both. This scheme of taxation does not apply, however, to revocable trusts or other trusts if the grantor is considered to be the owner for tax purposes because of retained interests or powers or because of certain interests or powers granted to other people. Moreover, it is possible for a third party to be deemed the owner of a trust because of certain interests in or powers over a trust. Instead, in these circumstances, Subpart E of Subchapter J applies. These rules contained in sections 671–79 are commonly known as the grantor trust rules.

When the grantor trust rules apply, section 671 provides in part that:

> there shall then be included in computing the taxable income and credits of the grantor or the other person those items of income, deductions, and credits against tax of the trust which are attributable to that portion of the trust to the extent that such items would be taken into account under this chapter in computing taxable income or credits against the tax of an individual.[1]

Only the income of a trust not subject to the grantor trust rules is governed by the remainder of subchapter J. Nevertheless, it is possible for a grantor to be taxed under assignment of income principles[2] or family partnership rules.[3] The assignment of future trust income by a trust beneficiary may not effectively transfer the tax liability to the assignee unless the assignment is of such a permanent nature that a grantor would be relieved of tax on creation of a similar trust.[4] For example, the assignment of interest accruing on a bond to a non-grantor trust may not transfer the income tax liability to the trust.[5] In addition, the regulations provide that an assignment of income from an employment contract to a non-grantor trust may not relieve the assignor of the tax liability.[6]

The grantor trust rules discussed in this chapter are broken down into separate sections. First, general principles and the applicable definitions are discussed. Second, trusts in which the donor has retained some beneficial interest are reviewed. Third, trusts in which the donor has retained a power over the trust are examined. Fourth, trusts in which a third party is granted some power or interest that causes the trust to be treated as a grantor trust are considered. Fifth, trusts that are treated as owned by a third party are reviewed. Finally, several special topics are examined.

### *§ 4:1.2 History*

To prevent the excessive use of trusts to avoid tax by splitting income among several taxpayers, tax law has long required the income of a trust to be taxed to the grantor if the grantor had either a right to receive the income of the trust or a power to revest the trust corpus, even if the grantor did not actually receive the income or exercise the power.[7] Taxation of the grantor of a trust was expanded by applying the "satisfaction of obligation" or "benefit" concept[8] in some situations that fell outside the early application of the rule. These early cases recognized that a valid trust had been created and that under the normal trust income tax rules, the income would be taxable to either the trust or the named beneficiaries. However, in these circumstances the trust income was taxed to the grantor because it was used to satisfy a legal obligation of the grantor and was thus used for grantor's benefit.

Subsequently, the Supreme Court expanded the grantor trust concept in what has come to be known as the *Clifford Trust* doctrine.[9] Under the Court's holding, the income of an inter vivos trust may be taxed to the grantor under the broad provisions of the section that generally defines "gross income,"[10] if the grantor retained such control over the corpus or income of the trust to be deemed the owner for tax purposes. Subsequently, the *Clifford Trust* doctrine was embodied in the so-called *Clifford Regulations* under the 1939 Code.[11] The 1954 Code adopted the general principles of the *Clifford Regulations*, but did so as a part of separate, statutory taxation of trust sections rather than under the definition of gross income. The 1954 Code provisions, commonly known as the "grantor trust" rules, specifically provided that a person is not taxable on the income of a trust, under any other sections, including the gross income definition, solely on the ground of dominion and control.[12] The codification of the *Clifford Regulations* resulted principally in an organizational change in the rules affecting grantor trusts. Relatively few substantive changes occurred; thus, many court decisions in this area decided before codification continue to apply as precedent.

Some changes were made in 1969[13] to the grantor trust rules, and a rule applicable to foreign trusts was added in 1976.[14] Significant changes to the grantor trust rules were made by Congress in 1986 as a part of the adoption of the 1986

Code.[15] In general, these changes expanded the application of the grantor trust rules. Additional changes were made in 1988[16] and the foreign trust rules were added to and amended in 1990[17] and 1996.[18]

## § 4:2 General Rules

Any discussion of the grantor trust rules must start with the general rules applicable to grantor trusts and the controlling definitions.

### *§ 4:2.1 Who Is a Grantor?*

The identification of a trust's grantor was determined under case law until regulations were issued in 2000. The regulations are applicable to transfers to trusts or transfers of interests in trusts made after the 1999 effective date of the regulations.[19] Obviously, a person who creates a trust and funds it is the grantor. The issue is no less clear if the person who creates a trust is not the same person who transfers property to the trust: the property transferor is the grantor. For example, in *Moore v. Commissioner*,[20] a state court order set up a trust to hold the residue of a decedent's estate and the residual beneficiaries of the estate consented to the creation of the trust. The Tax Court ruled that each beneficiary was the grantor to the extent of each beneficiary's interest in the trust. Similarly, in Revenue Ruling 83-25,[21] the Service ruled a minor was the grantor of a trust that was created for the minor by a court order to hold a personal injury award.[22]

In Private Letter Ruling 200620025,[23] a decedent's disabled son was one of four designated beneficiaries of the decedent's IRA. Because the disabled son was eligible for Medicaid, his guardian sought permission of a local court to create a special needs trust for the son and to transfer his interest in the IRA to the trust. The Service ruled that the court created special needs trust was a grantor trust of the decedent's son under sections 671 and 677(a) and that the transfer of the IRA to the trust was not a taxable disposition under section 691(a)(2).

Trusts created by court orders are distinguishable from trusts created by the government, however. For example, in Revenue Ruling 77-230,[24] the United States was determined to be the grantor of a trust set up in settlement of a claim against it, because income in excess of expenses were accumulated and corpus reverted to the United States when the trust terminated.[25]

The 2000 regulations apply to gratuitous transfers and transfers of trust interest made after August 9, 1999.[26] The regulations provide that "a grantor includes any person to the extent such person either creates a trust, or directly or indirectly makes a gratuitous transfer (within the meaning of . . . [Treasury Regulation section 1.671-2(e)(2)]) of property to a trust."[27] The regulations provide three applicable examples:

> Example 1. *A* creates and funds a trust, *T*, for the benefit of her children. *B* subsequently makes a gratuitous transfer to *T*. Under [Treasury Regulation section 1.671-2(e)(1)], both *A* and *B* are grantors of *T*.[28]
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> . . .
>
> Example 7. *A*, *B*'s brother, creates a trust, *T*, for *B*'s benefit and transfers $50,000 to *T*. The trustee invests the $50,000 in stock of Company X. *C*, *B*'s uncle, purportedly sells property with a fair market value of $1,000,000 to *T* in exchange for the stock when it has appreciated to a fair market value of $100,000. Under [Treasury Regulation section 1.671-2(e)(2)(ii)], the $900,000 excess value is a gratuitous transfer by *C*. Therefore, under [Treasury Regulation section 1.671-2(e)(1)], *A* is a grantor with respect to the portion of the trust valued at $100,000, and *C* is a grantor of *T* with respect to the portion of the trust valued at $900,000. In addition, *A* or *C* or both will be treated as the owners of the respective portions of the trust of which each person is a grantor if *A* or *C* or both retain powers over or interests in such portions under sections 673 through 677.[29]
>
> . . .
>
> Example 9. *G* creates and funds a trust, *T1*, for the benefit of *B*. *G* retains a power to revest the assets of *T1* in *G* within the meaning of section 676. Under the trust agreement, *B* is given a general power of appointment over the assets of *T1*. *B* exercises the general power of appointment with respect to one-half of the corpus of *T1* in favor of a trust, *T2*, that is for the benefit of *C*, *B*'s child. Under [Treasury Regulation section 1.671-2(e)(1)], *G* is the grantor of *T1*, and under [Treasury Regulation 1.671-2(e)(1) and (5)], *B* is the grantor of *T2*.[30]

Entities such as partnerships and corporations may be trust grantors.[31] Nevertheless, if the transfer is not for a business purpose of the entity, but rather is for a personal purpose of a shareholder or a partner, the transfer may be reclassified as a constructive distribution to the shareholder or partner. The regulations provide an example: "if a partnership makes a gratuitous transfer to a trust that is for the benefit of a child of a partner, the gratuitous transfer will be treated as a distribution to the partner under section 731 and a subsequent gratuitous transfer by the partner to the trust."[32]

The regulations define a gratuitous transfer as any transfer that is not a transfer for fair market value, whether or not the transfer is a transfer for gift tax purposes.[33] Consideration received by the transferor includes services rendered by the trust, property, or the use of property, but only to the extent of the arm's length value of the services or property received.[34] Consideration does not include an interest in the trust.[35] Distributions on property owned by a trust, such as a dividend on stock, are not gratuitous transfers.[36]

If, however, a person establishes a trust but does not make gratuitous transfers to the trust, that person is not treated as the owner, nor is a person considered an owner even if that person transfers property to the trust if the transferor is reimbursed within a reasonable period of time.[37] The regulations provide an example:

> Example 3. *A*, an attorney, creates a foreign trust, *FT*, on behalf of *A*'s client, *B*, and transfers $100 to *FT* out of *A*'s funds. *A* is reimbursed by *B* for the $100 transferred to *FT*. The trust instrument states that the trustee has discretion to distribute the income or corpus of *FT* to *B* and *B*'s children. Both *A* and *B* are treated as grantors of *FT* under [Treasury Regulation section 1.671-2(e)(1)]. In addition, *B* is treated as the owner of the entire trust under section 677. Because *A* is reimbursed for the $100 transferred to *FT* on behalf of *B*, *A* is not treated as transferring any property to *FT*. Therefore, *A* is not an owner of any portion of *FT* under sections 671 through 677 regardless of whether *A* retained any power over or interest in *FT* described in sections 673 through 677. Furthermore, *A* is not treated as an owner of any portion of *FT* under section 679. Both *A* and *B* are responsible parties for purposes of the requirements in section 6048.[38]

The trust created in the example is a foreign trust, but for the general principal, it should not matter whether the trust is foreign or domestic.

Nevertheless, if a "person creates or funds a trust on behalf of another person, both persons are treated as grantors of the trust."[39] When a grantor's interest in a trust is acquired by another, the transferee becomes the grantor. The regulations provide an example:

> Example 2. *A* makes an investment in a fixed investment trust, *T*, that is classified as a trust under [Treasury Regulation section 301.7701-2(c)(1)]. *A* is a grantor of *T*. *B* subsequently acquires *A*'s entire interest in *T*. Under [Treasury Regulation section 1.671-2(e)(3)], *B* is a grantor of *T* with respect to such interest.[40]

Borrowing from a trust will not make the borrower the grantor of the trust if the loan is at arm's length. The regulations provide:

> Example 6. *A* borrows cash from *T*, a trust. *A* has not made any gratuitous transfers to *T*. Arm's length interest payments by *A* to *T* will not be treated as gratuitous transfers under [Treasury Regulation section 1.671-2(e)(2)(ii)]. Therefore, under [Treasury Regulation section 1.671-2(e)(1)], *A* is not a grantor of *T* with respect to the interest payments.[41]

However, borrowing by the grantor from the trust may result in grantor trust status if section 675 applies.[42]

The regulations distinguish between being the grantor and the owner when a beneficiary of a trust is taxed under the grantor trust rules because of section 678.[43] In this circumstance, the beneficiary is the deemed owner, but not the grantor. The regulations provide:

> Example 4. *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 [Treasury Regulation section 1.671-2(e)(1)] because *B* neither created *T* nor made a gratuitous transfer to *T*.[44]

Thus, the beneficiary of a "crummey" trust of an irrevocable life insurance trust (ILIT) with annual exclusion withdrawal powers will become the owner of a trust to the extent of the crummey withdrawal power, but the beneficiary is not deemed the grantor even after the crummey withdrawal right expires.[44.1]

In some cases, a trust may be set up indirectly. For example, a reciprocal trust may be set up in which *A* creates a trust for *B* in return for *B*'s creation of a trust for *A*.[45] Estate tax authority on reciprocal trusts is plentiful and would probably apply to income tax cases. Other indirect transfers may occur. For example, *A* may furnish other consideration to *B* to create a trust. In such case, *A*, the indirect grantor of the trust for his or his family's benefit, is still treated as the grantor for purposes of these rules.[46]

The Service has not applied the reciprocal trust doctrine, however, when each trust was a grantor trust for its nominal grantor.[47] The nominal grantor should not be treated as the grantor where another provides the consideration.[48] A second

person who makes contributions to a trust originally created by another is treated as the grantor of an appropriate portion of the trust.[49]

### *§ 4:2.2 Portion Rule*

Section 671 provides that where the grantor is "treated as the owner of any portion of a trust," the income, deductions, and credits of "that portion of the trust" are taken into account in computing the taxable income of the owner.[50] This application of the grantor trust rules is carried out in the operative provisions of sections 673 to 679. As a result of the portion rule, it is possible for a grantor to be taxed on some, but not necessarily all, of the income of a trust. The regulations provide that a portion may be ordinary income of a trust, income allocable to corpus, income related to specific trust property, or a fractional share of the income of a trust.[51] The portion rule will tax the grantor on the ordinary income of a trust if the grantor has a sections 674–78 power over only ordinary income portion of a trust.[52] A grantor with a reversionary interest in the principal of a trust under section 673 will be taxed on the gains allocable to principal, even if not taxed on the ordinary income.[53]

The portion rule is discussed in greater depth with grantor trust rules below.

### *§ 4:2.3 Tax Year*

A trust that is entirely a grantor trust is not required to file returns on a calendar year as required generally for non-charitable trusts by section 644, at least if the grantor is a corporation. Instead, the trust's tax year and accounting method for a wholly grantor trust must be the same as the grantor.[54] While it is possible for individuals to be fiscal year taxpayers, it is not common; thus, grantor trusts with individuals as owners will generally be required to file a calendar year return. For corporations filing on a fiscal-year basis, a grantor trust created by the corporation must use the same reporting year as the corporation, if it is a wholly grantor trust.

### *§ 4:2.4 Definitions*

#### [A] Adverse Party and Non-Adverse Party

Section 672(a) defines adverse party as "any person having a substantial beneficial interest in the trust which would be adversely affected by the exercise or nonexercise of the power which he possesses respecting the trust," and includes a person who holds a general power of appointment over the trust property.[55] The term is largely a replacement for references in the 1939 Code and regulations to persons not having a "substantial adverse interest," and the meaning is probably much the same.[56] The use of the word "beneficial" introduced a requirement that an adverse interest be economic.[57] Probably, the power is "exercisable" by such

persons whenever the conditions as to decision-making give them power to act without the approval or consent of others. This conclusion is specified in other sections in the subpart on grantor trusts.[58]

A non-adverse party is anyone who is not an adverse party.[59]

The question of adverse interest is essentially one of fact to be determined by considering in each case the particular interest created by the trust instrument and the relative size of that interest. For example, an interest in income of *$X* a year may be regarded as substantial in one situation, in another it may not be. The regulations provide that an interest is substantial "if its value in relation to the total value of the property subject to the power is not insignificant."[60] In one case, a remainder interest in which the court took to be under 4% was held to be too "slim a restraint" to be adverse as to the entire trust.[61] A beneficiary of the income or corpus ordinarily possesses a substantial beneficial interest that would be adversely affected by a revocation of the trust because revocation would cut off the rights to the property or income.

A trustee is not considered an adverse party solely because of being in the position of trustee.[62] The right of a trustee to commissions so long as the trust exists does not make the interest substantially adverse to that of the grantor.[63]

Generally, the grantor is treated as holding any power or interest that the grantor's spouse holds.[64]

If a person, particularly the grantor, has the power to make himself or herself the trustee, or perhaps even merely to be a substitute trustee (other than substituting one independent trustee for another), it is possible that the person could be treated as having all the powers that normally belong to others as trustee.[65] In at least one case, such a contention for taxability was rejected in view of a "savings clause" in the instrument (perhaps more commonly used as administrative "boilerplate") to the effect that any provisions determined to cause taxability to the grantor would not be operative.[66]

A person may be an adverse party as to one power over the trust, but not as to another power: a person may have a substantial beneficial interest that is adverse to only part of a trust or of its income. For example, an ordinary income beneficiary with a life interest, remainder to the grantor, has an adverse interest as to ordinary income but not as to income allocable to corpus. A remainderman's interest is normally adverse as to powers over corpus but not as to powers over any income interest preceding the remainder. In such cases, there is excluded from attribution to the grantor only that part of the trust as to which the person's exercise or nonexercise of a power would adversely affect the person's own interest.[67] The regulations provide an example:

> [I]f *A*, *B*, *C*, and *D* are equal income beneficiaries of a trust and the grantor can revoke with *A*'s consent, the grantor is treated as the owner of a portion which represents three-fourths of the trust; and items of income, deduction, and credit attributable to that portion are included in determining the tax of the grantor.[68]

The following are examples of cases in which a substantial adverse interest was held to exist where the grantor, together with the persons indicated, retained a power of revocation:

(1) The grantor reserved the power to revoke the trust with the consent of her husband, who was named as a cotrustee. After the wife's death, the husband was to receive the income and also such amounts of corpus as the trustees deemed necessary for his support and maintenance. It was held that although his interest was contingent upon his wife's predeceasing him, he nevertheless had a substantial adverse interest.[69]

(2) The grantor's wife was named the life beneficiary of a trust, with a limited power of appointment over the remainder. She was also one of the trustees. The trust agreement required the consent of all the trustees to revest the corpus in the grantor. It was held that the wife had a substantial adverse interest, and therefore, the capital gains of the trust, which were to be added to corpus, were not taxable to the grantor.[70]

(3) The trust agreement provided that if the grantor-wife predeceased her husband he might cancel the agreement, in which event he would be entitled to receive absolutely the corpus of the trust fund and any undistributed income. The husband was held to have a substantial adverse interest.[71]

(4) The wife created a trust primarily for her children, reserving a power to revoke with her husband. Thereafter the parties were divorced. It was held that the income was not taxable to the grantor-wife because the husband, being liable for the support of the children, had a substantial adverse interest in the trust.[72] Subsequent cases cast doubt on this rule, at least where the income is not actually needed to meet the obligation.[73] As a result, it is not clear whether an indirect interest of this type will suffice, even if the interest has some potential economic significance. But it would appear, at least, from the above examples, that a contingent interest can sometimes suffice.

In the following cases, no substantial adverse interest was found to exist:

(1) A brother and sister were joint grantors and joint beneficiaries, with equal rights. The trust could be terminated by their joint action as beneficiaries. If either should die without leaving lawful issue, the entire interest would pass

to the survivor. There were no children, and there was no indication of any special factors making survival of one beneficiary more likely than the other except for normal actuarial differences.[74]

(2) The grantor named her mother and a trust company as trustees. By direction of the mother any part or all of the corpus could be transferred to the grantor. It was held that the mother did not have a substantial adverse interest, although under local law she could, if destitute, demand support from the grantor; and if the grantor died intestate, she would have an interest in the grantor's estate. The mother's right to the property was considered to be too remote.[75]

(3) A trust instrument provided that the trust could be revoked by a committee with the consent of the grantor's wife. The committee had no interest in the trust. The wife's only interest was that the trustees in their discretion might pay to her any part of the principal or accumulated income. It was held that the wife's interest was not substantially adverse because the trustees were not required to pay her anything, and even that right could have been destroyed by an exercise of the power to amend, given to the committee by the trust instrument.[76]

(4) The grantor's divorced wife, with whom he could revoke, had a remainder that would take effect upon the death of either of her children before age thirty-five without issue; her children each had one child at the time. Her interest was deemed to be too remote.[77]

(5) The grantor reserved the right to revoke with the consent of any beneficiary having "a substantial adverse interest." Nevertheless, the income was held taxable to the grantor on the ground that: "In view of the broad powers of the donor, as trustee, and the family relation, we think it may be reasonably assumed that such a consent would be freely given."[78]

The latter case may reflect a tendency to presume that beneficiaries of a trust who are members of the grantor's family are under his domination and control and consequently, do not have a substantial adverse interest in the trust. Even without a presumption, the cases at least indicate that arrangements under family trusts will be scrutinized carefully to determine whether the beneficial interests of persons who are members of the grantor's family are, in fact, adverse. It has been held under case law before to the 1954 Code, that a wife's interest in a trust created by her husband was not substantially adverse, because of "the normal consequences of family solidarity."[79] But consideration must still be given to the explicit definition in section 672 of nonadverse party enacted by the 1954 Code. On the other hand, it is certainly still a possibility that a wife may have a substantial adverse interest.[80]

### [B] Related or Subordinate Party

A related or subordinate party is a nonadverse party who is:

1. the grantor's spouse if living with the grantor;
2. the grantor's father, mother, issue, brother or sister;
3. an employee of the grantor;
4. a corporation or any employee of a corporation in which the stock holdings of the grantor and the trust are significant from the viewpoint of voting control; or
5. a subordinate employee of a corporation in which the grantor is an executive.[81]

In addition, for purposes of sections 672(f),[82] 674,[83] and 675,[84] related or subordinate persons are "presumed to be subservient to the grantor in respect of the exercise or nonexercise of the powers conferred on [them] unless such [person] is shown not to be subservient by a preponderance of the evidence."[85]

### [C] Powers Subject to a Condition Precedent

A person is considered to have power that is subject to a condition precedent if the condition is giving notice or the expiration of a period of time.[86] Nevertheless, a grantor will not be treated as an owner by reason of such a power if the exercise effects only the beneficial enjoyment of income to be received after a period of time expires, but only if the grantor would not be treated as the owner under section 673, if the power is a reversionary interest.[87] The regulations provide an example:

> [I]f 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 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 [the period of time necessary to satisfy the 5% rule of section 673] . . . , the power does not cause him to be treated as an owner with respect to ordinary income during the term [, the period of time necessary to satisfy the 5% rule of section 673,] has expired.[88]

### [D] Powers and Interest of the Grantor's Spouse

Section 672(e), added to the Code in the Tax Reform Act of 1986[89] and expanded by the Technical and Miscellaneous Revenue Act of 1988,[90] provides

that any power or interest in a trust that is held by the grantor's spouse is considered an interest or power held by the grantor. This rule applies if the grantor was married to the spouse with the interest or power at the time the power or interest was created.[91] However, if the grantor and spouse subsequently legally separated "under a decree of divorce or of separate maintenance," they are not considered married for purposes of the election.[92] In addition, if a person with a power or interest in a trust and the grantor of the trust marry after the trust is created, the grantor is considered to have the interests or powers of the spouse.[93] This rule applies for transfer made to trusts after March 1, 1986.[94]

No regulations have been promulgated for section 672(e). The legislative history of the Technical and Miscellaneous Revenue Act of 1988 provides:

> In addition, the grantor is treated as owner of a trust by virtue of certain powers exercisable by trustees if the grantor's spouse is a trustee or more than half of the trustees are related or subordinate parties subservient to the wishes of the spouse. The grantor also is treated as the owner where the trust makes certain loans to the grantor's spouse.[95]

### [E] Foreign Trust Limitation

Section 672(f) provides a special rule applicable to foreign trusts. It is discussed in detail in section 5:4.

## § 4:3 Trust in Which the Grantor Has Retained a Beneficial Interest or Power— Sections 676 and 673—Revocable Trusts

Section 676(a) provides the general rule that a grantor of a trust is considered to be the owner of any portion of a trust if the grantor or a nonadverse party, or both, or the grantor's spouse[96] have the power to revest title to the portion.[97] Section 676(a) does not apply, however, in situations where the corpus will revert to the grantor automatically at the expiration of a term certain.[98] In that circumstance, the income may be taxed to the grantor under section 673. It is possible also that revocable trusts might fall under section 674,[99] dealing with power to control beneficial enjoyment. However, perhaps reflecting historical distinctions, revocable trusts are separately treated under section 676.

In Private Letter Ruling 200128048, the Service ruled that section 676 was not applicable when trust distributions could be made to the grantor or the grantor's spouse, among other beneficiaries, but only as instructed by a distribution committee consisting of two beneficiaries, other than the grantor or the grantor's spouse, eligible to receive distributions, if they both act jointly or if one acts with grantor because distribution committee members were deemed to have substantial

adverse interests to distributions to any beneficiary and to accumulation of income when grantor held testamentary power of appointment.[100]

Section 676 applies if the power to revest exists, even though it is not exercised in the taxable year. The grantor may be taxed under this section, even if the power is not immediately operative and, thus, the revesting can take effect only in a subsequent year.[101]

It does not apply if the exercise of the power to revest affects "the beneficial enjoyment of the income" for the period that correlates in general with the section 673 rule that permits a reversion after a period of time.[102] Thereafter, the grantor may be treated as the owner if the power has not been relinquished.[103]

The regulations state that a power to revest can be present "regardless of whether the power is a power to revoke, terminate, alter or amend, or appoint."[104] The device or mechanics by which a power to revest may be exercised is immaterial in determining the taxability of the income to the grantor. For example, if the grantor reserves the power to purchase the trust corpus for a nominal consideration, the trust is revocable to the extent of the excess of the value of the property that can be reacquired over the amount to be paid.[105] Similarly, the reservation of broad powers of sale, under which the grantor may buy from or sell to the trust at his own price, is substantially equivalent to a power to revest.[106] The income is likewise taxable to the grantor if a power to terminate the trust is reserved through the retention of a power to appoint an individual other than the grantor to exercise the right to terminate the trust.[107]

Nevertheless, a contingent power is not necessarily covered.[108] Also, a power to substitute securities producing a substantially equal income for securities[109] that constitute the corpus of the trust is not a power to revest, nor is it a power to purchase trust assets at a fair price.[110] The grantor is not taxable under section 676 if the only power retained is the right to direct investments.[111] A power to appoint the remainder by deed or will does not constitute a power to revest.[112] Similarly, a provision that reserves to the grantor a power to change the beneficiaries or to modify the distributive shares is not a power to revest if power cannot be exercised to revest the corpus in the grantor.[113] However, depending upon the existence or absence of other material circumstances, the income of such trusts may be included in the grantor's income under other grantor trust sections of the Code.[114]

A so-called "Totten trust" is a revocable trust taxable to the grantor under section 676.[115]

Whether a trust is revocable or not is a state law issue. The Uniform Trust Code section 602 creates a basic presumption that a trust is revocable unless the trust expressly provides otherwise.[116] This reverses the common law rule that trusts are presumed irrevocable unless a power to revoke was reserved at the time of creation.[117]

## § 4:4 Revocable Trust Problems Common to Other Grantor Trusts—Computation of Taxable Income

The Code provides in detailed sections that, where various powers and controls exist over portions of a trust, the grantor or another person shall be treated "as the owner" of that portion. This is specified to mean that

> there shall then be included in computing the taxable income and credits of the grantor or the other person those items of income, deductions, and credits against tax of the trust which are attributable to that portion of the trust to the extent that such items would be taken into account under this chapter in computing taxable income or credits against the tax of an individual.[118]

This rule (treat like an individual) should not be taken literally in the case of a revocable trust created by a corporation.[119] Thus, for example, if a revocable trust pays a portion of its income to charity, the grantor will include the income in his or her own return and can add the charitable payments with his or her other charitable gifts for purposes of the charitable deduction under section 170.[120]

No such specific rule applies to estates. A grantor's estate is not deemed taxable on trust income, such as capital gain, currently accumulated for distribution to it even where trust income of this nature was taxable to grantor during his lifetime.[121]

Similarly, where income from corpus is taxable to the grantor by reason of a power to revoke, the grantor has been allowed the same deductions related to corpus as would be allowed had the trust not been created.[122] The grantor of such a revocable trust has been allowed to deduct losses on the sale of securities by the trustee.[123] The theory of continued ownership in a revocable trust has been extended to preserve the basis of property transferred in trust, even when special rules exist that normally would change the basis.[124]

The taxable year of the grantor, even in connection with a partial grantor trust, will govern the year in which the grantor must pick up his or her portion of the income.[125]

The regulations describe in detail the rules on the necessary allocation of the appropriate income, deductions, and credits to be made in the case of a grantor who is treated as owner of only a portion of a trust.[126] If any part of the income of a trust is taxable to the grantor or to another person under these sections, it should not be reported on the trust's return, but such income and the applicable deductions and credits should be shown in a separate statement attached to the trust return.[127]

When real property is transferred to a trust with a lease back option, the transfer to the trust is not sufficient to enable the grantor to deduct the rental payments to the trust.[128]

## § 4:5 Trusts with Income for Benefit of Grantor or Spouse

Section 676 deals with the possible return to the grantor of the *corpus* of a trust. On the other hand, section 677 deals with the situation in which the *income* of a trust may be distributed to or used for the benefit of the grantor or accumulated for the grantor—including distribution, use, or accumulation to or for the grantor's spouse.[129] The two provisions complement each other in that they both attempt to tax to the grantor the income of a trust in which the grantor has not surrendered substantially all interest or control. In their construction, therefore, the two sections are governed "by similar considerations."[130]

### *§ 4:5.1 Discretionary Distribution of Income to Grantor or Spouse*

Section 677(a) of the Code provides in part that the grantor shall be treated as the owner of any portion of a trust whose income, without the approval or consent of any adverse party, is or may be, in the discretion of the grantor or a nonadverse party or both, either (1) distributed to the grantor or the grantor's spouse, or (2) held or accumulated for future distribution to the grantor or the grantor's spouse. Four possibilities are covered, all assuming no approval or consent of an adverse party:

(1) income is distributed to the grantor or the grantor's spouse;

(2) in the discretion of the grantor, or nonadverse parties, income may be distributed to the grantor or the grantor's spouse;

(3) income is accumulated for future distribution to the grantor or the grantor's spouse; and

(4) in the discretion of the grantor, or nonadverse parties, income may be accumulated for future distribution to the grantor or the grantor's spouse.[131]

This analysis suggests, as does a literal reading of the Code, that section 677 would except situations where income is actually distributed or accumulated for future distribution to the grantor or his spouse, provided that the distribution or accumulation has to be, and is, with the consent of an adverse party.[132] However, the Committee Reports do not so specify, and the regulations take the opposite view.[133]

For post-October 9, 1969 transfer to trusts, the grantor's spouse is not an acceptable adverse party.[134] The regulations provide, however, that section 677's coverage of income to or for a spouse applies to the income solely during the period of the marriage of that person to the grantor.[135] Generally, the grantor is treated as holding any power or interest that the grantor's spouse holds if the individual was grantor's spouse at the time of the creation of such power or interest or the individual became the grantor's spouse after the creation of the power or

interest (but in this latter case only as to periods after such individual became the grantor's spouse).[136]

It appears that the words "may be" have a double function in categories (2) and (4) above. They cover both discretion and contingencies. First, the words appear to cover income that is subject to distribution to the grantor (or accumulation for the grantor)[137] at the discretion of the grantor or a nonadverse party. Second, in category (2) the words also seem to encompass income that in certain contingencies would have been distributable to the grantor. Similarly, in category (4) they seem to cover income that is (or discretionarily can be) accumulated if accumulated income can in the future be distributed to the grantor either at someone's discretion or upon the happening of a contingency.

The discretionary aspect is most clearly illustrated for category (2) above, which applies to income that is currently subject to discretion. One court stated in regard to the predecessor section: "Section 167 is not concerned with what *is* done under a trust agreement but with what *might be* done. The controlling statutory consideration is the existence of the described discretion, not the way in which that discretion is actually exercised."[138]

Therefore, if the trustees are persons not having a substantial adverse beneficial interest in the disposition of the income and if the income may, in their discretion, be distributed to the grantor or, alternatively, accumulated for someone else, all of such income is taxable to the grantor. Trust instruments frequently provide that the trustees have power to determine which receipts are capital and which are income. However, the relevant test is whether the item is income in the income tax sense.[139] A grantor who is entitled to the income is taxable on the capital gains of a trust if the gains could have been distributed as income, even though nonadverse trustees, in the exercise of their discretion, determine to treat the gains as an addition to corpus.[140] Similarly, even though the trust instrument directs capital gains to be treated as corpus, the grantor is taxable on such gains if the trustees, in their discretion, can invade corpus for his "proper education, care, comfort and support."[141]

The grantor is taxable even though the discretionary power cannot be exercised except in the contingent event that "accident, sickness, calamity, misfortune, adversity, bereavement or loss, financially or otherwise, shall visit" the grantor.[142] The question of how remote the contingency must be before the grantor can escape tax on income that "may be" distributed to him arises also for income that "may be" accumulated for him. The question is discussed below. As to this income that can be distributed to the grantor upon a nonremote contingency, apparently the fact that the contingency has not occurred will not prevent the grantor from being taxed.[143]

Further, similar to the case with revocable trusts, indirect devices by which income may be distributable to the grantor will not overcome the substance. The grantor will be treated as the owner.[144]

### *§ 4:5.2 Accumulation of Income for Future Distribution to Grantor or Spouse*

Under section 677 the income of a trust is taxable to the grantor if, without the approval or consent of an adverse party, it "is" or, in the discretion of the grantor or of a nonadverse party, "may be" held or accumulated for future distribution to the grantor or his spouse in the case of a post-October 9, 1969, transfer in trust. Thus, if the trust instrument provides for the distribution of accumulated income to the grantor upon the happening of some event in the future, the statute presents the problem of whether the nature or the remoteness of the contingency is to be taken into account, or whether the statutory language referring to income that "is" or "may be . . . held or accumulated for future distribution to the grantor" covers every contingent accumulation, regardless of its nature or however remote.

The regulations take the broad position that the grantor is treated as the owner if "he has retained any interest which might, without the approval or consent of an adverse party, enable him to have the income from that portion distributed to him at some time either actually or constructively."[145] The First Circuit has said: "the statute means that if under any circumstances or contingencies any part of the accumulated income might inure to the benefit of the grantor such portion of the income is taxable to him."[146] The instrument in that case provided that the corpus and any accumulated income was to revert to the grantor if he survived his wife, who was named life beneficiary.

But the Board of Tax Appeals declared that it did not think

> that the language of this section covers or was intended to cover the situation where there is no definite provision for such future distribution to the grantor, but only the bare possibility that upon certain contingencies over which the grantor has no control the corpus and accumulations may revert to him."[147]

In that case the corpus and any accumulated income was to revert to the grantor if his son died before the age of thirty and the grantor survived him. Apparently, the rule is that the grantor will be taxable if an eventual distribution to him (personally, during his lifetime) depends upon a contingency but not if the occurrence of the contingency is highly unlikely.[148]

The regulations imply that an accumulation solely for the grantor's estate is permissible: a sentence specifies that the grantor may be deemed the owner, in the

case of a post-October 9, 1969, trust, on an accumulation for the spouse during grantor's lifetime, even where the spouse cannot receive it before the grantor's death.[149] No such statement is extended to possible receipt by grantor's estate. Contrast this with the taxability of a grantor whose estate may enjoy a reversionary interest.[150]

The "income" referred to by section 677 is taxable income. Thus, if capital gains are treated as corpus in a particular trust, and if corpus may eventually be distributed to the grantor, the grantor is taxable on the capital gain.[151]

The regulations indicate that it does not matter when presently accumulated income will be distributed to the grantor or his spouse.[152] However, it does acknowledge one exception: the Code makes section 677 inapplicable "to a power the exercise of which can only affect the beneficial enjoyment of the income for a period commencing after a period such that" a reversionary interest would be permissible under section 673 (in general, where, as of the inception of the trust, the value of the reversionary interest is not greater than 5% for transfers in trust after March 1, 1986, as discussed below and after ten years, for transfers in trust before March 2, 1986).[153] Thereafter, the grantor may be taxable unless the power is relinquished. This exception from section 677 means that for transfers in trust after March 1, 1986, if the *power* cannot be exercised before the initial time period that satisfied the 5% rule to cause the income to be distributed to the grantor or his spouse, or to be accumulated for distribution to the grantor or his spouse, the grantor is not taxable on the income for the time period.[154] Note that the exception is phrased only as to a power, and not as to a requirement of distribution to or accumulation for a grantor or his spouse after the period.[155] The exception does not apply where income of the actual year is accumulated and will be distributed to the grantor or his spouse even only after the qualifying term expires.[156]

It is questionable whether section 677 should be construed to tax the grantor on current income for transfers in trust that cannot be distributed to or accumulated for the grantor or the grantor's spouse even though income of some later year may be so distributed or accumulated (for example, when, upon the grantor's death, after a short life expectancy, income becomes currently distributable to the grantor's widow). Taxing the grantor may in fact be the regulatory intention of the phrase treating the grantor as owner if the grantor or the grantor's spouse may get income "for the taxable year or for a period not within the exception" in the regulations.[157] An implication to the same effect may exist in the last sentence of Treasury Regulations section 1.677(a)-1(e).[158]

### *§ 4:5.3 Satisfaction of Legal Obligations of Grantor or Spouse*

The income of a trust may be considered distributable to the grantor and may be taxed to the grantor under section 677 if that income is or may be devoted by the

grantor or by nonadverse parties to the discharge of an obligation of the grantor or the grantor's spouse. The Supreme Court applied this rule to income that could be used for the support, education, and maintenance of the grantor's minor children.[159] To reverse this decision, Congress added a provision that trust income is not taxable to the grantor merely because, in the discretion of another person, the trustee or the grantor acting as trustee or cotrustee, it may be applied or distributed for the support or maintenance of a beneficiary (other than the grantor's spouse) whom the grantor or the grantor's spouse is legally obligated to support, except to the extent that such income is actually so applied or distributed.[160] In other words, such undistributed income is not treated as income when it may be indirectly distributed to the grantor. It should be noted that this provision applies only if the income, "in the discretion of another person, the trustee, or the grantor acting as trustee or co-trustee, may be applied or distributed for the support or maintenance of a beneficiary (other than grantor's spouse) whom the grantor is legally obligated to support or maintain." If the grantor, individually and not as trustee, retains the right to require that income be expended for the interests of his children, he may be taxed upon the entire trust income.[161]

The exception for support obligations of the spouse is covered in the regulations, perhaps emphasizing that grantor is taxable as to other possible obligations of the spouse.[162] If a distribution is made out of other than current income, it may be taxed to the grantor under the rules as to distributions out of other than income by ordinary trusts.[163]

The extent of the legal obligations of a grantor is generally determined by local law. The obligation that may be discharged need not be an obligation of support. The income of a trust may be taxable to the grantor if, pursuant to a contract or otherwise, the income may be used, for example, to discharge encumbrances on real estate by paying creditors' claims,[164] to discharge a debt of the grantor,[165] or to pay gift or estate taxes on the grantor's estate.[166]

### *§ 4:5.4 Insurance Trusts*

Section 677(a)(3) specifically provides that the grantor is treated as the owner of any portion of a trust from which income, without the approval or consent of any adverse party, is, or in the discretion of the grantor or a nonadverse party, or both, may be applied to the payment of premiums upon policies of insurance on the life of the grantor or, in the post-1969 case, his spouse (except policies of insurance irrevocably payable for a purpose specified in section 170(c), defining charitable contributions). The constitutionality of the predecessor provision to section 677(a)(3) was established in *Burnet v. Wells*.[167] Currently, the Service will not issue rulings or determination letters as to whether the grantor will be considered the owner of any portion of a trust where, among other cases, the trust corpus

consists or will consist substantially of insurance policies on the life of the grantor or the grantor's spouse.[168]

The purpose of section 677 is to prevent the avoidance of income tax by the use of trusts created with income-producing properties to pay the premiums necessary to keep in force insurance policies owned by the same trust.[169] The section makes no distinction between endowment policies and other kinds of policies, such as ordinary life insurance policies, but is equally applicable to all.[170]

The section refers to any portion of a trust from which income is or may be applied to the payment of premiums for policies of insurance "on the life of the grantor." Thus, the section has been inapplicable unless the insurance policies in the trust cover the grantor's life. Because the 1969 amendments to section 677 apply only in respect of property transferred in trust after October 9, 1969, policies on the grantor's spouse can remain significant in old trusts. The effect of the section has been avoided by arrangements under which the grantor of the trust was not the insured under the policies placed in the trust. For example, the Board of Tax Appeals held that a grantor-wife was not taxable where the trust was set up by her under an agreement that provided that current dividends should be used to pay the premiums on life insurance policies on the life of her husband, when the husband had the policies placed in a separate trust.[171]

Notwithstanding the technical creation of a pre-1969 trust by the wife, a husband may be taxable on the income if he is found to be the real grantor. Thus, a husband was held taxable on the income of a funded insurance trust holding policies on his life where shortly before the trust was created he transferred to his wife the property used by her in creating the trust.[172]

Although under section 677(a)(3) the grantor could not be taxed upon trust income used or available for the payment of premiums on policies that did not cover the grantor's life, the grantor may nevertheless be taxed on such income under other provisions of the Code.

In one case,[173] a wife created two trusts from which income was to be used by the trustee to pay premiums on life insurance policies on the life of her husband. She was sole beneficiary of eight policies involved in one of the trusts, and she also had the right to change the beneficiary and could exercise for her own benefit the right to their cash surrender or loan value. The proceeds of the policies in the second trust were payable, via the trustee, to the grantor if she survived her husband. Power to terminate the trusts was vested in the husband. Upon termination of the trusts during the grantor's life, the corpus was to revert to the grantor, and any accumulated income was to go to the husband. The Seventh Circuit held that because the grantor directly or indirectly was the beneficiary under the insurance policies on the life of her husband and was entitled to the cash surrender and loan value of the policies, the income remained, in substance, that of

the grantor, being used to purchase property for her, and consequently was taxable to her under section 167(a)(1) and (2) of the 1939 Code, relating generally to income distributed to or accumulated for the grantor.

Somewhat similarly, it has been held that the grantor-wife is taxable upon the income of a funded insurance trust if the insurance policies on her husband's life are to be used to pay inheritance taxes on her share of her husband's estate with any balance to be paid to her after her husband's death.[174]

Because of the 1969 change in section 677(a)(3) to include the grantor's spouse in the scope of the section, the cases acknowledging the distinctions discussed above will still be potentially applicable when the grantor of the trust is the insured and not husband and wife. For example, similar situations could arise in parent-child arrangements or with domestic partners who are not married but that have significant personal relationships.

It should also be noted that under section 677(a)(3) the grantor is to be taxed not only if the income "is" but also if it "may be" applied to the payment of premiums on policies of insurance on the life of the grantor. Thus, the trust income need not actually be applied to the payment of premiums. It is sufficient if, in the discretion of the grantor or some person without an adverse interest,[175] the income may be applied to the payment of the premiums upon existing policies. However, the policies probably must be in existence during the year.[176] And it seems likely that there must be some positive suggestion by the grantor that income be so used.[177] However, this is not necessary if income is actually so used.[178]

Unresolved is whether the application of section 677(a)(3) is limited to the maximum amount of premium that might be paid. For example, if the premium for a policy on the life of the grantor is $1,000 per year and the trust's taxable income is $30,000 per year, does section 677(a)(3) apply to the entire $30,000 or only to the extent of $1,000, the annual premium?

## § 4:6 Other Grantor Trusts

Before the enactment of the 1954 Code, the statute only contained specific provisions for revocable trusts and retained-income trusts. The 1954 Code added provisions for the taxability of grantors of certain other types of trusts.

The 1954 Code provisions were taken with relatively little change from the detailed *Clifford Regulations*[179] under the 1939 Code. The regulations resulted from *Helvering v. Clifford*,[180] in which the Supreme Court applied the broad definition of taxable income then contained in section 22(a) of the 1939 Code and taxed to the grantor the income of a five-year trust created for the benefit of his wife, for which he retained broad powers of management and control. On the basis of the grantor's retained "bundle of rights" and "in the absence of . . . appropriate

regulations," the Court declared that the grantor "retained the substance of full enjoyment of all the rights which previously he had in the property."[181]

In *Helvering v. Stuart*,[182] the Supreme Court remanded to the Tax Court for a determination, on the facts, whether the grantor was similarly taxable, although it recognized "the impossibility of reversion to the grantors." Thus, a reversion to the grantor after a short term seemed unessential as a reason to tax the grantor.

Both *Clifford* and *Stuart* indicated that no single factor was to be considered controlling, and the two cases did not set up precise standards. A great number of cases were decided by the lower federal courts, variously applying the doctrine of the *Clifford* case.[183] The result was confusion and uncertainty.

This uncertainty was considerably reduced by the Treasury's so-called *Clifford Regulations*, which have now largely been incorporated into the Code.[184] There was not much litigation under the *Clifford Regulations*, although the United States Court of Appeals for the Seventh Circuit in *Commissioner v. Clark*[185] rejected them partly on constitutional grounds, stating that even Congress would be without power to create a conclusive presumption that the short-term trust there involved was taxable. Nevertheless, it was clear that the *Clifford Regulations*, and now the Code, should be carefully followed by taxpayers' attorneys. The 1954 Code sections made little change from the regulations, and most of the changes are liberalizations; on the other hand, it should be noted that it is sometimes possible for the new sections to tax the grantor of a trust on income that was not taxable to him under the regulations. For example, now the broad powers over beneficial enjoyment permitted by section 674(c) are not available in some instances that the *Clifford Regulations* would have permitted if the power could not affect the interests of the spouse or a child of the grantor.[186] Moreover, half of the trustees who can exercise such power must now be independent, whereas under the *Clifford Regulations* one independent trustee with veto power was apparently sufficient.[187] Under changes made by the Tax Reform Acts of 1969, 1976, and 1986, there are additional circumstances not provided for in the *Clifford Regulations* in which the grantor may be treated as the owner of a portion of the trust.

The *Clifford Regulations* and the 1954 and 1986 Code sections depart from the cases in that they make single factors sufficient for taxation of the grantor. The Code thus sets forth three categories in which trust income will be held taxable to the grantor even if the trust is not revocable and income cannot be distributed to or accumulated for the grantor. These three categories are discussed below.

### *§ 4:6.1 Reverter to Grantor*

Before the enactment of the Tax Reform Act of 1986, section 673 of the Code provided that the grantor was treated as the owner of any portion of a trust, regardless of who the beneficiaries may be, if, as of the inception of that portion of

the trust, the corpus or the income therefrom "will or may *reasonably be expected*" to revert to the grantor within ten years commencing with the date of the transfer of that portion of the trust.[188] This provision continues to apply to transfers in trust made before March 2, 1986.[189]

Under section 673, for transfers in trust made after March 1, 1986, subject to one special rule, the grantor is treated as the owner of any portion of the trust in which he has a reversionary interest in either corpus or income, if, as of the inception of that portion of the trust, the value of the interest exceeds 5% of the value of that portion.[190] This means, in effect, that regardless of the length of time before property will revert to the grantor, if the value of the grantor's interest exceeds 5% of the value of the portion, the income, deductions, and credits of the portion will be attributed to the grantor. However, under a special rule, in the case of a beneficiary who is a lineal descendant of the grantor (such as a child) who holds all the "present" interests[191] in any portion of the trust, the grantor is not treated as the owner solely by reason of a reversion to take effect upon the death of that lineal descendant before that beneficiary attains the age of twenty-one years.[192] Conforming amendments were made by the 1986 Act to other grantor trust provisions that substitute the 5% valuation and lineal descendant beneficiary rules for the ten-year rule used previously under the grantor trust provision.[193]

As to the duration question, the test is: What is the expectation as of the time of transfer of each particular portion of or addition to the trust?[194] In determining if the value of the grantor's reversionary interest exceeds 5%, it is assumed that any discretionary powers are exercised in such a way as to maximize the value of the reversionary interest.[195] Also, any postponement of the date specified for the reacquisition of possession or enjoyment of the reversionary interest is treated as a new transfer in trust commencing on the date the postponement is effective and ending on the date prescribed by the postponement.[196] However, income for any such period is not to be attributed to the grantor under this postponement-of-date rule if the income would not be attributed to the grantor in the absence of the postponement.[197]

For transfers in trust before March 2, 1986,[198] it should be noted that the expiration of a specific term of years is not considered necessary to measure the reverter. Section 673, in effect as to transfers in trust before March 2, 1986, is applicable if the reversion of the trust depends upon contingencies that may reasonably be expected to occur in less than ten years.[199] But by specific provision a grantor is not taxable on trust income merely because he has a reversionary interest in the corpus which "is not to take effect in possession or enjoyment until the death of the person or persons to whom the income therefrom is payable," whatever the life expectancy of such person or persons at the time of the creation of the trust.[200] The rule concerning reversion at the death of the grantor illustrates

that the grantor may be taxable even if only the grantor's estate, and not the grantor, can receive the reversion. The test in such a case is the time at which the estate may reasonably be expected to enjoy the reversion.[201]

For transfers in trust both before March 2, 1986, and after March 1986, if the date the reverter will or may occur is postponed, that postponement will be considered to be a new transfer in trust.[202] However, the grantor will not be held taxable during that part of the period of postponement that overlaps the prior period, provided the grantor is not otherwise taxable during such part of the prior period.[203]

It should be noted that section 673 refers to a reversionary interest in the income itself as well as to a reversionary interest in the corpus. Section 677 specifically covers income that may be accumulated for the grantor, although there is some doubt as to what this means. Likely, the duplication is just a case of overlap between the sections. The term "income" as here used probably should not be taken to mean future income, but it is possible that an attempt will be made to tax the grantor on the income of the first years of the trust if the trust's income for a later year within the current greater than 5% in value test is to be distributed to the grantor. A different possible view might be that the term "income" means past income, so that if 2006's income is accumulated to go to the grantor in less than the period applicable to the current greater than 5% in value test, then in 2007 the income earned on the 2006 accumulated income will be taxable to the grantor, even if the 2007 income is not distributed to or accumulated for the grantor.[204]

### *§ 4:6.2 Control over Beneficial Interests*

Section 674(a) provides broadly that the grantor is treated as the owner of any portion of a trust if the beneficial enjoyment of the corpus or the income is subject to a power of disposition exercisable by the grantor, a nonadverse party, or both, without the approval or consent of any adverse party.[205] This provision does not apply if the power is merely a power in the discretion of either another person, the trustee, or the grantor acting as trustee, to apply or distribute income for the support or maintenance of a beneficiary whom the grantor is legally obligated to maintain.[206] This exception correlates with section 677(b), which does not treat such income as distributable to the grantor except to the extent that it is so applied or distributed. Similarly, section 674's rule to tax the grantor, where he or nonadverse parties can control the beneficial enjoyment, does not apply if the power may only affect the beneficial enjoyment of the income for a period commencing after the occurrence of an event such that a grantor would not be treated as the owner under section 673 (using the same criteria as explained above regarding reversionary interests).[207] In that event, the grantor will not be taxable on

the income of the trust during the period before the occurrence but may be taxable thereafter, unless the power is relinquished.

The broad additional exceptions to this sweeping provision determine its real substance. The existence of certain powers will *not* cause the trust income to be taxed to the grantor. These powers are divisible generally into three groups—those permitted to be held by anyone, those that may be held solely by trustees not including the grantor or the grantor's spouse, and those broadest powers permitted to be held only by certain people. The powers permitted to be held by anyone, whether or not as trustee, are:

(1) a power exercisable only by will, except where the income is accumulated for the grantor to appoint or may be accumulated by nonadverse parties for the grantor to appoint; for example, where the trust provides for income to be accumulated during the life of the grantor, then to go to the grantor's appointees by will, the grantor is taxable on the income;[208]

(2) a power to determine the recipients of the corpus or income, if the corpus or income is irrevocably payable to charitable beneficiaries, as specified in section 170(c);[209]

(3) a power to pay out corpus to or for any current-income beneficiary, provided the payment is chargeable against the beneficiary's share held in trust as if it constituted a separate trust *or* to or for any beneficiary (whether or not an income beneficiary), provided that the power is limited by "a reasonably definite standard," which must be set forth in the trust instrument;[210]

(4) a power to distribute or apply income to or for any current income beneficiary, or alternatively, to accumulate the income for the beneficiary, provided the beneficiary (or the beneficiary's estate, or appointees) must ultimately get the income accumulated *or* provided that it must ultimately be payable in fixed shares to current-income beneficiaries, under rules specified in the Code and regulations;[211] and

(5) a power to distribute or apply income to or for a beneficiary, or alternatively, to accumulate and add the income to the corpus, provided the power is exercisable only during (a) the existence of a legal disability of any current-income beneficiary or (b) the period in which the beneficiary is under the age of twenty-one.

In a special second category is a power that must be exercisable solely by trustees and may not be exercisable by, or subject to the approval of, any nontrustee, the grantor, or the grantor's spouse living with the grantor:

(6) a power—not limited, as in (4) and (5)—to distribute, apportion, or accumulate income to or for a beneficiary or beneficiaries or to, for, or

within a class of beneficiaries, *provided* the power is limited by a reasonably definite external standard that is set forth in the trust instrument.[212]

The 1954 Code liberalized this power (number 6) by removing the regulatory requirement that the standard consist of needs and circumstances of the beneficiaries.[213] In Revenue Ruling 54-41,[214] a grantor was held taxable when the grantor retained as trustee a power to distribute or accumulate income pursuant to what may have come close to being a sufficient standard. However, it is doubtful that the standard described therein would have satisfied Treasury Regulations section 1.674(b)-1(b)(5).

The third group of powers consists of extremely broad "sprinkling" powers. They are permitted only if exercisable solely (without the approval or consent of any other person) by trustees, none of whom is the grantor[215] and no more than half of whom are nonadverse parties—the grantor's spouse, living with the grantor; the grantor's father, mother, issue, brother, sister, or employee; a corporation or any employee of a corporation in which the stockholdings of the grantor and the trust are significant from the viewpoint of voting control; or a subordinate employee of a corporation in which the grantor is an executive.[216] Because, for transfers in trust after March 1, 1986, the grantor is treated under section 674(c) as holding any power held by any person treated under section 672(e)(2) as his or her spouse, the prohibited group must also include such a person for purposes of section 674(c) to transfers in trust after March 1, 1986.[217] However, a related or subordinate party is excepted from this limitation if it is shown by a preponderance of the evidence (which probably would be difficult to do) that the person is not subservient to the wishes of the grantor.[218] The test of independent trustees is in some respects a liberalization of the *Clifford Regulations*, but in other respects is stricter.[219]

Permitted powers are, for example, powers held by a trust company and the grantor's daughter as trustees,

(7) to distribute, apportion, or accumulate income to or for a beneficiary or beneficiaries or to, for, or within a class of beneficiaries; and

(8) to pay out corpus to or for a beneficiary or beneficiaries or to or for a class of beneficiaries (whether or not income beneficiaries).

A power does not fall within the scope of any of the foregoing powers except the first two if any person has a power to add beneficiaries to a class of beneficiaries designated to receive the income or corpus, except that children born or adopted after the creation of the trust may be added. Because of power (2) above[220] (that is, a power to determine the recipients of the corpus or income, if irrevocably payable to charitable beneficiaries), it is possible that the ability to add charitable beneficiaries may be deemed permissible. It should be noted that a power to allocate receipts and disbursements between corpus or income is not treated as a

power over beneficial enjoyment of income or corpus, even though it may be expressed in broad language.[221]

### *§ 4:6.3 Administrative Control for Benefit of Grantor*

Section 675 provides that the grantor is treated as the owner of any portion of a trust over which the grantor has certain administrative powers or controls. The following are the situations covered:

(1) Where there is a power in the grantor, nonadverse party, or both, whereby the grantor or anyone else can "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.

(2) Where there is a power in the grantor, nonadverse party, or both, that enables the grantor to borrow corpus or income without adequate interest or security. But if a trustee (other than the grantor) has a general power to make loans without interest or security to persons other than the grantor, the trustee's power to make unsecured loans to the grantor on the same terms and conditions will not cause the trust income to be taxable to the grantor. Apart from this broad exception, both this and first power, are "disapproved" even if held by trustee.[222]

The permissible exception to power (2) is purposely broadened to let the grantor's spouse hold the general power as trustee and to let the power be to lend without interest as well as without security.[223] The exception is generally designed to avoid difficulty with "boiler-plate" provisions in trust instruments. The regulation demonstrates this purpose.[224]

(3) Where the grantor[225] has directly or indirectly borrowed the trust corpus or income and has not completely repaid the loan, including any interest, before the beginning of the taxable year. This rule does not apply to a loan with adequate interest and security made by a trustee other than a related or subordinate party, as defined in the statute. When the rule does apply, if the amounts are on loan during the entire year, the effect will be to offset the grantor's interest deduction by interest income in the same amount.[226]

(4) Where any one of the following powers of administration is exercisable in a nonfiduciary capacity by any person without the approval or consent of anyone in a fiduciary capacity:

    (a) a power to vote or direct the voting of stock or other securities of a corporation in which the holdings of the grantor and of the trust are significant from the viewpoint of voting control;[227]

(b) a power to control investment of trust funds either by directing or vetoing proposed investments or reinvestments to the extent that the trust consists of securities of corporations in which the holdings of the grantor and of the trust are significant from the viewpoint of voting control (apparently broad powers over other types of investments now being permissible);[228] or

(c) a power to reacquire trust corpus by substituting other property of equivalent value.

A power exercisable by a trustee will be presumed to be exercisable in a fiduciary capacity primarily in the interests of the beneficiaries.[229] Under the regulations, if a power is not exercised by a person as trustee, the determination of whether the power is exercisable in a fiduciary or nonfiduciary capacity depends upon "all the terms of the trust and the circumstances surrounding its creation and administration."[230] In general, the regulations indicate that the presence of administrative powers will be judged not only by the provisions of the trust instrument but also by the actual facts of administration.[231] In private rulings the Service has consistently ruled that the application of section 675 is a question of fact that may only be resolved in an examination.[232]

### *§ 4:6.4 Foreign Trust with U.S. Beneficiary*

Grantor trust rules for a U.S. person who directly or indirectly transfers property to a foreign trust are discussed in detail in chapter 5.

### *§ 4:6.5 Taxability of Income to Person Other Than the Grantor*

Although the question in the *Clifford* case was the taxability of trust income to the grantor, in some situations the rule of that case has been extended to tax the income to a person other than the grantor where the powers granted to the other person have enabled the other person to vest the corpus or income in himself or herself.[233]

Similarly, section 678, following the pre-existing regulations,[234] provides that a person other than the grantor is treated as the owner of any portion of a trust over which the person has a power exercisable solely by himself or herself to vest the corpus or the income therefrom in himself or herself.[235] Further, even though such a power has been partially released or otherwise modified so that the person holding it can no longer vest the corpus or the income of the trust in himself or herself, the person continues to be treated as the owner if, after the release or modification, the person has retained such control over the trust as would subject a grantor of such a trust to treatment as the owner.[236]

Section 678(a)(i) distinguishes between "income" and "corpus," although section 643(b) directs that the term "income" (where not modified) means fiduciary accounting income. This direction extends to section 678(b) and other grantor trust rules. Nonetheless, section 678(b) states that section 678(a) does not apply to a power over "income," although the Service appears to apply the exception even as to a power over corpus.[237] In private rulings the Service explains its position: a power over principal may affect income.[238]

For many years, the Service has ruled that if the real grantor of a trust is taxable under sections 671–77, section 678(b) excuses application of section 678 to a beneficiary with a power.[239]

Section 678 is inapplicable to a power that has been renounced or disclaimed within a reasonable period after the holder first became aware of its existence.[240] Moreover, if disclaimer is beyond a reasonable time, apparently section 678 may no longer apply thereafter.[241] In addition, the section is inapplicable to a power over income if the grantor is taxable. No rule exists to determine taxability of the grantor or one or more persons who might fall under this section because of having a power over corpus.

Another exception, contained in section 678(c), makes the entire section inapplicable to a power that enables a person as trustee "merely to apply the income of the trust to the support or maintenance of a person whom the holder of the power is obligated to support or maintain except to the extent that such income is so applied." This parallels the similar provisions for income taxable to grantors. However, the possible implication of the above quotation that a person is taxable where he has a power to and does apply income to a dependent's support (with perhaps a further implication of taxability where he or she must so apply it; for example, a trust for support of the grantor's minor grandchildren with the beneficiaries' father as trustee)[242] might be a tightening of prior law.[243] The Committee Reports describe the provision as a "liberalizing provision,"[244] on the theory that under prior law the holder of the power would have been taxed even if he had not exercised it. The regulations take the position that the holder of such a power is taxable except to the extent that he falls exactly within the exception.[245] On the other hand, probably because of the controversy aroused by section 678(c), the regulations state that section 678(c) has no application to the taxability of income not subject to a power specified in the section, and that the taxability of such income is governed by other provisions.[246]

Apart from this support situation, taxation of a person under section 678 seems avoidable because of the section's requirement that the power be exercisable *solely* by the person who is to be taxed, so a jointly held power is outside the reach of section 678.[247] Moreover, the section may be inapplicable where the power is subject to a reasonable standard.[248]

## § 4:7 Income Tax Reporting Requirements for Grantor Trusts[249]

Although grantor trusts are "ignored" generally for purposes of calculating taxable income of the trust; they are not ignored for purposes of reporting taxable income. Historically, the income, deductions, and credits of trusts were reported on the United States Fiduciary Income Tax Return (Form 1041), if any reporting was required. Because of the rise in popularity of revocable trusts, however, general income tax reporting requirements for trusts were modified to provide that, at least in the case of a revocable trust, where the grantor is the trustee, no income tax return need be filed for the trust. Effective January 1, 1996, the Service issued final regulations on the income tax reporting requirements of grantor trusts.[250] The regulations permit a trustee to file a Form 1041 with a statement attached showing items of income, deductions, and credits or the use the procedure discussed below.[251]

Treasury Regulations section 1.671-4 provides that the trustee of a trust that is a grantor trust in its entirety has two basic options for reporting a trust's income.[252] The trustee may either file the U.S. Fiduciary Income Tax Return (Form 1041) or comply with the provisions of Treasury Regulations section 1.671-4. A trustee may not use the regulation reporting regime, however, if the trust is characterized as

(i) a common trust fund, as defined in section 554;

(ii) a trust that has its situs or any of its assets located outside the United States;

(iii) a trust that is a qualified subchapter S trust;

(iv) a trust all of which is treated as owned by one grantor or one other person who is a fiscal year taxpayer;

(v) a trust all of which is treated as owned by one grantor or one other person who is not a U.S. person; or

(vi) a trust all of which is treated as owned by two or more grantors or other persons, one of whom is not a U.S. person.[253]

If the trust does not fall into one of those ineligible categories, the trustee must first determine whether the trust is treated for income tax purposes as owned by only one person or by more than one person, to ascertain the precise steps a trustee must take to comply with Treasury Regulations section 1.671-4. If the trust has just one grantor (or just one other person which is treated under section 678 as owner of the trust assets), the trustee must follow a particular set of rules.[254] If the trust is treated as owned by two or more grantors or other persons, the trustee follows a different set of rules.[255] *See* Figure 4.1 at the end of the chapter.

In the case of a trust that is a grantor trust in its entirety for one person only,[256] a trustee has two options for complying with the alternatives permitted by Treasury Regulations section 1.671-4. First, the trustee may furnish to all income payors the

*grantor's* name (or the section 678 owner's name) and taxpayer identification number as well as the *trust's* address. The payors then annually send the trustee the Forms 1099. The trustee delivers those to the grantor, who then presumably files them with his or her income tax return. The regulations explicitly provide that the trustee should *not* provide a copy of Form W-9, discussed below, to a payor, because the W-9 shows the grantor's address, not the trust's address (which the regulations require).[257]

It is important to note that for a trustee to be able to report to any income payor the required taxpayer identification information for the trust's grantor (as opposed to the trust itself), the trustee must require the grantor to provide the trustee with a complete Form W-9 or an acceptable substitute Form W-9 signed under the penalties of perjury.[258] If that Form W-9 then indicates that the grantor or other person is subject to backup withholding, the trustee has an affirmative duty to notify all payors of reportable interest and dividend payments of their obligation to backup withhold.[259] Interestingly, however, the trustee does not have a corresponding duty to notify payors that backup withholding is not required, in the event that the Form W-9 does not indicate that the grantor or other trust owner is subject to backup withholding.[260]

In the case of a trust that is a grantor trust in its entirety as to one taxpayer,[261] once the trustee has furnished to each payor the grantor's name and taxpayer identification number, along with the trust's address, the trustee has no further reporting obligations depending on yet another variable: whether or not the trust's grantor is the trustee or co-trustee of the trust. If the grantor is the trustee or co-trustee, the trustee has no further reporting requirements, once the trustee provides the income payors with the grantor's name, taxpayer identification number and the trust's address.[262] A husband and wife are treated as one person for these purposes.[263] Note, however, that the regulations do not specifically address the case of a trust created jointly by husband and wife. In such a case, presumably the trustee satisfies the requirements of the regulations by furnishing either grantor's taxpayer identification number. Note also, that this raises complexities when the husband and wife file separate tax returns. In such a case, it may be advisable for the trustee to furnish both grantors' taxpayer identification numbers.

If the grantor is not the trustee or co-trustee of a particular grantor trust, however, the regulations require the trustee to take another step after providing the payors with the taxpayer identification information for the grantor, described above. The trustee must furnish to the grantor a statement with the following information:

- all of the trust's items of income, deduction, and tax credit for the taxable year;

- identification of the payor of each item of income;
- the information necessary to take the items into account (for example, cost basis) when determining the grantor's own taxable income; and
- notice that the grantor is treated as the owner of all of the trust's income, deductions and credits for the taxable year, and that such information must be included on the grantor's income tax return for that year.[264]

Upon providing this information to the grantor, the trustee has satisfied its reporting obligation and is not required to make any further filings with the Service.[265]

Instead of furnishing to income payors the grantor's name and taxpayer identification number, along with the trust's address, the trustee may choose instead to furnish to all payors the trust's name, taxpayer identification number, and address.[266] If so, each income payor will then issue a Form 1099 to the trustee showing the trust as payee of the particular item of income.[267] The trustee must then file with the Service the appropriate Forms 1099, reporting the income and gross proceeds received during the taxable year, showing the trust as the payor, and showing the grantor as both the owner of the trust and as payee.

Generally speaking, the trustee has the same obligations for filing Forms 1099 with the Service as any payor would have, except that the trustee must report income aggregated by type and must report each item of gross proceeds separately.[268] It is important to note, however, that the amounts that must be included on the Forms 1099 filed by the trustee do not include any information that the original payor would not have reported on a Form 1099.[269] Thus, in the case of a grantor trust that holds partnership units, for example, because the partnership itself does not report its income to its partners on Forms 1099 (it reports income to its partners on Forms K-1), the grantor's share of partnership income and gain is not included on any Forms 1099 filed by the trustee.[270] Note also that in choosing to furnish each payor with the name and taxpayer identification number of the trust, instead of those of the grantor, the trustee has added another layer to the trustee's administrative responsibilities. The trustee must sift through each item of income and deduction to categorize and report it correctly to the grantor. Furthermore, the trustee must understand whether, in the hands of the original payor, the income would have been reportable by the original payor on Form 1099 or not. That may require a commitment of time and expertise that many trustees, including institutional trustees with hundreds of trusts under administration, may not want to make.

Assuming that the trustee has furnished the payors with the trust's name and taxpayer identification number, once the relevant Forms 1099 have been filed by the trustee with the Service, whether the trustee has any further reporting

obligation again turns on whether the grantor is the trustee (or co-trustee) of the trust. If the grantor is a trustee, the trustee has satisfied its responsibilities under Treasury Regulations section 1.671-4. If the grantor is not a trustee, however, the trustee again must provide the grantor with a statement that shows the trust's income, deductions, and tax credits; identifies the payor of each item of income; provides the grantor with information he or she needs to compute his or her own taxable income; and informs the grantor that he or she is treated as the owner of all the trust's income, deductions, and credits, and that such information must be included in the grantor's income tax return for that year.[271]

In the case of a trust that is treated as owned in its entirety by two or more grantors or other persons, the trustee does not have the option to report to all income payors the grantor's name and taxpayer identification number. Instead, the trustee is limited to furnishing to the payors the trust's name, taxpayer identification number, and address.[272] Presumably, that is because in the case of a trust of which the income, deductions, and tax credits are attributable to more than one person, the Service has decided that the trustee, not the initial payor, should be responsible for the allocation of income, for example, between or among trust grantors.

Treasury Regulations section 1.671-4 provides that, after furnishing to each payor the trust's name, taxpayer identification number, and address, each payor will then issue a Form 1099 to the trustee showing the trustee as payor.[273] The trustee then files with the Service the appropriate Forms 1099, reporting the income paid to the trustee as payor and each grantor as payee, in proportion to the grantor's deemed ownership of the trust assets. Thus, again the trustee has the same obligations for filing Forms 1099 with the Service as any payor would have, except that the trustee must report income aggregated by type and each item of gross proceeds separately.[274]

Once Forms 1099 have been filed with the Service, in the case of a trust with multiple owners for income tax purposes, the trustee must furnish statements to each grantor of the trust.[275] As in the case of the statements furnished to a single-grantor trust's owner, each owner of a multiple-grantor trust must receive a statement of the items of income, deductions, and tax credits attributable to the portion of the trust owned by the grantor; the information necessary to compute the grantor's taxable income; and a statement that the grantor must take into account the items of income, deduction, and tax credit shown on the statement.[276]

It is possible to switch between methods.[277] The regulations set forth the steps that a trustee must take to change the reporting method to the method described in Treasury Regulations section 1.671-4(b). The trustee must file a final Form 1041 for the taxable year immediately before the year in which the trustee wishes to begin reporting under Treasury Regulations section 1.671-4(b).[278] On the front of

that Form 1041, the trustee must write: "Pursuant to section 1.671-4(g), this is the final Form 1041 for this grantor trust."[279]

If, in contrast, a trustee has in the past reported trust income pursuant to Treasury Regulations section 1.671-4(b) specifically by furnishing the grantor's name and taxpayer identification number to all payors and the trustee wishes to report in future years by means of Form 1041, the trustee must furnish to the income payors the trust's name, taxpayer identification number, and address.[280] Similarly, if the trustee was reporting pursuant to Treasury Regulations section 1.671-4(b)(2)(i)(B), or (b)(3)(i) (and therefore furnished to the payors the trust's name, taxpayer identification number, and address and filed Forms 1099 with the Service), but the trustee wishes to switch to reporting on Form 1041, in the last taxable year of its compliance with Treasury Regulations section 1.671-4(b) the trustee must file with the Service Form 1096, Annual Summary and Transmittal of U.S. Information Returns, on which it indicates that it is making its final return by such method.[281] Although the regulations refer to the filing of "final" Forms 1041 and "final" Forms 1099 for a trust, they do not contemplate explicitly that an election to report income either by means of Form 1041 or pursuant to Treasury Regulations section 1.671-4(b) is irrevocable. Indeed, by implication, a trustee may comply by a different method from year to year.[282]

## § 4:8 The Termination of Grantor Trust Status[283]

It is the position of the Service that the existence of a wholly grantor trust is ignored for income tax purposes.[284] Such a trust does not appear to be ignored for estate, gift, and generation-skipping transfer tax purposes.[285] In fact, it seems that the use of a grantor trust may help to achieve certain estate planning results.[286] Grantor trusts are used affirmatively to enhance three common estate planning strategies:

(1) to permit the income earned by the trust to grow free of income tax, because the tax burden is imposed upon the grantor, and the payment of the income tax is not a gift;[287]

(2) to permit assets to be sold by the grantor to the trust for their fair market value without the imposition of gift tax[288] or income tax even if the assets sold are appreciated; and

(3) to permit the purchase or exchange by the grantor shortly before death, without the imposition of income tax, of low basis assets in exchange for higher basis assets, such as cash, so the low basis assets will be included in the grantor's gross estate at death and have a basis, once the grantor dies, equal to their estate tax values.[289]

Even if the grantor receives a note in exchange for the transfer of trust assets to the trust, he or she incurs neither income nor gift tax liability at the time of the sale: for gift tax purposes, because the individual taxpayer receives full consideration, the transaction is viewed as a sale and, therefore, is not subject to gift tax;[290] for income tax purposes, on the other hand, because the grantor of the trust is deemed to own all of the assets in the trust,[291] no sale is deemed to occur and, therefore, no part of the gain inherent in the asset becomes taxable by reason of the sale from the grantor to the trust.[292]

### *§ 4:8.1 Termination of Grantor Trust Status During the Grantor's Lifetime*

#### [A] Third-Party Indebtedness

If, during the individual taxpayer's lifetime, a trust ceases to be a grantor trust, the income tax consequences appear to be certain: the grantor is deemed for federal income tax purposes to have transferred the assets in the trust at that time. For example, if there is indebtedness on the assets held by the trust, the grantor will be deemed to have sold them. If liabilities owed to a third party secured by the assets are in excess of the basis of the assets and the grantor does not remain liable for such debt, the grantor will realize gain.[293] By a parity of logic, the trust takes as its basis in the assets the amount of such indebtedness.[294]

#### [B] Grantor Indebtedness

Although some commentators[295] have concluded that gain similarly will be recognized where liabilities secured by the assets are in excess of the basis of the assets and the grantor does not remain liable for such debt, even where the indebtedness is owed not to a third party but to the grantor, no authority so holds and the conclusion may not be correct. Under the official position of the Service, there never is any debt for federal income tax purposes during the period that the trust is a grantor trust.[296] Thus, although the property is treated as though it was transferred from the grantor to the trust at the time grantor trust status ends, the property was not treated at that time as being subject to indebtedness. As a result, authority that holds that the grantor is treated as though the grantor transferred a debt-laden asset when the debt that was recognized as being in existence, for federal income tax purposes, before grantor trust status terminated is inapposite. Nevertheless, where the debt owed on the property is recourse to the trust (at least once grantor trust status terminates during the grantor's lifetime), it seems the grantor is treated as though he or she sold the property to the trust in exchange for the amount of the debt (although timing of recognition of income by the grantor may not be immediate). The result may well be the same where the debt is non-

resource to the trust (that is, the assets are treated as transferred to the non-grantor trust subject to the indebtedness), but there is no authority that discusses the issue; it may be that income is recognized only as the debt is paid off, as section 453 installment reporting is automatic unless elected out of or the asset sold does not qualify for an installment sale.

### *§ 4:8.2 Termination of Grantor Trust Status by Reason of the Grantor's Death*

Where, however, the trust ceases to be a grantor trust as a result of the grantor's death, well developed tax principles seem to support with reasonable certainty that neither the grantor nor his or her estate should be viewed as having made a sale of the assets in the trust. In addition, it appears relatively certain that no income in respect of a decedent[297] is created by reason of the grantor's death for the assets of the trust. Under current law, there does not seem to be a clear answer to what the basis of the assets held in a grantor trust after the death of the grantor is in all cases.

#### [A] Basic Rule of No Gain at Death

Although no section of the Code explicitly addresses the question, the traditional, well-ingrained view is that gain is not recognized by the transferor in connection with a testamentary or lifetime gift.[298] Indeed, some argue that a contrary approach would raise constitutional questions,[299] thereby obliging the courts to avoid any construction that would tax gain at death in the absence of an unambiguous direction from Congress.[300] Not only does the Code fail to contain such a direction, it implicitly reflects the no-gain approach. In section 1001(b) of the Code, the term "amount realized" is defined "as including cash and the fair market value of other property received upon a sale or disposition of an asset." Therefore, in the case of a lifetime gift, which ordinarily does not involve the receipt of any consideration, gain is not recognized.[301] The no-gain implication in section 1001 is consistent with the rule in section 1015 that the donee of a lifetime gift takes, as a general matter, the donor's basis, again implying that the donor does not recognize any gain.[302]

Similarly, in the case of a bequest, there being no consideration, neither the decedent nor the estate is required to recognize gain.[303] In its landmark decision in *Crane v. Commissioner*,[304] the Supreme Court's treatment of the legatee strongly suggests that testamentary gifts do not trigger gain. In *Crane*, the legatee inherited an asset that was encumbered by a liability exactly equal to its fair market value. Given that equality, the Court could have treated the transfer as a sale and given the legatee a cost basis for the purchase under the predecessor of current section 1012 of the Code. Instead, the Court treated it as a devise and, therefore,

determined the legatee's basis under the predecessor of section 1014, which provides, as a general rule, for the basis of each asset included in a decedent's gross estate to be equal to its estate tax value. In refusing to treat the legatee as a purchaser, it tacitly rejected the view that the decedent or the estate had made a sale.

Ironically, many years later, the Supreme Court relied on a different aspect of its analysis in *Crane* to establish an exception to the no-gain rule. In *Diedrich v. United States*,[305] the Court held that, in the case of a lifetime gift under which the donee of the gift agreed to pay the gift tax, *Crane* requires that the donor be treated as having made a sale in-part and as having recognized a gain when the liability encumbering the gifted asset exceeds the donor's basis. The exception recognized by the Court in *Diedrich* has never been applied in the case of a testamentary gift. Indeed, while the regulations under section 1001 do not affirmatively state that the exception to the no-gain rule is limited to lifetime transfers, it would be difficult to read them as contemplating otherwise. Neither the text nor any of the examples of the section 1001 regulations suggest that gain is triggered on a testamentary transfer of an asset encumbered by a liability in excess of the decedent's basis.[306]

Limiting the exception to lifetime transfers is not only consistent with *Crane's* logic but also appears to make sense as a matter of policy. The *Crane* decision can be read as having established two propositions. First, the Court held that the testamentary transfer of an asset that is fully encumbered by liability is to be treated as a bequest or devise, not a purchase. Also, as suggested, that implies that neither the decedent nor the decedent's estate should be viewed as having made a sale. Second, the Court held that when a taxpayer transfers an asset encumbered by a liability, the amount of the liability is to be included in the taxpayer's amount realized in computing gain or loss. These two holdings are somewhat in tension with each other. Under the latter holding, one might conclude that a testamentary transfer of an encumbered asset should result in gain. But, under the former holding, a decedent should not be viewed as having made a sale or taxable disposition at death. The treasury regulations under section 1001[307] implicitly resolve this tension by creating the exception to the no-gain rule only for lifetime transfers. The treasury regulations contain no indication that the exception should be applied in the case of a testamentary transfer.

In terms of policy, the exception to the no-gain rule for lifetime transfers is critical to prevent potential abuse by taxpayers, whereas there is no necessity for such an exception regarding testamentary transfers. In the absence of the exception, a taxpayer could borrow against an asset an amount equal to its value and then "gift" it subject to the liability without recognizing the gain—in effect converting the asset to cash on a tax-free basis. The potential for such abuse makes an exception to the no-gain rule necessary for lifetime transfers. In recognizing the

need for the exception for such transfers in *Diedrich*, the Supreme Court—although ostensibly basing its decision on *Crane*—obviously perceived the policy-based need for the exception. In the case of a testamentary transfer, in contrast, the potential for abuse is much more limited because taxpayers seeking to enjoy the benefit of the no-gain rule must first die to come within its scope. And while, as a matter of policy, it might be contended that a similar exception to the no-gain rule should apply in the testamentary context as well, the justification for extending the exception is certainly not as compelling as the justification for the exception in the lifetime context.[308]

In legislation enacted in 2001,[309] Congress explicitly rejected an exception to the no-gain rule in the testamentary context. In explaining section 1022 of the Code, the new carryover basis at death regime that is scheduled to be operative during the year 2010 (when the estate tax is not operative), the Conference Committee explained: "The bill clarifies that gain is not recognized at the time of death when the estate or heir acquires from the decedent property subject to a liability that is greater than the decedent's basis in the property."[310]

Given that framework, the issue may become should the transfer be treated as lifetime (and, therefore, subject to the exception) or testamentary (and, therefore, not subject to the exception)? Initially, it might appear that the transaction seems more in the nature of a lifetime transfer. After all, the transfer is made by the taxpayer during life into a lifetime trust. On closer scrutiny, however, it would seem more appropriate to treat it as a testamentary transfer. The reason is that when a taxpayer engages in transactions with a grantor trust there are no income tax consequences.[311] That is, transactions between the grantor and a grantor trust are completely disregarded for federal income tax purposes until the trust ceases to be a grantor trust.[312] Consequently, it would seem that, if the trust is to be disregarded for income tax purposes until the grantor's death, the transfer should be viewed as occurring at the time of the grantor's death and, therefore, treated as testamentary in nature. The regulations under section 1001 contain an example where the taxpayer transfers an asset encumbered by a liability to a grantor trust and then, in a subsequent transaction, renounces the power that causes it to be a grantor trust.[313] The example concludes that a sale is deemed to occur (that is, gain must be recognized to the extent that the encumbering liability exceeds the grantor's basis in the asset) at the time the power is renounced, not when the transfer to the grantor trust occurred.[314] That is simply an application of the exception to the no-gain rule for lifetime transfers.[315] In the circumstances of the example, it would be inappropriate to treat the transfer as a testamentary one given that, during the grantor's life, the asset ceases to be owned by the grantor and the donee becomes obligated to discharge the encumbering liability. If the exception were not applicable on those facts, taxpayers would be able to convert their

appreciated assets into cash on a tax-free basis through the simple expedient of making the transfer in three steps: by encumbering the appreciated asset; then contributing it to a grantor trust; and then relinquishing the power that caused it to be a grantor trust.

Treating an incomplete lifetime transfer as if it were a testamentary one is somewhat analogous to the approach taken for wealth transfer tax purposes. Where a power is retained by the grantor at the creation of a lifetime trust that renders the gift incomplete for gift tax purposes, the subsequent termination of the power completes the transaction and triggers a taxable gift at that time.[316] However, if the power terminates because of the grantor's death, it is treated as a testamentary transfer: the gift tax does not apply; instead, the trust corpus is included in the grantor's gross estate.[317] In *DiMarco v. Commissioner*,[318] the government argued that an incomplete gift became complete for federal gift tax purposes and, therefore, subject to the gift tax at the time of the donor's death. The court rejected that argument, holding that the gift tax regulations require that an incomplete lifetime transfer be treated as a testamentary transfer (that is, become subject to estate tax, not the gift tax) where the power making the gift incomplete terminates at the grantor's death. Assuming the same analysis is applied in the income tax setting, a transfer of assets to a grantor trust subject to indebtedness owed to the grantor should be treated as a testamentary transfer that does not trigger gain unless the power or right causing grantor trust status is released before death.[319]

Section 684 of the Code, provides that, as a general rule, a transfer to a foreign trust requires the transferor to recognize all gain inherent in the transferred asset at the time of transfer. The section was clearly designed to apply to lifetime gifts in trust, even in the absence of an encumbering liability.[320] Thus, the section contemplates at least a partial qualification of the no-gain rule. Echoing the notion in the domestic (non-foreign) trust setting that transactions or sales between the grantor and a grantor trust are to be disregarded, section 684(b) provides that the section does not apply and that gain, therefore, is not recognized where the transfer is made to a grantor trust.

The Treasury Department has issued regulations that seem to reveal its views about the no-gain rule in the context of a grantor trust that retains its character as such until the grantor's death. In setting forth the scope of that provision, the regulations address the same questions that arise in the case of a sale to a domestic (U.S.) grantor trust: (1) whether a sale is deemed to occur if the grantor trust status ends during the grantor's lifetime; and (2) whether the cessation of grantor-trust status by reason of the grantor's death triggers gain under the section. As to the first issue, the regulations provide, as do the regulations under section 1001, that gain must be recognized when grantor trust status ends.[321] Unlike the regulations under section 1001, however, which provide that the sale is deemed to occur at the

moment grantor trust status ceases, the section 684 regulations create the fiction that a sale is deemed to occur immediately *before* the cessation of such status.[322] As to the second issue, extending the fiction, the regulations provide that the grantor is deemed to make the sale immediately before death.[323]

As indicated in the preamble to the final regulations to Code section 684, one commentator questioned the authority for abandoning the no-gain-at-death rule.[324] Implicitly recognizing the foundational nature of this rule, the Treasury Department justified its departure from the rule by making an argument specific to section 678 of the Code (which provides that a beneficiary of a trust who is not its grantor may be treated as the owner of the trust for income tax purposes in certain situations). The preamble maintains that the language of the section, particularly when considered against the backdrop of language in sections 679 and 6048(a)(3)(A)(ii) (which provides special and essentially adverse rules for foreign trusts and transfers to foreign trusts), reveals that Congress intended to tax testamentary transfers under section 684.[325] Even so, it seems that the regulations make only a modest departure from the rule, providing that gain need not be recognized if section 1014 of the Code will determine the basis of the assets in the hands of the trustee.[326]

As a consequence, as reflected in the preamble to the section 684 regulations, the Treasury Department acknowledges the foundational nature of the no-gain-at-death rule and the need for a clear indication of Congress's intent before any departure from the rule is warranted. With no such indication from Congress in the context of a sale to a domestic grantor trust, the Treasury Department's apparent logic inexorably leads to the conclusion that the cessation of grantor trust status by reason of the grantor's death does not trigger gain.

In *Frane v. Commissioner*,[327] the Tax Court held that the cancellation of an installment note at the death of the obligee constituted a disposition of the note that triggered gain on the seller's final return under section 453B(f). Although this decision might be viewed as deviating from the no-gain-at-death rule, it should be emphasized that the decedent had elected installment reporting during his life. Under the cited section, a taxpayer electing this method of reporting gain implicitly agrees, in exchange for the privilege of deferring gain, that any cancellation of the note will result in the eventual recognition of the remaining untaxed gain.[328] In contrast, in the case of an installment sale to a grantor trust, no taxable sale or disposition is made by the grantor during life and, of course, no installment-method election is or could be made. Nor has Congress enacted a provision analogous to section 453B(f) that would make death a taxable event as a general matter or that would force the grantor of a grantor trust to recognize gain at death. If the section is relevant at all, it is in its implication that the Code should be understood as embracing the no-gain-at-death rule as generally controlling in the

absence of a specific section to the contrary, such as sections 453B(f) or 684. Of course, the Eight Circuit reversed the Tax Court and held that the balance of the installment note was reportable by the decedent's estate.[329]

In sum, given:

- the constitutional questions that taxing gain at death might raise and the rule that statutes should be construed so as to avoid such questions;
- the fundamental nature of the no-gain-at-death rule; Congress's rejection of a liability-in-excess-of-basis exception to the rule;
- the Supreme Court's implicit recognition of the rule in *Crane*; the Treasury Department's implicit recognition of the rule in the section 1001 treasury regulations and in the drafting of the section 684 treasury regulations;
- the lack of any clear indication from Congress that departure from the rule is appropriate, outside of section 684, where grantor-trust status terminates by reason of the grantor's death; and
- the notion that the assets in a grantor trust are deemed to be owned by the grantor as long as grantor-trust status has not terminated,

it seems nearly certain that there is no viable ground to lead to taxing gain at the death of a grantor with respect to which the trust is indebted at the grantor death.

### [B] Income in Respect of a Decedent

As previously stated, section 1014 provides, as a general rule, that the income tax basis of an asset included in a decedent's estate for federal estate tax purposes is equal to its estate tax value. An exception is created for "income in respect of a decedent" (IRD), described in treasury regulations under section 691.[330] IRD is taxable income to which the decedent was entitled at death (such as accrued interest or the unrecognized gain from a sale being reported under the installment method of reporting) and which is not properly reportable for a period before the decedent's death.

Whether or not IRD is triggered at the death of the grantor where there is indebtedness on property owned by a grantor trust is an issue that seems to be closely related to whether the grantor's death caused gain to be realized at that time. The reason is that, under section 691, any gain attributable to the collection of an installment note constituting IRD would be taxable to the estate (or the beneficiary who receives collection on the note).[331]

Inherent gain will represent IRD where the grantor (or the grantor trust) has made a sale before the grantor's death, which is being recognized under the installment sale rules of section 453. However, the rule applies where *indebtedness is owed to the grantor (or the grantor trust)*. That rule does not, by its terms at

least, apply *where the trust owes indebtedness*, regardless of how the indebtedness arose. As explained above, no income is recognized by the taxpayer or his or her estate by reason of dying and owning property subject to indebtedness, even if the liability exceeds the taxpayer's income tax basis at death.[332] Similarly, where a grantor trust is indebted on property it owns, there should be no gain recognition. Of course, property that a taxpayer owns at death will be included in his or her gross estate for federal estate tax purpose.[333] Property held by a grantor trust may not be. Nevertheless, it does not seem that the result should be any different. As a general rule, IRD means taxable income to which the decedent was entitled at death (but is not properly included in a pre-death income tax return of the decedent).[334] The payment by the grantor trust (treated for federal income tax purposes as paid by the grantor) cannot result in income to the grantor even if the payment is made during the grantor's lifetime. Therefore, there should be no IRD generated by reason of indebtedness owed by the trust to someone other than the grantor.

As mentioned above, there could be indebtedness owed by the trust to the grantor. But that indebtedness should not represent IRD.

The regulations under section 691 provide that where the decedent enters into an agreement providing for a sale that is to occur at the time of death, the sale proceeds do not constitute IRD.[335] Indeed, relying on these regulations, the Tax Court has stated that a sale does not result in IRD where "the sale is only effective upon the decedent's death."[336] Because a sale by the grantor to a grantor trust is ignored for income tax purposes, the earliest moment at which a sale should be viewed as having occurred is immediately after the grantor's death. And because sales occurring at the moment of death are not within the scope of the IRD concept, there is no basis for subjecting such an installment sale to the IRD rules under section 691.

### [C] Trustee's Basis

An additional issue for grantor trusts is: what is the income tax basis of the assets in the grantor trust immediately following the death of the grantor that terminates grantor trust status? There does not seem to be adequately developed law to provide a certain answer.

To attempt to provide an answer, it may be appropriate to characterize the trustee's acquisition. If the trustee is viewed as acquiring the assets by bequest or devise, section 1014 will determine basis, in which case it will equal the fair market value of the assets in the trust on the date of the decedent's death.[337] If, in contrast, the trustee is viewed as acquiring the assets by purchase, the trustee's basis will equal cost under section 1012. Or if the acquisition is viewed as either a

lifetime gift or a transaction that is in part a purchase and in part a gift, section 1015 will govern.[338]

Initially, it might seem that section 1014 is inapplicable if the terms of the grantor trust preclude it from being included in the grantor's gross estate for federal estate tax purposes. Indeed, section 1014 is commonly understood as applying only where the asset is included in the decedent's gross estate. A careful reading of the section, however, suggests more complexity. Although subsection (b)(9) of section 1014 does explicitly depend on estate-tax inclusion, subsection (b)(1) does not. It simply requires that the asset be acquired by bequest, devise or inheritance (or by the decedent's estate from the decedent). Also, the regulation interpreting subsection (b)(1) appears to contemplate that it will only apply in the case of property passing under the decedent's will or under the laws of intestacy.[339] However, neither the regulation nor the statutory language affirmatively preclude transfers made under a lifetime trust from qualifying as a bequest or devise.

In a colloquial sense, only an individual and not a lifetime trust effects a bequest or devise. Nevertheless, assets held by a grantor trust are deemed to be owned by the grantor for federal income tax purposes. Therefore, for federal income tax purposes, it seems that assets held in such a trust may be viewed as passing as a bequest or devise when the trust ceases to be a grantor trust at the moment of death. Ignoring the lifetime character of the transaction under state law in favor of its tax-determined status is not without precedent. The grantor trust example, discussed above, in the section 1001 treasury regulations adopts the tax fiction that the grantor owns a partnership interest that, in fact, is owned for all non-income tax purposes by the trust. And, based on this fiction, the example subjects the grantor to the provisions in Subchapter K of the Code[340] that apply only to taxpayers who actually own a partnership interest. Also, in *DiMarco*, the Tax Court treated the grantor of a lifetime trust as having made a testamentary transfer for tax purposes, even though it clearly would have been viewed as lifetime in character for all other purposes.

The most likely reply to this argument would be based on subsections (b)(2) and (b)(3) of section 1014. They make the section applicable in the case of certain lifetime trusts. In addition, because both of the lifetime trusts described in these subsections would constitute grantor trusts, one might infer in these subsections a negative implication that the assets in a grantor trust cannot be viewed as having been transferred by bequest or devise simply because they are deemed to be owned until death by the grantor (for if that were the case, there would have been no need to include these subsections in section 1014 given subsection (b)(1)). This was presumably the view that the Treasury Department took of the section when it drafted the regulations under section 684. These regulations provide that, where a grantor trust ceases to be such upon the grantor's death, a sale is deemed to occur

immediately before death unless section 1014 determines the trustee's basis in the assets. Thus, the treasury regulations under section 684 reflect the impression that section 1014 does not contemplate that it will apply in every case in which the assets are held in a grantor trust at the time of the grantor's death.

The weakness in that reply is that its premise, the negative implication, is not particularly compelling. None of the various subsections in section 1014 was enacted after the Service issued Revenue Ruling 85-13. Thus, at the time of enactment, it was not at all clear that grantor trusts should be disregarded for all income tax purposes. Indeed, in Revenue Ruling 85-13, in adopting the approach that all transactions between the grantor and a grantor trust should be disregarded for all income-tax purposes, the Service expressly rejected the Second Circuit's then-recent decision in *Rothstein v. United States*.[341] In short, given that history, it would be difficult to infer that, in drafting subsection (b)(1) of section 1014, Congress contemplated that it would not apply to assets in a trust that remained a grantor trust until the grantor's death.

As a matter of policy, the argument that subsection (b)(1) of section 1014 applies to all grantor trusts that terminate at the time of the grantor's death is attractive. Were the rule otherwise, taxpayers would easily be able to circumvent it provided they had access to competent counsel and did not die precipitously. In other words, as the rationale of Revenue Ruling 85-13 suggests, a taxpayer deemed to own the assets of a grantor trust having a basis less than value, if properly advised and assuming death were not completely unexpected, could purchase the assets for cash from the trustee without triggering a gain and thereby make the basis of the assets equal to their value under section 1014. Because it seems to make no sense—and, arguably, would be inequitable—to create an advantage for taxpayers who have more competent counsel or who have an advance indication of the time of their death, it is preferable to read subsection (b)(1) as applicable to all trusts that remain grantor trusts until the grantor's death. That is not to say that the law should continue to permit the estate-tax freeze that sales to such trusts presently provide while, at the same time, allowing the trustee's basis to be determined under section 1014. It is, rather, to say that it would be inappropriate to deny section 1014 treatment where the taxpayer dies without having made the repurchase while permitting such treatment where the taxpayer has the foresight to accomplish the repurchase before death.

Finally, it might be contended, at least where the indebtedness is owed by the grantor trust to the grantor at death, that the presence of an encumbering liability makes it inappropriate to apply section 1014. In other words, if the trustee has given a note to the grantor as consideration for acquiring the assets, it makes more sense to view the transaction as a purchase than as a bequest or devise.[342] This strand of analysis was rejected, however, in *Crane*, where the Supreme Court

applied the predecessor of section 1014 even though the asset acquired by the legatee was encumbered by a liability equal to its value. Consequently, the fact that the trustee undertakes the liability in connection with the acquisition (or, more precisely, the grantor's estate) does not inexorably render section 1014 inapplicable. To be sure, a reply might be made that *Crane* involved a devise and the transaction under inquiry has more of a lifetime flavor. Nevertheless, as indicated, the trust must be ignored for income tax purposes until the grantor's death, so it may be more appropriate to view the trustee's acquisition as a bequest or devise and to apply, therefore, *Crane*'s analysis.

In the alternative, the trustee's acquisition could possibly be viewed as a purchase. Under this view, given the requirement that the transaction be ignored during the grantor's life, the trustee would be treated as having acquired the assets in exchange for the note at the moment of the grantor's death. The trustee's basis would, as a result, be equal to cost under section 1012, which would be the amount of the note (assuming the post-death interest rate on the note is sufficient or the note is immediately payable).[343] This, of course, would have the asymmetrical effect of treating the trustee as having made a purchase while treating neither the decedent nor the estate as having made a sale. But, pointed out above, there is no basis under current law for treating the decedent or the estate as having made a sale where grantor-trust status terminates by reason of the grantor's death.

It seems that the final alternative is to view the trustee as having acquired the assets by lifetime gift. That, of course, implicates section 1015, which provides the basis rule for assets acquired by gift. There are three different rules under section 1015 that might conceivably be employed to determine the trustee's basis.[344]

First, if the acquisition is viewed as a "pure gift" (that is, as if the assets were acquired without any consideration), then section 1015(a) would determine basis.[345] Under this subsection, for purposes of computing gain on any subsequent sale (as well as for purposes of computing depreciation),[346] the trustee's basis in the assets would be equal to the grantor's basis. For purposes of computing loss on any subsequent sale, however, the trustee's basis would be equal to the lesser of (a) the donor's basis or (b) the fair market value of the asset on the date of the gift.[347] The requirement that fair market value be used as the donee's basis for purposes of computing loss, where less than the donor's basis, is designed to prevent the shifting of losses that accrue during the donor's ownership to the donee.

In the case of a loss, one would have to determine the date of the gift because of the requirement that the fair market value on the date of the gift be ascertained. Under the regulations, the donee is treated as acquiring the asset when the donor relinquishes dominion over it. Does this suggest that the date of the gift, for this purpose, is the date of the sale to the grantor trust? But this violates the rule that

transactions between the grantor and a grantor trust be ignored for income tax purposes— and, of course, section 1015 is an income tax provision.[348]

Second, it might be argued that, because of the liability undertaken by the trustee, section 1015(b) should determine the basis. This subsection applies to a transfer in trust other than by gift, bequest or devise. In other words, it contemplates that it will apply where (a) the transfer is in trust, not outright, and (b) there is at least some consideration present.[349]

When it applies, the trustee's basis is equal to the sum of the donor's basis and the amount of gain recognized by the donor on the transfer (or the donor's basis reduced by any recognized loss). The Congressional purpose in creating this differentiation in these two subsections was to prevent the shifting of losses for transactions falling under the former subsection while permitting it for transactions falling under the latter subsection. Apparently, Congress was of the view that abusive loss-shifting strategies that could be deployed in the context of an outright gift were not as problematic where the transfer is made in trust for a consideration. In contrast, in terms of determining basis for purposes of computing gain or depreciation, Congress intended the two subsections to be parallel: basis, for purposes of computing gain or depreciation, would be the same under either subsection.

To illustrate why Congress may have decided it was unnecessary to include a loss-shifting provision in subsection (b) of section 1015, assume a taxpayer owns an asset with a basis of $200,000 and a value of $100,000. If the taxpayer were to sell the asset to a trust for its value of $100,000, the basis of the asset in the hands of the trustee would be $100,000 under subsection (b)—the trustee's basis, under the subsection, would be equal to the taxpayer's basis of $200,000 less the taxpayer's recognized loss of $100,000. Applied in this fashion, subsection (b) does not permit the trustee to deduct a loss on any subsequent sale that accrued economically during the taxpayer's ownership of the asset. Therefore, if so applied, subsection (b) does not permit loss-shifting to occur, making unnecessary the kind of rule designed to prevent it in the context of subsection (a) of section 1015 transactions. It is, however, possible that subsection (b) might, contrary to Congress' expectations, permit loss-shifting. If, in this example, the taxpayer had first created the trust (even if the taxpayer made no contribution of funds) and the loss on the sale to the trust was consequently disallowed because it was a sale between a trust grantor and the fiduciary,[350] the trustee's basis would be $200,000. Thus, the loss that accrued economically during the taxpayer's ownership of the asset is shifted to the trust on a subsequent sale.

Third, the part-sale-part-gift provision contained in the regulations might apply.[351] Under this provision, the trustee's basis would be equal to the greater of (a) the grantor's basis or (b) the amount paid by the trustee.[352] While this provision

is commonly understood as producing a basis in the recipient's hands equal to the sum of the donor's basis and the amount of gain recognized by the donor on the transaction, it might, surprisingly, produce a different result if applied in the context of a sale to a grantor trust. To illustrate, assume that the grantor has an asset with a basis of $1 million and a value of $2 million. If the asset is sold to a grantor trust for $2 million, the part-sale-part-gift provision produces a basis in the hands of the trustee of $2 million (because the consideration paid, $2 million, is greater than the grantor's basis, $1 million). The provision obviously assumes that, to the extent that the recipient has furnished consideration, consideration enters into the grantor's amount realized and is therefore subjected to income tax. But the assumption does not hold if, as earlier suggested, neither the decedent nor the decedent's estate recognizes any gain on the sale. The predicate for invoking this provision is that the transaction be in part a gift and in part a sale. Seeking to limit the trustee's basis to the grantor's basis, the Service would presumably argue in response to any taxpayer argument based on this provision that it does not apply where the sale is for a consideration equal to the asset's value. In terms of planning, therefore, it might be appropriate to consider making the sale for a consideration that is somewhat less than full value.

In sum, it appears that a more compelling argument can be made to have the basis of assets held in a grantor trust at the grantor's death determined under section 1014 than under either section 1012 or 1015.

**Figure 1-1**
**Flowchart of Compliance with**
**Treasury Regulations § 1.671-4(b)**
**(Reporting Requirements)**

1. I.R.C. § 671.
2. *Compare* Blair v. Comm'r, 300 U.S. 5 (1937), *with* Helvering v. Horst, 311 U.S. 112 (1940). For a general discussion of assignment of income principals, *see* Lyon & Eustice, *Assignment of Income: Fruit and Tree as Irrigated by the* P.G. Lake *Case*, 17 TAX L. REV. 293 (1962); supplemented in Eustice, *Contract Rights, Capital Gain, and Assignment of Income The* Ferrer *Case*," 20 TAX L. REV. 1 (1964).
3. Treas. Reg. § 1.671-1(c); H.R. REP. NO. 83-1337, at A212 (1954), *as reprinted in* 1954 U.S.C.C.A.N. 4017, 4089 [hereinafter H.R. REP. NO. 1337]; S. REP. NO. 83-1622, at 365 (1954), *as reprinted in* 1954 U.S.C.C.A.N. 4621,

4719 [hereinafter S. REP. NO. 1622]; *see* Hogle v. Comm'r, 132 F.2d 66, 71 (10th Cir. 1942); *see also* I.R.C. § 704(e) concerning family partnerships.

4. Rev. Rul. 55-38, 1955-1 C.B. 389; Helvering v. Wood, 309 U.S. 344 (1940); Blair v. Comm'r, 300 U.S. 5 (1937).
5. Treas. Reg. § 1.671-1(c).
6. *Id*.
7. Revenue Act of 1924, § 219(g)-(h); *see* Corliss v. Bowers, 281 U.S. 376 (1930) (sustaining the constitutionality of I.R.C. § 219(g)).
8. *See* Douglas v. Willcuts, 296 U.S. 1 (1935) (alimony trust relieving grantor of obligation to support divorced wife); Comm'r v. Schweitzer, 296 U.S. 551 (1935) (trust for support of minor children), *rev'g* 75 F.2d 702 (7th Cir. 1935); *cf.* Helvering v. Fitch, 309 U.S. 149 (1940). Special rules for alimony trusts have subsequently been enacted. *See* section 6:2.
9. Helvering v. Clifford, 309 U.S. 331 (1940). *See* R. OLSON & R. GRADISHAR, SAVING INCOME TAXES BY SHORT TERM TRUSTS (1956); Murray, *Income Taxation of Short-Term and Controlled Trusts*, 1955 U.S. CAL. TAX INST. 497; Paul Lieberman, *Taxation of the Irrevocable Trust: Consequences of Control Exercised by a Party to the Trust*, 116 TR. & EST. 654 (1977); Jay A. Soled, *Reforming the Grantor Trust Rules*, 76 NOTRE DAME L. REV. 375 (Jan. 2001); James W. Colliton, *Standards, Rules and the Decline of the Courts in the Law of Taxation*, 99 DICK. L. REV. 265 (Winter 1995) (discussion of history of grantor trusts in the courts, in the Treasury Department and in Congress). Jerry Horn, *Avoiding and Attracting Grantor Trust Treatment*, 24 ACTEC NOTES 204 (1998). A qualified funeral trust described in I.R.C. § 685 is not a grantor trust. *See* I.R.S. Notice 98-66, 1998-2 C.B. 810, for guidance on the application of amendments made to I.R.C. § 685 by the Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. No. 105-206, 112 Stat. 685 (1998).
10. I.R.C. § 22(a) (1939) (current revision at I.R.C. § 61(a)).
11. Treas. Reg. 118, § 39.22(a)-21 (1939). The relevant regulations under the 1954 Code and 1986 Code sections are Treas. Reg. §§ 1.671-1 through 1.678(d)-1.
12. I.R.C. § 671.
13. Tax Reform Act of 1969 §§ 201(c), 332(a), Pub. L. No. 91-172, 83 Stat. 487, 560, 592 (1969).
14. See discussion of I.R.C. § 679 in section 5:5.
15. Tax Reform Act of 1986 § 1402, Pub. L. No. 99-514, 100 Stat. 2085, 2711 (1986).
16. Technical and Miscellaneous Revenue Act of 1988 § 1014, Pub. L. No. 100-647, 102 Stat. 3342, 3559 (1988).

17. Omnibus Budget Reconciliation Act of 1990 § 11343, Pub. L. No. 101-508, 104 Stat. 1338, 1338 (1990).
18. Small Business Protection Act § 1904, Pub. L. No. 104-188, 110 Stat. 1755, 1910 (1996).
19. T.D. 8890, 2000-2 C.B. 122 (effective after August 9, 1999).
20. Moore v. Comm'r, 23 T.C. 534 (1954).
21. Rev. Rul. 83-25, 1983-1 C.B. 116.
22. *See also*, Priv. Ltr. Rul. 95-02-019 (same where parent as guardian for incompetent creates trust for incompetent with court approval); *see, e.g.*, I.R.C. § 646 (Alaska Native Settlement Trusts); Priv. Ltr. Rul. 97-13-011 (Alaskan Native Corporation apparently treated as grantor of state-chartered settlement trust created with the approval of its shareholders even though the transfer of cash and other assets, other than Alaska Native Claims Settlement Act land, by the corporation to the trust treated as distribution of an economic benefit by the corporation to the shareholders); Rev. Proc. 2003-14, 2003-1 C.B. 319 (providing safe harbor for each American Indian tribe, as therein defined, to be treated as the owner of certain trusts under the grantor trust rules for receipt of revenues under the Indian Gaming Regulatory Act; the trust beneficiaries will not be required to include payments received by the trust in gross income until the taxable year the beneficiaries actually or constructively receive the amounts pursuant to the tax accounting principles of I.R.C. § 451). Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.
23. Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.
24. Rev. Rul. 77-230, 1977-2 C.B. 214.
25. Priv. Ltr. Rul. 89-43-083 (similar as to a county government). Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.
26. Treas. Reg. § 1.671-2(e)(7).
27. Treas. Reg. § 1.671-2(e)(1).
28. Treas. Reg. § 1.671-2(e)(6).
29. *Id.*
30. *Id.*
31. Treas. Reg. § 1.671-2(e)(4).
32. *Id.*
33. Treas. Reg. § 1.671-2(e)(2)(i).
34. Treas. Reg. § 1.671-2(e)(2)(ii).
35. *Id.*

36. Treas. Reg. § 1.671-2(e)(2)(iii).
37. Treas. Reg. § 1.671-2(e)(1).
38. Treas. Reg. § 1.671-2(e)(6). I.R.C. § 6048 imposes certain reporting requirements for foreign trusts.
39. Treas. Reg. § 1.671-2(e)(1).
40. *Id.*
41. *Id*.
42. *See* I.R.C. 675(2)-(3); *supra* section 4:6.3.
43. I.R.C. § 678 is discussed in section 4:6.5.
44. Treas. Reg. § 1.671-2(e)(6).

44.1. However, the Service has continuously ruled that such a beneficiary is not deemed the owner if the grantor is treated as the owner. *See generally* Jonathan G. Blattmachr and Frederick Sembler, *Crummey Powers and Income Taxation*, THE CHASE REVIEW (July 1995).

45. *See* Howard O. Colgan & Robert T. Molloy, *Converse Trusts: The Rise and Fall of a Tax Avoidance Device*, 3 TAX L. REV. 271 (1948); *cf.* United States v. Estate of Grace, 395 U.S. 316 (1969) (estate tax: interrelationship is sufficient without subjective "consideration"); Meek v. Comm'r, T.C. Memo. 1996-236 (although governing California law provides a trust is created only if it has corpus, such corpus can be provided by a *quid pro quo* sale, making the seller the grantor for purposes of I.R.C. § 267, where trust does not otherwise have gratuitously provided corpus). *But cf.* Estate of Newberry v. Comm'r, 201 F.2d 874 (3d Cir. 1953) (estate tax: independent cross trusts); Estate of Ruxton v. Comm'r, 20 T.C. 487 (1953) (estate tax: same); Estate of Bischoff v. Comm'r, 69 T.C. 32 (1977) (estate tax: independent cross trusts with naked I.R.C. § 2036(a)(2) and I.R.C. § 2038 powers without economic interests); Krause v. Comm'r, 497 F.2d 1109 (6th Cir. 1974), *aff'g*, 57 T.C. 890 (1972), *cert. denied* 419 U.S. 1108 (1975).
46. *See* Jackson v. Comm'r, 64 F.2d 359 (4th Cir. 1933); Kraus v. Comm'r, 497 F.2d 1109 (6th Cir. 1974), *aff'g*, 57 T.C. 890 (1972); Priv. Ltr. Rul. 8813039; Chief Counsel Advice 2004-45-025 (Individual who created corporation treated as the grantor of trust to which corporation issued stock). Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.
47. *See, e.g.*, Priv. Ltr. Rul. 95-08-007; Priv. Ltr. Rul. 200340015. Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.
48. Stern v. Comm'r, 137 F.2d 43 (2d Cir. 1943). *See also* Mosby v. United States, 42 A.F.T.R. (P-H) 1095 (W.D. Tenn. 1949); Nicollet County Bank v. Comm'r, B.T.A.M. (P-H) ¶ 39,097 (1939).

49. *See* Stavroudis v. Comm'r, 27 T.C. 583 (1956). *But see* Stern v. Comm'r, 747 F.2d 555 (9th Cir. 1984), *rev'g* 77 T.C. 614 (1981). Field Service Advice 99-52-114 (although concluding that neither trust was a grantor trust with respect to certain trust beneficiaries because they "neither created . . . nor made any gratuitous transfer to the trusts," it added "[w]here settlors only nominally fund a trust they create, and other persons make large gratuitous transfers to the trust, the subsequent transferors may be considered grantors for purposes of the grantor trust rules"). Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.
50. I.R.C. § 671.
51. Treas. Reg. § 1.671-3.
52. Treas. Reg. § 1.671-3(b)(1).
53. Treas. Reg. § 1.671-3(b)(1)(2).
54. Rev. Rul. 90-55, 1990-2 C.B. 161.
55. I.R.C. § 672(a).
56. Gift and estate tax cases are also relevant on adverse interest. In general, on trustee selection, *see* Steven A. Winkelman, *The Trust and the Trustee*, 38 TAXES 569 (1960).
57. *See* 2 A.L.I. FED. INCOME TAX STAT. 454 (Draft Feb. 1954); Baer, *Keeping Control of the Spray Trust in the Family: Income Tax Problems*, 34 TAXES 734 (1956).
58. I.R.C. §§ 674(a), 674(d), 675(1), 675(4), 677; *see also* I.R.C. § 675(3). A special rule is provided for I.R.C. § 674(c); *see also* 2 A.L.I. FED. INCOME TAX STAT. 454 cmt. 3 (Draft Feb. 1954). The Code sections in this whole area are largely taken from the American Law Institute provisions. These sections could be avoided if the powers could be exercised, for example, only with the consent of any one out of ten adverse parties.
59. I.R.C. § 672(b).
60. Treas. Reg. § 1.672(a)-1(a); *see* Paxton v. Comm'r, 57 T.C. 627 (1972), *aff'd* 520 F.2d 923 (9th Cir. 1975), *cert. denied* 423 U.S. 1016 (1976). As a result of amendments, however, a trustee-son may come to have a substantial adverse interest, so the grantor is not taxed. Estate of Paxton v. Comm'r, T.C. Memo. 1982-464, *appeal dismissed* (9th Cir. 1983) (some amendments were nullities as there was no reservation of power to make them); Vercio v. Comm'r, 73 T.C. 1246, 1258 (1980) ("Congress effectively ruled out the possibility of a spouse being treated as an adverse party when a provision in the trust allows for the income to be used for that spouse's benefit.").
61. Paxton v. Comm'r, 520 F.2d 923 (9th Cir. 1975), *cert. denied* 423 U.S. 1016 (1976); *see* Paxton v. Comm'r, T.C. Memo. 1982-464 (reported but

unauthorized changes by trustees to create adverse interest ignored; but son found to have adverse interest in another trust); *see also* May v. United States, 40-2 U.S. Tax Cas. (CCH) ¶ 9,725, 27 A.F.T.R. (P-H) 1167 (W.D. Pa. 1940) ($350 a year out of several thousand).

62. Treas. Reg. § 1.672(a)-1(a).
63. Reinecke v. Smith, 289 U.S. 172 (1933); Morton v. Comm'r, 109 F.2d 47 (7th Cir. 1940) (even though the annual fee was about $700); *cf.* Miller v. Comm'r, 12 T.C.M. (CCH) 506 (1953).
64. I.R.C. § 672(e) (for transfers in trust after March 31, 1986); Technical and Miscellaneous Revenue Act of 1988 § 1019(a), Pub. L. No. 100-647, 102 Stat. 3342, 3593 (1988).
65. Treas. Reg. § 1.674(d)-2(a); Treas. Reg. § 20.2038-1(a)(3) (estate tax); Rev. Rul. 73-21, 1973-2 I.R.B. 15 (estate tax); Walter v. United States, 295 F.2d 720 (6th Cir. 1961) (estate tax); Van Beuren v. McLoughlin, 262 F.2d 315 (1st Cir. 1950) (estate tax), *cert. denied*, 359 U.S. 991 (1959); Corning v. Comm'r, 239 F.2d 646 (6th Cir. 1956), *aff'g* 24 T.C. 907 (1955); Loughridge's Estate v. Comm'r, 183 F.2d 294, 299–300 (10th Cir. 1950) (estate tax), *cert. denied*, 340 U.S. 830 (1950); Stockstrom v. Comm'r, 151 F.2d 353 (8th Cir. 1945), *aff'g* 4 T.C. 5 (1944); *cf.* United States v. Byrum, 408 U.S. 125 (1972), *aff'g* 404 F.2d 949 (6th Cir. 1971) (estate tax: may substitute corporate trustee) (but this case was reversed, in part, by the Tax Reform Act of 1976 by amendment of I.R.C. § 2036); Mathey v. United States, 491 F.2d 481 (3d Cir. 1974) (estate tax); Clark v. United States, 267 F.2d 501 (1st Cir. 1959), *on remand*, 180 F. Supp. 696 (D.M. 1960) (estate tax); Ernest E. Monrad, *Power of Disposition*, 34 TAXES 693, 699 (1956). In Rev. Rul. 79-353, 1979-2 C.B. 325, *modified*, Rev. Rul. 81-51, 1981-1 C.B. 458, the Service held that for certain estate tax purposes powers held by a corporate trustee are attributable to grantor whose only power or interest in the trust is to substitute another corporate trustee. This position was explicitly rejected in Estate of Wall v. Comm'r, 10 T.C. 300 (1993), and then to a large degree disallowed by the Service in Rev. Rul. 95-58, 1995-2 C.B. 191.
66. Oakes v. Comm'r, 44 T.C. 524, 531 (1965); *see also* Estate of Goodwyn v. Comm'r, 1976-238 (not taxable with only "persuasive control"). *But cf.* Rev. Rul. 65-144, 1965-1 C.B. 442.
67. Treas. Reg. § 1.672(a)-1.
68. Treas. Reg. § 1.672(a)-1(b).
69. Shiverick v. Comm'r, 37 B.T.A. 454 (1938).
70. Estate of Childs v. Comm'r, 44 B.T.A. 1191 (1941).
71. Stetson v. Comm'r, 27 B.T.A. 173 (1932).

72. Savage v. Comm'r, 82 F.2d 92 (3d Cir. 1936); Fleischmann v. Comm'r, 40 B.T.A. 672 (1939).
73. Comm'r v. Caspersen, 119 F.2d 94 (3d Cir. 1941), *cert. denied*, 314 U.S. 643 (1941); Loeb v. Comm'r, 113 F.2d 664 (2d Cir. 1940), *cert. denied*, 311 U.S. 710 (1940); *cf.* Treas. Reg. § 1.662(a)-4, which provides, in part, that any amount which, pursuant to the terms of the 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 such person under I.R.C. § 662(a)(1) or § 662(a)(2), whichever is applicable, as though directly distributed to him as a beneficiary, except in cases to which I.R.C. § 71 (relating to alimony payments) or I.R.C. § 682 (relating to income of a trust in case of divorce, etc.) applies.
74. De Amodio v. Comm'r, 299 F.2d 623 (3d Cir. 1962) (the distributability of the income to the grantors was a separate ground under I.R.C. § 677). The sister was five years older than the brother and was not currently married. De Amodio v. Comm'r, 34 T.C. 894, 898, 902 (1960). *But cf.* Priv. Ltr. Rul. 90-16-079 (other trustees, who also are discretionary beneficiaries, are adverse parties as to grantor-trustee where the trustees and others can receive income and corpus in absolute discretion of trustees; direction that there must always be an adverse party trustee ensures grantor-trustee cannot act independently of an adverse party). *See also* Priv. Ltr. Rul. 200148028; Priv. Ltr. Rul. 200247013 (similar). Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.
75. Cushing v. Comm'r, 38 B.T.A. 948 (1938).
76. Fulham v. Comm'r, 110 F.2d 916 (1st Cir. 1940).
77. D.G. McDonald Trust v. Comm'r, 19 T.C. 672 (1953), *aff'd sub nom.* Chase Nat'l Bank v. Comm'r, 225 F.2d 621 (8th Cir. 1955).
78. Cox v. Comm'r, 110 F.2d 934, 936 (10th Cir. 1940), *cert. denied*, 311 U.S. 667 (1940).
79. Altmaier v. Comm'r, 116 F.2d 162 (6th Cir. 1940), *cert. denied*, 312 U.S. 706 (1940); *see* J. RABKIN & M. JOHNSON, FEDERAL INCOME, GIFT AND ESTATE TAXATION § 55.04 (1973).
80. Laganas v. Comm'r, 281 F.2d 731, 735 (1st Cir. 1960); Comm'r v. Katz, 139 F.2d 107 (7th Cir. 1943); Phipps v. Comm'r, 137 F.2d 141 (2d Cir. 1943); Camp v. Comm'r, 195 F.2d 999, 1004 (1st Cir. 1952) (gift tax: extraneous factors do not enter, unless there is some advance agreement to acquiesce). *But see infra* section 4:2.4 [D].
81. I.R.C. § 672(c); Treas. Reg. § 1.672(c)-1.
82. I.R.C. § 672(f) concerns foreign trusts. See discussion at section 5:4.

83. I.R.C. § 674 concerns powers over beneficial interests. See discussion at section 4:6.2.
84. I.R.C. § 675 concerns administrative powers. See discussion at section 4:6.3.
85. I.R.C. § 672(c); *see* Treas. Reg. § 1.672(c)-1.
86. I.R.C. § 672(d).
87. Treas. Reg. § 1.672(d)-1.
88. *Id.*
89. Tax Reform Act of 1986 § 1402, 100 Stat. 2085, 2711 (1986).
90. Technical and Miscellaneous Revenue Act of 1988 § 1014, 102 Stat. 3342, 3559 (1988).
91. I.R.C. § 672(e)(1)(A).
92. I.R.C. § 672(e)(2).
93. I.R.C. § 672(e)(1)(B).
94. *See supra* note 89, § 1401, 100 Stat. 2085, 2711; *see supra* note 90, § 1014, 102 Stat. 3342, 3559.
95. S. REP. NO. 100-445, 100th Cong., 2d Sess. 387 (1988).
96. For transfers in trust after March 1, 1986, the grantor is treated as holding powers that the grantor's spouse holds, under I.R.C. § 672(e). *See* section 4:2.4[D], *supra* for a discussion of when I.R.C. § 472(e) is not applicable.
97. I.R.C. § 676(a).
98. Helvering v. Wood, 309 U.S. 344 (1940).
99. *See* Batson v. Comm'r, T.C. Memo. 1983-545.
100. Priv. Ltr. Rul. 200128048; *see also* Priv. Ltr. Rul. 200247013 (same); Priv. Ltr. Rul. 200502014 (similar); Priv. Ltr. Rul. 200731019 (similar); Priv. Ltr. Rul. 200715005 (similar). Under I.R.C. § 6110(k)(3), neither a National Office Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.
101. I.R.C. §§ 672(d), 676(b); Treas. Reg. §§ 1.672(d)-1, 1.676(b)-1.
102. The measurement of this period, when it is not specifically measured by a term of years or when it is subsequently extended or when the income is payable to charity, is discussed *infra* at section 4:6.1.
103. I.R.C. § 676(b). The Committee Reports (H.R. REP. NO. 1337, *supra* note 3, at 4089, S. REP. NO. 1622, *supra* note 3, at 4714) indicate that the nontaxability of a power to revoke in over ten years (now a much longer period of time under section 673 as amended in 1986) is a change in the law, and the regulations under the 1939 Code (Treas. Reg. 118, § 39.166-1(b)(1)(ii) (1939)).
104. Treas. Reg. § 1.676(a)-1; *see* Krag v. Comm'r, 8 T.C. 1091 (1947) (revocable despite state court); Rev. Rul. 71-548, 1971-2 C.B. 250 (right to cause sale of trust assets, which triggers reversion). In general, however, the appropriate

state law governs the trust relationships. *See* Helvering v. Stuart, 317 U.S. 154 (1942); Rev. Rul. 62-148, 1962-2 C.B. 143 (savings bank deposit "as trustee," so-called New York Totten trust, is revocable); Estate of Stewart v. Comm'r, 436 F.2d 1281 (3d Cir.), *cert. denied*, 404 U.S. 828 (1971) (estate tax: limitations under state law then applicable did not sufficiently prevent discretionary powers from being power to invade charitable remainder).

105. Fisher v. Comm'r, 28 B.T.A. 1164 (1933); *see also* I.R.C. § 675(1), which treats this as a taxable administrative power.
106. Chandler v. Comm'r, 119 F.2d 623 (3d Cir. 1941); *cf.* Heyman v. Comm'r, 44 B.T.A. 1009 (1941).
107. Pulitzer v. Comm'r, 36 B.T.A. 964 (1937); *cf.* Rev. Rul. 79-353, 1979-2 C.B. 325, *modified*, Rev. Rul. 81-51, 1981-1 C.B. 458 (estate tax).
108. Comm'r v. Betts, 123 F.2d 534 (7th Cir. 1941); Comm'r v. O'Keefe, 118 F.2d 639 (1st Cir. 1941); Corning v. Comm'r, 104 F.2d 329 (6th Cir. 1939). Coverage may depend upon the likelihood of the contingency. *See* I.R.C. § 673(a); Treas. Reg. § 1.673(a)-1(c), (d). *But cf.* Treas. Reg. 118, § 39.166-1(b)(1)(ii) (1939). *See* Mills v. Comm'r, 39 B.T.A. 798 (1939); *cf.* I.R.C. § 675(4)(c).
109. Frick v. Driscoll, 41-1 U.S. Tax Cas. (CCH) ¶ 9,187, 29 A.F.T.R. (P-H) 1298 (W.D. Pa. 1941), *rev'd on other grounds*, 129 F.2d 148 (3d Cir. 1942).
110. Palmer v. Comm'r, 40 B.T.A. 1002 (1939), *aff'd*, 115 F.2d 368 (2d Cir. 1940).
111. Maloy v. Comm'r, 45 B.T.A. 1104 (1941).
112. Comm'r v. Bateman, 127 F.2d 266 (1st Cir. 1942).
113. Knapp v. Hoey, 104 F.2d 99 (2d Cir. 1939); Donner v. Comm'r, 40 B.T.A. 80 (1939); Downs v. Comm'r, 36 B.T.A. 1129 (1937). *But cf.* Todd v. Comm'r, 32 B.T.A. 1067 (1935), *aff'd*, 82 F.2d 1020 (2d Cir. 1936).
114. This subject is discussed *infra* in section 4:6.
115. Rev. Rul. 62-148, 1962-2 C.B. 153; *see also* Oppenheimer v. Comm'r, T.C. Memo. 1980-537.
116. UNIF. TRUST CODE § 602 (2005), 7C U.L.A. 546 (2006).
117. 76 AM. JUR. 2D TRUSTS (2005).
118. I.R.C. § 671.
119. Treas. Reg. § 1.671-2(e); Rev. Rul. 57-390, 1957-2 C.B. 326 (also holding that the grantor's fiscal year and method of accounting both apply).
120. Treas. Reg. § 1.671-2(c); H.R. REP. NO. 1337, *supra* note 3, at 4084; S. REP. NO. 1622, *supra* note 3, at 4719. The language of these authorities may suggest that it was intended to permit such a deduction even if the charitable payment was not out of income: a situation in which individuals can take deductions but trusts may not.

121. Rev. Rul. 75-267, 1975-2 C.B. 254.
122. *See* Miller v. Comm'r, 12 T.C.M. (CCH) 506 (1953).
123. Stoddard v. Eaton, 22 F.2d 184 (D. Conn. 1927); Cochran v. United States, 62 F. Supp. 872 (Ct. Cl. 1945); Catlin v. Comm'r, 25 B.T.A. 834 (1932); Boynton v. Comm'r, 11 B.T.A. 1352 (1928).
124. Welch v. Bradley, 130 F.2d 109 (1st Cir. 1942), *cert. denied*, 317 U.S. 685 (1942); *see also* I.T. 3207, 1938-2 C.B. 181 (nature of income as fixed or determinable, annual or periodical).
125. Scheft v. Comm'r, 59 T.C. 428 (1972).
126. Treas. Reg. § 1.671-3; *see* Treas. Reg. § 1.677(a)-1(g); Rev. Rul. 66-161, 1966-1 C.B. 164 (grantor could demand payment over of capital gains added to corpus, which reverts, and must therefore include income attributable to that portion of corpus); *see also* Rev. Rul. 67-241, 1967-2 C.B. 225 (nongrantor "owner" of portion may be taxed less on actual invasion than if she had been ordinary beneficiary); Schmolka, *Selected Aspects of the Grantor Trust Rules*, 9 INST. ON EST. PLAN. ¶ 1400 (1975). In regard to special problems raised by the presence of annuities or capital gains, *see respectively*, Louis A. Del Cotto & Kenneth F. Joyce, *Taxation of the Trust Annuity: The Unitrust Under the Constitution and the Internal Revenue Code*, 23 TAX L. REV. 257, 317B59 (1968); John J. Costello, *Capital Gains Realized by Trusts: Taxation to Persons Other than the Trustee*, 22 TAX LAW. 495, 503-27 (1969); *see also* Note, *Taxation of Capital Gains Realized by Trusts*, 12 TAX L. REV. 99, 103–09 (1956); John R. Howard, *Discretionary Distributions of Current Capital Gains Realized by Trusts*, 116 TR. & EST. 301 (1977). As to determining the portion over which the grantor is the owner, *see* the estate tax cases of Northeastern Pa. Nat'l Bank & Trust Co. v. United States, 387 U.S. 213 (1967) (a "specific portion" qualifying for marital deduction can be computed from a fixed monthly stipend payable to widow) (overruled by Pub. L. No. 102-486, § 1941(a) by adding I.R.C. § 2056(b)(10)); Estate of Tomec v. Comm'r, 40 T.C. 134 (1963) (capitalizes amount needed to produce the first $10,000 of income payable to other beneficiaries, and the rest is for the grantor); *see also* Crane v. Comm'r, 368 F.2d 800 (1st Cir. 1966) (reversionary interest sufficient to require grantor's inclusion of entire income rather than "elaborate calculations"); *see* Benson v. Comm'r, 76 T.C. 1040 (1981) (grantor who borrows past and current years' income of trust treated as owner of entire trust under I.R.C. § 675); Bennett v. Comm'r, 79 T.C. 470 (1982) (grantor who borrows some of prior years' income of trust treated as owner under I.R.C. § 675 of that fractional portion of trust whose numerator is amount of loan at beginning of year and whose denominator is all years' income).

127. *See infra* section 4:7; *see also* Treas. Reg. § 1.671-4; Rev. Rul. 61-175, 1961-2 C.B. 200 (with several grantors). *See also* Rev. Rul. 60-370, 1960-2 C.B. 203, treating a sale of appreciated property as having been made directly by the grantor where grantor, who had an income interest in a trust, had given the property to trustee-remainderman—a tax-exempt university—with instructions to sell the property and reinvest. Some private letter rulings state that inherent gain on property contributed to a charitable remainder trust described in I.R.C. § 664 realized by the trust will be attributed to the grantor if there was an express or implied obligation on the trustee to sell the contributed assets. *See, e.g.*, Priv. Ltr. Rul. 92-25-063. However, more recent private letter rulings state that the gain will not be attributed to the grantor unless the trustee is legally bound or can be compelled to sell the contributed property, *citing* Palmer v. Comm'r, 62 T.C. 684 (1974), *aff'd on other grounds*, 523 F.2d 1308 (8th Cir. 1975), *acq.* 1978-2 C.B. 2, and Rev. Rul. 78-197, 1978-1 C.B. 83. *See, e.g.*, Priv. Ltr. Rul. 94-52-026; Priv. Ltr. Rul. 94-52-020; Priv. Ltr. Rul. 94-13-020. Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.
128. Treas. Reg. § 1.671-1(c); H.R. REP. NO. 1337, *supra* note 3, at 4084, S. REP. NO. 1622, *supra* note 3, at 4719.
129. The provisions concerning the grantor's spouse apply to transfers in trust after October 9, 1969. Treas. Reg. § 1.677(a)-1(a)(1). For the definition of income, see note 151, *infra*, and accompanying text.
130. Front v. Comm'r, 38 B.T.A. 1402, 1404 (1938), *nonacq.* 1939-1 C.B. 48.
131. *See* LaFargue v. Comm'r, 689 F.2d 845 (9th Cir. 1982) (annuitant treated as creditor and not grantor with retained interest for the trust with which taxpayer had exchanged property for lifetime annuity); *cf.* Horstmier v. Comm'r, 46 T.C. Memo. 1983-409 (taxpayer's sale to trust for annuity and trust's creation treated as shams); Lazarus v. Comm'r, 513 F.2d 824 (9th Cir. 1975); Bixby v. Comm'r, 58 T.C. 757 (1972); *see* Priv. Ltr. Rul. 200407002 (transfer of liquidating trust assets to a trust will be treated for all federal tax purposes as a transfer from the bankruptcy estate to the beneficiaries, who apparently are the creditors, followed by a deemed transfer by the beneficiaries to the trust which will be considered a grantor trust; the beneficiaries will be treated as the owners under I.R.C. § 677 where trust agreement provides that the liquidating trustee will make annual distributions to its beneficiaries).
132. 1939 I.R.C. § 167(a)(2) failed even to specify that it applied to income that *is* distributed to the grantor. *See* H.R. REP. NO. 1337, *supra* note 3, at 4089, S. REP. NO. 1622, *supra* note 3, at 4719. The 1954 Code corrected this, at least

apart from the adverse party consent situation. Of course, if any actual distribution to a grantor were excepted from the grantor trust rules, presumably the normal rules of taxability of a trust beneficiary would apply to the grantor.

133. *See* Treas. Reg. § 1.677(a)-1(b)(1), (2). However, *see supra* note 97 and accompanying text.
134. Treas. Reg. § 1.677(a)-1(b)(2).
135. *Id.*
136. I.R.C. § 672(e) (for transfers in trust after March 1, 1986). For purposes of determining whether the individual is married to the grantor at the time of the creation of the interest or power, the individuals are not considered married if they are legally separated under a decree of divorce or of separate maintenance.
137. The latter is category (4) above, and led to taxation of grantors in Humphrey v. Comm'r, 39 T.C. 199 (1962).
138. Rollins v. Helvering, 92 F.2d 390, 395 (8th Cir. 1937), *cert. denied* 302 U.S. 763 (1937); *see also* Greenough v. Comm'r, 74 F.2d 25 (1st Cir. 1934).
139. *See* Treas. Reg. §§ 1.671-2(b), -3(b). I.R.C. § 677 provides the reason why the grantor of a reversionary trust that meets the criteria of I.R.C. § 673 is taxed on most capital gain. *See* Rev. Rul. 81-98, 1981-1 C.B. 40 (no disposition of installment note accelerating gain under I.R.C. § 453 by transfer of note to ten-year-and-one-month trust because taxpayer to receive deferred profit and return of capital, but not interest); *cf.* Springer v. United States, 69-2 U.S. Tax Cas. (CCH) ¶ 9,567 (N.D. Ala. 1969); Rev. Rul. 67-70, 1967-1 C.B. 106; Rev. Rul. 67-167, 1967-1 C.B. 107.
140. Greenough v. Comm'r, 74 F.2d 25 (1st Cir. 1934); Sharp v. Comm'r, 42 B.T.A. 336 (1940); *cf.* Comm'r v. O'Keefe, 118 F.2d 639 (1st Cir. 1941) (general power to allocate does not give trustees discretion as to ordinary dividends).
141. Rollins v. Helvering, 92 F.2d 390 (8th Cir. 1937), *cert. denied*, 302 U.S. 763 (1937).
142. Wenger v. Comm'r, 42 B.T.A. 225 (1940), *aff'd*, 127 F.2d 523 (6th Cir. 1942), *cert. denied*, 317 U.S. 646 (1942).
143. Helvering v. Evans, 126 F.2d 270 (3d Cir. 1942), *cert. denied*, 317 U.S. 638 (1942).
144. Rev. Rul. 68-183, 1968-1 C.B. 308 (sale of stock for lifetime private annuity in amount equal to projected income yield). *See supra* note 131.
145. Treas. Reg. § 1.677(a)-1(c). This language is buttressed by I.R.C. § 672(d). The regulation makes exception for little more than the possibility of

voluntary return by inheritance; *cf.* Rosenblatt v. Comm'r, 8 T.C. 1245 (1947), *acq.* 1947-2 C.B. 4.

146. Kaplan v. Comm'r, 66 F.2d 401, 402 (1st Cir. 1933).

147. Boeing v. Comm'r, 37 B.T.A. 178, 185 (1938), *rev'd on other grounds*, 106 F.2d 305 (9th Cir. 1939), *cert. denied*, 308 U.S. 619 (1939). *But cf.* Estate of Wadewitz v. Comm'r, 32 T.C. 538 (1959) (taxable where grantor had to outlive spouse to receive reversion).

148. Kent v. Rothensies, 120 F.2d 476 (3d Cir. 1941), *cert. denied*, 314 U.S. 659 (1941); Moore v. Comm'r, 39 B.T.A. 808 (1939), *acq.* 1939-2 C.B. 25; May v. Comm'r, 3 T.C.M. (CCH) 733 (1944); Downie v. Comm'r, 46 B.T.A. 937 (1942), *aff'd*, 133 F.2d 899 (6th Cir. 1943); Ayer v. Comm'r, 45 B.T.A. 146 (1941); Baker v. Comm'r, 43 B.T.A. 1029, 1035 (1941) (and cases cited); Ward v. Comm'r, 40 B.T.A. 225 (1939), *rev'd on other grounds*, 119 F.2d 207 (3d Cir. 1941); Rev. Rul. 54-306, 1954-2 C.B. 240; Rev. Rul. 77-230, 1977-2 C.B. 214 (United States held owner of trust it created and over which it had possibility of reverter on accumulated income without discussing probabilities of accumulation or reverter). If eventual distribution will be to the grantor's appointees or heirs, apparently the grantor is not taxable. Comm'r v. Bateman, 127 F.2d 266 (1st Cir. 1942); Goodan v. Comm'r, 12 T.C. 817 (1949), *aff'd*, 195 F.2d 498 (9th Cir. 1952); *cf.* I.R.C. § 674(b)(3).

149. Treas. Reg. § 1.677(a)-1(f) (last sentence).

150. *See* Priv. Ltr. Rul. 200234054 (trust formed by REIT's limited partnership and partnership's wholly owned management corporation to avoid value of securities rule for REITs under I.R.C. § 856(c)(4)(B)(iii)(III), where partnership is trustee and corporation is sole beneficiary apparently not a grantor trust, because ruling holds assets owned by trust are treated as owned by it for purposes of that section and not by REIT). Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

151. Treas. Reg. § 1.677(a)-1(g), Example (2); Rev. Rul. 75-267, 1975-2 C.B. 255; Rev. Rul. 66-161, 1966-1 C.B. 164; Samuel v. Comm'r, 306 F.2d 682 (1st Cir. 1962) (rejecting contention that taxpayer sold the "Dead Sea Scrolls" for an annuity); De Amodio v. Comm'r, 299 F.2d 623 (3d Cir. 1962); Rev. Rul. 58-242, 1958-1 C.B. 251; Comm'r v. Wilson, 125 F.2d 307 (7th Cir. 1942); Graff v. Comm'r, 117 F.2d 247 (7th Cir. 1941); *cf.* Comm'r v. Jergens, 127 F.2d 973, 974–75 (5th Cir. 1942) (not taxable on accumulations whose income might go to grantor). *See* N.Y. EST. POWERS & TRUSTS LAW § 7-1.11 (McKinney Supp. 2002) (adjustment to grantor who is taxed on trust principal); *cf.* Rev. Rul. 75-267, 1975-2 C.B. 254 (capital gains realized after grantor's death are taxable to the trust and not the grantor's estate).

152. Treas. Reg. § 1.677(a)-1(c).
153. *See* section 4:6.1.
154. Treas. Reg. § 1.677(a)-1(e); S. REP. NO. 1622, *supra* note 3, at 4719.
155. *See* Treas. Reg. § 1.677(a)-1(e), (Example).
156. Duffy v. United States, 487 F.2d 282 (6th Cir. 1973), *cert. denied*, 416 U.S. 938 (1974); Humphrey v. Comm'r, 39 T.C. 199 (1962); Treas. Reg. § 1.677(a)-1(f); Rev. Rul. 57-363, 1957-2 C.B. 326.
157. Treas. Reg. §§ 1.677(a)-1(b)(1), 1.677(a)-1(b)(2). For related discussion, *see* Duffy v. United States, 487 F.2d 282 (6th Cir. 1973), *cert. denied*, 416 U.S. 938 (1974).
158. As to the particular textual example of a change becoming effective upon the grantor's death, compare I.R.C. § 673(c), which excepts short-term reversionary interests taking effect at the death of an income beneficiary.
159. Helvering v. Stuart, 317 U.S. 154, 169–71 (1942). Taxation to the grantor of income that could be used to discharge his obligations also was sustained under 1939 I.R.C. § 22(a), which defined gross income. *See* Douglas v. Willcuts, 296 U.S. 1 (1935); Helvering v. Schweitzer, 296 U.S. 551 (1935); Helvering v. Blumenthal, 296 U.S. 552 (1935); Anesthesia Serv. Med. Group, 825 F.2d 241 (9th Cir. 1987) (trust established by corporation to obtain malpractice insurance to pay claims against grantor's employees is grantor trust and no current deduction for contributions to it).
160. I.R.C. § 677(b). Or required to be distributed. Treas. Reg. § 1.677(b)-1(f).
161. Treas. Reg. § 1.677(b)-1(e). As to the determination of the amount of legal obligation of support in this situation, *see* Hopkins v. Comm'r, 144 F.2d 683 (6th Cir. 1944). The case also suggests that where the grantor is taxed because of actual distributions to the beneficiary, it will be difficult for him to show that the obligation was in an amount less than the distribution. *See also* Morrill v. United States, 288 F. Supp. 734 (D. Me. 1964); Peierls v. Comm'r, 12 T.C. 741 (1949). *But cf.* Brooke v. United States, 468 F.2d 1155 (9th Cir. 1972) (no obligation under circumstances under Montana law to furnish private school tuition and music, swimming, and public speaking lessons); Estate of Hamiel v. Comm'r, 253 F.2d 787 (6th Cir. 1958); Wyche v. United States, 36 A.F.T.R.2d ¶ 75-5816 (Ct. Cl. Trial Judge's Op. 1974) (no obligation under South Carolina law under circumstances to furnish private school education or music or dance lessons); Braun v. Comm'r, 48 T.C. Memo. 1984-285 (obligation for private high school for minor children and college for adult children under the circumstances under New Jersey law); Stone v. Comm'r, T.C. Memo. 1987-454 (similar under California law, noting that although questions of parent's obligation to support child generally occur in divorce setting, child's rights are not limited to that

context); *see* Stanley Nitzburg, *The Obligation of Support: A Proposed Federal Standard*, 23 TAX L. REV. 93 (1967); David L. Samuels, *Beware of Trusts for Dependents!* 37 TAXES 1009 (1959); Tomlinson, *Support Trusts and Gifts to Minors*, Proc. of Probate and Trust Law Divisions, A.B.A. (1958); Wood, *Taxability of the Income from a Federal Tax Aspects of the Obligation to Support*, 74 HARV. L. REV. 1191 (1961). *See also* Treas. Reg. § 1.662(a)-4 (last four sentences); *see generally* Marvin Goodson, *When Is Payment In Discharge of Parent's Legal Obligation*, 99 TR. & EST. 17 (1960); Pearle, *Income Tax Consequences of the Support Obligation*, EST., GIFTS & TR. J., Mar.-Apr. 1978, at 4; Note, *The Taxation of Educational Trust Funds: Private Schools and Lessons*, 37 TAX LAW. 205 (1983); Jonathan G. Blattmachr, *Family Income Shifting Techniques*, 43 INST. ON FED. TAX'N ¶ 45.00 (1985).

In considering the effect of "shifting" tax income to a child, it is important to note that under I.R.C. § 1(g), generally, unearned income of a child under age eighteen (and sometimes age twenty-one) is taxed at the higher of the marginal rate of the child or of the child's parents. Note that gain taxed to a trust, of which a parent is the transferor, under I.R.C. § 644 is added to the parent's income for this purpose. I.R.C. § 1(g)(3)(c).

162. Treas. Reg. § 1.677(b)-1(a), (d).
163. Treas. Reg. § 1.677(b)-1(b), (c); Rev. Rul. 74-94, 1974-1 C.B. 26. Rev. Rul. 61-223, 1961-2 C.B. 125, distinguishes this rule requiring actual distributions for taxability from the rule of I.R.C. § 170(b)(1)(D) (before the 1969 amendments), under which a probability or possibility of such a distribution could be deemed a reversionary interest sufficient to prevent a charitable deduction.
164. *See* Wiles v. Comm'r, 59 T.C. 289 (1972), *aff'd,* 491 F.2d 1406 (5th Cir. 1974); Rev. Rul. 54-516, 1954-2 C.B. 54 (grantor remaining liable on mortgage on real estate transferred to trust); Gayton v. Comm'r, B.T.A.M. (P-H) 87,702. *But cf.* Rev. Rul. 64-240, 1964-2 C.B. 172 (charitable pledges are not legal obligations for this purpose); Priv. Ltr. Rul. 82-42-043 (similar as to binding charitable pledge made by corporate grantor before trust created); Rev. Rul. 55-286, 1955-1 C.B. 75 (recognizing a trust that paid annuities and/or gifts to the grantor's employees). Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.
165. Helvering v. Blumenthal, 296 U.S. 552 (1935), *rev'g* 76 F.2d 507 (2d Cir. 1935); Knight v. Comm'r, 39 B.T.A. 436 (1939).
166. Sheaffer v. Comm'r, 313 F.2d 738 (8th Cir. 1963), *cert. denied,* 375 U.S. 818 (1963); Estate of Sheaffer v. Comm'r, 25 T.C. Memo. 1966-126 (related

case); Krause v. Comm'r, 56 T.C. 1242 (1971); Hirst v. Comm'r, 63 T.C. 307 (1974); Downie v. Comm'r, 46 B.T.A. 937, 942–43 (1942), *aff'd,* 133 F.2d 899 (6th Cir. 1943); Rev. Rul. 57-564, 1957-2 C.B. 328 (gift taxes of grantor on creation of trust itself). *But cf.* Comm'r v. Goodan, 195 F.2d 498 (9th Cir. 1952); Estate of Morgan v. Comm'r, 37 T.C. 981, *aff'd,* 316 F.2d 238 (6th Cir. 1962), *cert. denied,* 375 U.S. 825 (1963) (trust agreement required trustees to pay gift tax, which is usually donor's obligation and they had done so by borrowing from a bank; repayment to bank out of income held, with three dissents, not to be payment of grantor's obligation); Estate of Davis v. Comm'r, 30 T.C. Memo. 1971-318, *aff'd per curiam*, 469 F.2d 694 (5th Cir. 1973) (not taxable); Priv. Ltr. Rul. 97-13-011 (neither the Alaskan Native Corporation nor its shareholders treated as owners of a state-chartered settlement trust by the corporation, pursuant to federal law, with the consent of its shareholders, where the assets of the trust are not available to the creditors or to the corporation's creditors other than those creditors of the corporation before the transfer to the trust where corporation expected that its retained assets would be sufficient to discharge existing liabilities and under federal law trust assets are liable to existing creditors only if the corporation's other assets are inadequate). Michael M. Sachs, *Assumption of Indebtedness by a Donee: Income Tax Consequences*, 17 STAN. L. REV. 98 (1964); Peter Somers, *Short-Term and Other Inter Vivos Trusts: Avoiding Current Problems*, 31 J. TAX'N 224, 227 (1969). Neither a Private Letter Ruling nor a Technical Advice Memorandum may be cited or used as precedent. I.R.C. § 6110(k)(3).

167. Burnet v. Wells, 289 U.S. 670 (1933).
168. Rev. Proc. 2007-3, 2007-1 I.R.B. 108; *see* Priv. Ltr. Rul. 90-09-047 (income only charitable remainder trust described in I.R.C. § 664(d)(3) is not grantor trust where proceeds of insurance on life of first of two life recipients, who is the grantor, will be allocable to corpus). Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.
169. *See* Randolph E. Paul, *The Background of the Revenue Act of 1937*, 5 U. CHI. L. REV. 41, 71 (1937).
170. Heffelfinger v. Comm'r, 32 B.T.A. 1232, *aff'd*, 87 F.2d 991 (8th Cir. 1935), *cert. denied*, 302 U.S. 690 (1937).
171. Blumenthal v. Comm'r, 30 B.T.A. 591, *rev'd on other grounds,* 76 F.2d 507 (2d Cir. 1934), *rev'd,* 296 U.S. 552 (1935); *see also* Barbour v. Comm'r, 39 B.T.A. 910 (beneficiary may use income by premiums), *rev'd on other grounds*, 122 F.2d 165 (2d Cir. 1939), *cert. denied,* 314 U.S. 691 (1941); Baldwin v. Comm'r, 36 B.T.A. 364 (1937).

172. Whiteley v. Comm'r, 120 F.2d 782 (3d Cir.), *cert. denied*, 314 U.S. 657 (1941). On indirect grantors, *see supra* text accompanying note 45. *Cf.* Bel v. United States, 452 F.2d 683 (5th Cir. 1971); Detroit Bank & Trust Co. (Ritter Estate) v. United States, 467 F.2d 964 (6th Cir. 1972), *cert. denied,* 410 U.S. 929 (1973); Leder v. Comm'r, 89 T.C. 3468 (1987); Ronk v. Comm'r, T.C. Memo. 1988-432.
173. Comm'r v. Morton, 108 F.2d 1005 (7th Cir. 1940); *see* Priv. Ltr. Rul. 80-14-078 (grantor gets interest deduction of trust). *But see* Rev. Proc. 81-37, 1981-2 C.B. 592 (Internal Revenue Service will not rule). Neither a National Office Technical Advice Memorandum nor a Private Letter Ruling can be cited or used as precedent. I.R.C. § 6110(k)(3).
174. Phipps v. Helvering, 124 F.2d 288 (D.C. Cir. 1941); *see also* Comm'r v. Van Dusen, 138 F.2d 510 (6th Cir. 1943), *cert. denied*, 321 U.S. 776 (1943) (invoking old I.R.C. § 22(a)).
175. Rieck v. Comm'r, 41 B.T.A. 457 (1940) (indirectly paid via beneficiaries), *aff'd*, 118 F.2d 110 (3d Cir. 1941); *cf.* Todd v. Comm'r, 32 B.T.A. 1067, 1070 (1935), *aff'd*, 82 F.2d 1020 (2d Cir. 1936).
176. Comm'r v. Mott, 85 F.2d 315 (6th Cir. 1936); Weil v. Comm'r, 3 T.C. 579 (1944); Moore v. Comm'r, 39 B.T.A. 808 (1939). *But cf.* Priv. Ltr. Rul. 88-52-003 (indicates that merely authorizing the trustee in the trust instrument to purchase policies on the life of the grantor and pay premiums from income or corpus, or both, causes I.R.C. § 677(a)(3) to apply). Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.
177. *See* Corning v. Comm'r, 104 F.2d 329, 333 (6th Cir. 1939); Foster v. Comm'r, 8 T.C. 197, 205 (1947); *cf.* Dunning v. Comm'r, 36 B.T.A. 1222 (1932) (taxable where grantor's suggestion to beneficiary was not in trust instrument), *appeal dismissed*, 97 F.2d 999 (4th Cir. 1938). *But cf.* Cent. Hanover Bank & Trust Co. v. Hoey, 74 F. Supp. 770 (S.D.N.Y. 1947); Booth v. Comm'r, 3 T.C. 605 (1944) (not taxable where independent act of beneficiary); Rev. Rul. 66-313, 1966-2 C.B. 245 (second trust, whose beneficiaries were the grantor's children and who agreed to have that trust pay life insurance premiums on policy owned by first trust created by same grantor, was grantor trust under I.R.C. § 677(a)(3) to the extent so paid despite no provision in second trust to so pay); *see also* Priv. Ltr. Rul. 88-39-008 (taxable "because the insurance premiums paid by . . . Trust . . . exceeds . . . the taxable income of . . . Trust," despite prohibition that trust accounting income could not be used to pay premiums and corpus did not consist of policies). *But cf.* Priv. Ltr. Rul. 87-01-007 (not a grantor trust under I.R.C. § 677(a)(3) where trust includes policy on grantor's life but trust agreement

prohibits use of ordinary income or gain for payment of premiums). Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

178. Foster v. Comm'r, 8 T.C. 197, 205 (1947); Rand v. Comm'r, 40 B.T.A. 233 (grantor was trustee), *aff'd*, 116 F.2d 929 (8th Cir. 1939), *cert. denied*, 313 U.S. 594 (1941).
179. Treas. Reg. 118, § 39.22(a)-21 (1939).
180. Helvering v. Clifford, 309 U.S. 331 (1940).
181. *Id.* at 335–36.
182. Helvering v. Stuart, 317 U.S. 154 (1941); *cf.* Hormel v. Helvering, 312 U.S. 552 (1941); Helvering v. Fuller, 310 U.S. 69 (1940).
183. Erwin R. Griswold, *A Plan for the Coordination of the Income, Estate, and Gift Tax Provisions with Respect to Trusts and Other Transfers*, 56 HARV. L. REV. 337, 339 (1942).
184. T.D. 5488, 1946-1 C.B. 19; T.D. 5567, 1947-2 C.B. 9, *amending* Treas. Reg. 111, §§ 29.22(a)-21, 29.161-1, 29.162-1, 29.166-1, 29.166-2 (1939); *see also* Lazarus v. Comm'r, 513 F.2d 824 (9th Cir. 1975) ("sale" for private annuity deemed creation of trust with reserved life interest); Krause v. Comm'r, 497 F.2d 1109 (6th Cir. 1974) (trusts not bona fide family partners), *cert. denied*, 419 U.S. 1108 (1975); Van Zandt v. Comm'r, 341 F.2d 440, 444 (5th Cir.), *cert. denied*, 382 U.S. 814 (1965) (trust factors, while permissible, can bear upon business purpose: taxpayer cannot deduct rent on business premises in building he gave to ten-year reversionary trust); Brooke v. United States, 468 F.2d 1155 (9th Cir. 1972) (holding similar rent deductible); Iber v. United States, 409 F.2d 1273 (7th Cir. 1969); Mathews v. Comm'r, 520 F.2d 323 (5th Cir. 1975); Thomas D. Aitkin, *Coping with the Tough New Court Tests for Deductions in Leaseback Situations*, 44 J. TAX'N 47 (1976); Quinlivan v. Comm'r, 599 F.2d 269 (8th Cir. 1979), *cert. denied,* 444 U.S. 996 (1979); Lerner v. Comm'r, 71 T.C. 290 (1978), *acq. in result* 1984-1 C.B. 1; May v. Comm'r, 76 T.C. 7 (1981), *aff'd*, 723 F.2d 1434 (9th Cir. 1984); Rosenfeld v. Comm'r, 43 T.C. Memo. 1982-263, *aff'd*, 706 F.2d 1277 (2d Cir. 1983); Evans v. United States, 572 F. Supp. 74 (C.D. Ill. 1983); *see* Orbach & Reiner, *IRS Approves Third-Party Gift Leasebacks*, TAX HOTLINE, Jan. 1985, at 6 (suggesting that the "IRS has now taken the position that it will no longer litigate gift-leaseback transactions where the lessee is a third party—*i.e.*, a corporation—*unless* the third party is a partnership or an S corporation," apparently on the basis of the Service's acquiescence in the result in *Lerner*); *cf.* Gatto v. Comm'r, 1 F.3d 826 (9th Cir. 1993) (taxpayer who created reversionary trust and immediately borrowed trust fund for note could not deduct interest because debt not genuine).

185. Comm'r v. Clark, 202 F.2d 94, 100 (7th Cir. 1953), *aff'g* 17 T.C. 1357 (1952) (upholding short-term charitable trust that antedated the regulations), *limited in* Rev. Rul. 54-48, 1954-1 C.B. 24, and *questioned in* Note, *The Seventh Circuit v. The Clifford Regulations: "Due Process" Emancipates the Tax Avoider*, 62 YALE L.J. 1236 (1953); *see* Thuet v. Riddell, 104 F. Supp. 521 (S.D. Cal. 1952); Estate of Stockstrom v. Comm'r, 7 T.C. 251, 254–55 (1946), 6 T.C.M. 268 (1947), *vacated,* 164 F.2d 697 (8th Cir. 1947). *But cf.* Kay v. Comm'r, 178 F.2d 772, 773 (3d Cir. 1950); Farkas v. Comm'r, 170 F.2d 201, 204–05 (5th Cir. 1948); Shapero v. Comm'r, 165 F.2d 811 (6th Cir.), *cert. denied,* 334 U.S. 844 (1948); George E. Cleary, *The Clifford Regulations Reexamined*, 12 INST. ON FED. TAX'N 741 (1954).
186. Treas. Reg. 118, § 39.22(a)-21(d)(2)(iv)(a)(2) (1939).
187. *See generally* James P. Johnson, *Trusts and the Grantor*, 36 TAXES 869 (1958); Anderson A. Owen, *Tax Planning for the Beneficiary*, 36 TAXES 876 (1958).
188. *See generally*, and in particular with regard to a device that the 1969 amendments to section 677 will now restrict, Maurice S. Spanbock & Israel Katz, *An Attractive Trust Proposal: The Short-Term Accumulation for a Spouse,* 14 J. TAX'N 258 (1961); Harry Yohlin, *The Short-Term Trust—A Respectable Tax-Saving Device*, 14 TAX L. REV. 109 (1958).
189. Section 1402(a) of the Tax Reform Act of 1986. Apparently, it also continues to apply to any transfer in trust made after March 1, 1986, pursuant to a binding property settlement agreement entered into on or before March 1, 1986, to the extent it required the taxpayer to establish a grantor trust and for the transfer of a specified sum of money or property to the trust by the taxpayer. Tax Reform Act of 1986 § 1402(c)(2), 100 Stat. 2085 (1986).
190. As a result of changes, discussed above, to I.R.C. § 672 made by the Tax Reform Act of 1986, the grantor generally is treated as the owner of any portion of the trust (contributed after March 1, 1986) in which the value of the grantor's spouse's interest in corpus or income exceeds 5% of the value of such portion.
191. No definition of "present interests" is provided under I.R.C. § 673. It may or may not have the same meaning as for gift tax purposes. *See* I.R.C. § 2503(b).
192. I.R.C. § 673(b).
193. *See* I.R.C. §§ 674(b)(2), 676(b), 677(a).
194. Rev. Rul. 56-601, 1956-2 C.B. 458; *see also* Bibby v. Comm'r, 44 T.C. 638 (1965) (period does not commence until valid conveyance of the property). *But see* Priv. Ltr. Rul. 99-06-015 (minor member of Indian tribe is owner of trust to receive, hold and invest payments for tribal members for gaming proceeds and the tribe is not the owner pursuant to I.R.C. § 673, because,

despite the possibility of reverter to the tribe, no reasonable assumption exists that the possibility that the minor having issue who would succeed to interest upon minor's death may be ignored or discounted). Neither a Private Letter Ruling nor a National Office Technical Advice Memorandum may be cited or used as precedent. I.R.C. § 6110(k)(3).

195. I.R.C. § 673(c).
196. I.R.C. § 673(d).
197. *Id*. *See* Priv. Ltr. Rul. 91-52-034 (indicating that if total actuarial interests of grantor in trust of which grantor retained right to annuity payments for a term and contingent reversion to take effect only if grantor died during annuity term exceeds 5%, the grantor is the owner of the entire trust); *see also* Priv. Ltr. Rul. 89-23-017 (grantor taxed on trust income where payment (1) to trust to prepay cost of funeral would revert if funeral business company ends or (2) is used to pay grantor's funeral expenses); *cf*. Priv. Ltr. Rul. 99-06-015 (minor beneficiary, who is a member of Indian tribe that creates trust, is treated as trust owner under I.R.C. § 677, and not tribe under I.R.C. § 673, because, despite reversionary interest to tribe, no reasonable assumption exists that would permit possibility of minor dying without issue who could take remainder). Neither a Private Letter Ruling nor a National Office Technical Advice Memorandum may be cited or used as precedent. I.R.C. § 6110(k)(3).
198. Which applies after 1969 (except generally for transfers in trust after March 1, 1986), even if there is a charitable beneficiary.
199. It seems that similar rules should apply to the not more than 5% reversionary value rule in effect for transfers in trust after March 1, 1986. Note, however, that, in determining if the value exceeds 5%, it is assumed that any discretionary powers are exercised so as to maximize the value of the reversionary interest. I.R.C. § 673(c).
200. I.R.C. § 673(c) as in effect for transfers in trust before March 2, 1986. Where reversion will be at the death of a grantor whose own expectancy is less than ten years, the grantor is taxable. Treas. Reg. § 1.673(a)-1(c); Rev. Rul. 73-251, 1973-1 C.B. 324; Rev. Rul. 75-267, 1975-2 C.B. 255.
201. Rev. Rul. 58-567, 1958-2 C.B. 365; Rev. Rul. 56-601, 1956-2 C.B. 458. Both revenue rulings were modified by Rev. Rul. 73-251, 1973-1 C.B. 324, solely as to the appropriate actuarial table. *Cf.* Thuet v. Riddell, 104 F. Supp. 521 (S.D. Cal. 1952), which held that an eighty-four-year-old grantor who was entitled to $300 annually from the corpus of a $5,000 trust was not taxable.
202. I.R.C. § 673(d).
203. *Id*.

204. *Cf.* Comm'r v. Jergens, 127 F.2d 973 (5th Cir. 1942). *See also supra* text accompanying notes 151–58 (as to the possibility of taxation of the grantor if income of a later year can go to him). *Compare* the different language of I.R.C. § 2037(b) as to reversionary interests under the estate tax.
205. Wysong v. Comm'r, T.C. Memo. 1988-344 (grantor who borrows funds from banks, loans same to trust, is taxable on trust's income under I.R.C. § 674(a), because loan is repayable to grantor upon demand, which court states enables "him to exercise complete control over the beneficial enjoyment of corpus at any time"); Kushner v. Comm'r, T.C. Memo. 1991-26 (similar); Batson v. Comm'r, T.C. Memo. 1983-545, *aff'd*, 758 F.2d 652 (6th Cir. 1985) (applying I.R.C. § 674(a) to revocable trust nominally for grantor's daughter); Carson v. Comm'r, 92 T.C. 72 (1989) (grantor taxable where a trustee made unequal distributions to his children when the instrument was silent as to each child's share, despite grantor's claim that they had to be equal); *see also* Priv. Ltr. Rul. 91-26-015 (trust will be grantor trust under I.R.C. § 674(a) only after the nonadverse party becomes empowered under trust terms to affect beneficial enjoyment of trust property without consent of any adverse party, and not before); Priv. Ltr. Rul. 93-15-010 (direction that trustee, who will later have power to control beneficial enjoyment, must be subservient, related or subordinate party will make a trust a grantor trust at that time). Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.
206. I.R.C. § 674(b)(1).
207. I.R.C. § 674(b)(2).
208. *See* Priv. Ltr. Rul. 200148028; Priv. Ltr. Rul. 200247013; Priv. Ltr. Rul. 200502014 (not a grantor trust where distributions could be made to grantor or grantor's spouse, among other beneficiaries, only as instructed by distribution committee consisting of two beneficiaries, other than grantor or grantor's spouse, eligible to receive distributions, if they both act jointly or one acts with grantor, because each distribution committee member was deemed to have substantial adverse interest to distributions to any other beneficiary and to accumulation of income for the grantor's testamentary power of appointment); *see also* Priv. Ltr. Rul. 200731019; Priv. Ltr. Rul. 200715005. Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.
209. *See* Winthrop v. Meisels, 281 F.2d 694 (2d Cir. 1960) (gift to such trust deductible by individual); John Danz Charitable Trust v. Comm'r, 18 T.C. 454, 461–62 (1952), *aff'd*, 231 F.2d 673 (9th Cir. 1955), *cert. denied*, 352 U.S. 828 (1956); Rev. Rul. 53-194, 1953-2 C.B. 128.

210. The Code does not contain the *Clifford Regulations* requirement that the standard "must consist of needs and circumstances of the beneficiaries." Treas. Reg. 118, § 39.22(a)-21(d)(2)(iv)(b)(1) (1939); *see* Treas. Reg. § 1.674(b)-1(b)(5) (contains examples of what is deemed a reasonably definite standard).
211. *See* Treas. Reg. § 1.674(b)-1(b)(6).
212. I.R.C. § 674(d). Note that in I.R.C. § 674(b)(5)(A) the test is whether there is a "reasonable definite standard" without the requirement that it be "external," as required by I.R.C. § 673(d).
213. Treas. Reg. 118, § 39.22(a)-21(d)(2)(iv)(b)(5) (1939).
214. Rev. Rul. 54-41, 1954-1 C.B. 22.
215. This provision applies to any individual considered to be the grantor's spouse under I.R.C. § 672(e)(2). This provision that none may be the grantor applies to any individual considered to be the grantor's spouse under I.R.C. § 672(e)(2). Note that if the power is held by a non-trustee the I.R.C. § 674(c) exception to I.R.C. § 674 does not apply. This might occur if a "non-adverse" individual has a presently exercisable special power of appointment. Thus, such a special power could be used intentionally to make the trust a grantor trust.
216. I.R.C. § 672(c).
217. *See* Rev. Rul. 66-160, 1966-1 C.B. 164 (director of a corporation is not an "employee" within the meaning of the I.R.C. § 672(c) definition of the term "related or subordinate party" merely because the individual is a director); Priv. Ltr. Rul. 98-42-007; Priv. Ltr. Rul. 98-41-014 (state limited banking association is not a related or subordinate party within the meaning of I.R.C. § 672(c), where no trust created by grantors owned more than 10% of the voting stock, none of the trust created by one grantor when aggregated with other trusts created by the same grantor owns 10% or more of the voting power, bylaws prohibit the grantors and beneficiaries from participating in any decisions involving the exercise of discretionary powers, none of the grantors or beneficiaries, acting alone, can control the decisions of the bank, and each beneficiary constitutes an adverse party vis-à-vis the other beneficiary and other factors); Priv. Ltr. Rul. 97-13-011 ("Trustees are not 'employees' of a Corporation as that term is defined in § 672(c)(2) merely because they are directors of Corporation."). Rev. Rul. 58-19, 1958-1 C.B. 251 (brothers and sisters of the half-blood are related parties for the purposes of I.R.C. § 672(c)). Neither a Private Letter Ruling nor a National Office Technical Advice Memorandum may be cited or used as precedent. I.R.C. § 6110(k)(3).

218. I.R.C. § 672(c). For the above purposes, brothers and sisters include those by the half-blood. Rev. Rul. 58-19, 1958-1 C.B. 251.
219. *See supra* section 4:6.
220. *See supra* text accompanying note 209; Madorin v. Comm'r, 84 T.C. 667 (1985) (court appears to assume that power to add charities as beneficiaries does not fall under I.R.C. § 674(c) exception); *see* Priv. Ltr. Rul. 90-10-065 (independent trustee's power to add charities as beneficiaries causes trust to fall outside the I.R.C. § 674(c) exception, but grantor's spouse or brother had ultimate control over additions of such beneficiaries); Priv. Ltr. Rul. 97-29-001 (grantor treated as owner under I.R.C. § 674(a) where independent trustee had power to control beneficial enjoyment of income and corpus and could add charitable or educational organizations as beneficiaries). Neither a Private Letter Ruling nor a National Office Technical Advice Memorandum may be cited or used as precedent. I.R.C. § 6110(k)(3).
221. I.R.C. § 674(b)(8). Presumably this power must be subject to reasonable limits. S. REP. NO. 1622, *supra* note 3, at 4719. For a comparison of estate and gift tax effects with the income tax effects of some of these various powers, *see* A. James Casner, *The Internal Revenue Code of 1954: Estate Planning*, pts. 1 & 2, 68 HARV. L. REV. 222, 433 (1954–55). *See also* Stevens, *Pitfalls in Inter Vivos Trusts*, 37 TAXES 1088, 1103–07 (1959); Westfall, *Trust Grantors and Section 674: Adventures in Income Tax Avoidance*, 60 COLUM. L. REV. 326 (1960).
222. *See* Treas. Reg. § 1.675-1(c). In general, H.R. REP. NO. 1337, *supra* note 3, at 4089, and S. REP. NO. 1622, *supra* note 3, at 366, state that, except where otherwise provided, the fact that a power is held in the capacity of trustee is not material.
223. H.R. REP. NO. 1337, *supra* note 3, at 4089, S. REP. NO. 1622, *supra* note 3, at 4719.
224. Treas. Reg. § 1.675-1(b)(2); *see also* Treas. Reg. § 1.675-1(c).
225. The grantor is generally treated as holding any interest or power of his or her spouse as defined, and for the periods, specified in I.R.C. § 672(e). For any periods during which an individual is treated (under I.R.C. § 672(e)(2)) as the spouse of the grantor, any reference in I.R.C. § 675(3) to the grantor includes a reference to such person so treated as the grantor's spouse.
226. *Cf.* I.R.C. § 267; Mau v. United States, 355 F. Supp. 909, 912 (D. Haw. 1973) (the borrowing of trust property or trust income by the grantor at any time during the taxable year will result in the taxability of the grantor on the income of that year). It seems that this provides an opportunity to change "retroactively" the tax effect of a transaction that has already occurred during the year, such as attributing the trust's income, gains, losses, or credits to the

grantor. *See* Benson v. Comm'r, 76 T.C. 1040 (1981); *see also* Bennett v. Comm'r, 79 T.C. 470 (1982) (grantor trust, in part, as a result of indirect borrowing through partnership of which grantor is partner but not as to loan to corporation); Rothstein v. United States, 735 F.2d 704 (2d Cir. 1984) (indirect borrowing, resulting in grantor trust status, arising on sale to grantor from trust for his inadequately secured note). The Service will not follow *Rothstein*. Rev. Rul. 85-13, 1985-1 C.B 184. In many, but certainly not all, sections of the Code there are explicit provisions dealing with the effect under those sections of grantor trusts—*e.g.*, I.R.C. § 318(a)(2)(B)(ii), (3)(B)(ii). *See* I.R.C. § 163 for restrictions and limits on the deductibility of interest payments. *See also* National Office Tech. Adv. Mem. 88-02-004 (I.R.C. § 675(3) (applies when grantor-trustee fails to enforce or pay interest or corpus on note to partnership from grantor that is later transferred to the trust). Neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent. I.R.C. § 6110(k)(3).

227. Compare the inclusion in the gross estate for estate tax purposes of retained voting rights of I.R.C. § 2036(b).

228. S. REP. NO. 1622, *supra* note 3, at 4719 (1954); *see* United States v. Byrum, 408 U.S. 125 (1972) (estate tax: veto of transfer permitted, even with power to vote); Holdeen v. United States, 297 F.2d 886 (2d Cir. 1962) (for year 1946: investment advice permitted); Estate of Gilman v. Comm'r, 65 T.C. 296 (1976), *aff'd*, 547 F.2d 32 (2d Cir. 1977). *But see supra* note 227; I.R.C. § 2036(e).

229. Treas. Reg. § 1.675-1(b)(4); *cf.* Friedman v. Comm'r, 7 T.C. 54 (1946) (where the major factor leading to taxability of the grantor was his retention, as trustee, of broad powers of administration); *see also* Wheeling Dollar Sav. & Trust Co. v. Yoke, 204 F.2d 410 (4th Cir. 1953), *cert. denied*, 346 U.S. 898 (1953) (involving other powers also). In the case of an oral trust, it is difficult to show that the powers are suitably limited. *See* Reizenstein v. Comm'r, 22 T.C. 843 (1954). As to the standards for creation of an oral trust, *see* Del Drago v. Comm'r, 214 F.2d 478 (2d Cir. 1954). For cases of nontaxability where administrative powers were retained as trustee, *see, e.g.*, Cushman v. Comm'r, 153 F.2d 510 (2d Cir. 1946) (some powers held as grantor); Fruehauf v. Comm'r, 12 T.C. 681 (1949); Welch v. Comm'r, 8 T.C. 1139 (1947); Smith v. Comm'r, 4 T.C. 573 (1945); Weisman v. Comm'r, 3 T.C.M. 723 (1944). *See* Priv. Ltr. Rul. 92-24-049; Priv. Ltr. Rul. 96-42-039 (I.R.C. § 675(4)(C) applied where power of substitution held by person other than grantor); Priv. Ltr. Rul. 89-30-021 (similar where trustee, who was also the beneficiary, given the power by modification of the trust and held in nonfiduciary capacity); Priv. Ltr. Rul. 92-47-024 (grantor who is not trustee

but retains power to substitute property of trust is taxed on income of so-called "charitable lead trust;" does not discuss that the exercise of such a power may be subject to an excise tax under I.R.C. § 4941 for self-dealing); Priv. Ltr. Rul. 200434012 (power of substitution held by person(s) other than the grantor or the grantor's spouse causes trust to be a grantor trust under I.R.C. § 675(4)(C), if in fact held in a non-fiduciary capacity). Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

230. Treas. Reg. § 1.675-1(b)(4); *see also* Richards v. Comm'r, 213 F.2d 494 (5th Cir. 1954), *rev'g* 19 T.C. 66 (1952); Moskin v. Johnson, 115 F. Supp. 565 (S.D.N.Y. 1953), *aff'd*, 217 F.2d 278 (2d Cir. 1954); *cf.* Estate of Hamiel v. Comm'r, 253 F.2d 787 (6th Cir. 1958); Hemphill v. Comm'r, 8 T.C. 257, 265 (1947), where irregularities in the administration of a trust, subsequently corrected, did not transform income otherwise taxable to the trust into income taxable to the grantor. *See* Query v. Comm'r, T.C. Memo. 1954-160; Morgan v. Comm'r, 5 T.C. 1089 (1945). Several private letter rulings indicate the Service position is that whether the power to substitute property of equivalent value is held in a nonfiduciary capacity or not is a question of fact even if the trust agreement expressly provides it is held in a nonfiduciary capacity. *See, e.g.*, Priv. Ltr. Rul. 91-26-015; Priv. Ltr. Rul. 93-35-028; *cf.* Priv. Ltr. Rul. 93-45-035. Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

231. Treas. Reg. § 1.675-1(a); *see* Goemans v. Comm'r, 279 F.2d 12 (7th Cir. 1960) (under prior regulations).

232. *See, e.g.*, Priv. Ltr. Rul. 200731019; Priv. Ltr. Rul. 200715005. Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

233. Hirschmann v. United States, 309 F.2d 104 (2d Cir. 1962), *aff'g* 202 F. Supp. 722 (S.D.N.Y. 1962); Jergens v. Comm'r, 136 F.2d 497 (5th Cir.), *cert. denied*, 320 U.S. 784 (1943); Bunting v. Comm'r, 164 F.2d 443 (6th Cir. 1947); Emery v. Comm'r, 156 F.2d 728 (1st Cir. 1946); Grant v. Comm'r, 11 T.C. 178 (1948); Conant v. Comm'r, 7 T.C. 453 (1946); Stix v. Comm'r, 4 T.C. 1140 (1945); Oppenheimer v. Comm'r, 16 T.C. 515 (1951) (portions of income and corpus); Mallinckrodt v. Comm'r, 2 T.C. 1128, *aff'd*, 146 F.2d 1 (8th Cir. 1943), *cert. denied*, 324 U.S. 871 (1945); Russell v. Comm'r, 45 B.T.A. 397 (1941); Richardson v. Comm'r, 42 B.T.A. 830 (1940), *aff'd*, 121 F.2d 1 (2d Cir.), *cert. denied*, 314 U.S. 684 (1941). As to the relationship between the ordinary trust sections and a power of a beneficiary to demand

income or corpus, *see* Treas. Reg. §§ 1.641(b)-2, 1.643(c)-1(c); *see also* Treas. Reg. § 1.662(a)-4.

234. Treas. Reg. 118, § 39.22(a)-22 (1939); Priv. Ltr. Rul. 90-26-036 ("[L]egislative history of section 678 indicates Congress' interest to implement the principles of Mallinckrodt v. Nunan."). Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

235. *E.g.*, Koffman v. United States, 300 F.2d 176 (6th Cir. 1962); Rev. Rul. 67-241, 1967-2 C.B. 225 (nongrantor "owner" of portion may be taxed less on actual invasion than if she had been ordinary beneficiary); Richard B. Covey, *The Estate Planning Benefits Available Via a "5,000 and 5%" Withdrawal Power*, 34 J. TAX'N 98, 99–100 (1971); Roy M. Adams, *The Tax Consequences of Powers of Withdrawal Held Individually or as a Fiduciary: A Pandora's Box of Tax Consequences*, 23 INST. ON EST. PLAN. 1900 (1989); Charles E. Early, *Income Taxation of Lapsed Powers of Withdrawal: Analyzing Their Current Status*, 62 J. TAX'N 198 (Apr. 1985); Dye, *Several Routes Exist to Avoid IRS' Income Tax Roadblocks to Use of Crummey Trust Provisions*, 10 EST. PLAN. 220 (July 1983). In Rev. Rul. 54-153, 1954-1 C.B. 185, dealing with estate tax, it was held that New York law prevented a trustee-beneficiary from distributing principal to himself. *See also* Oppenheimer v. Comm'r, 16 T.C. 515 (1951); Rev. Rul. 81-6, 1981-1 C.B. 385 (minor taxed under I.R.C. § 678 even though no guardian appointed to exercise power).

236. *See also* Rev. Rul. 55-38, 1955-1 C.B. 389, as to the taxability of a beneficiary who has impermanently assigned trust income; *cf.* Rev. Rul. 77-436, 1977-2 C.B. 25 (beneficiary continues to be taxed on income from trust after assignment which is void under state law). *See* Priv. Ltr. Rul. 85-17-052 (rule under I.R.C. § 678(a)(2) continuing to treat nongrantor as owner under I.R.C. § 678 applies even as to "lapsed" power); *see also* Rev. Rul. 67-241, 1967-2 C.B. 225 (beneficiary treated as owner of trust in each year on that portion of corpus subject to her unilateral right of withdrawal even though right annually lapsed); Priv. Ltr. Rul. 95-04-024 (beneficiary treated as trust owner where non-beneficiary trustee could distribute to beneficiary after sixty-day term during which beneficiary could withdraw the trust assets lapsed); Priv. Ltr. Rul. 94-50-014 (similar); Priv. Ltr. Rul. 90-34-004 (beneficiary holding noncumulative right to withdrawal each year the greater of $5,000 or 5% of trust corpus treated as the owner of an increasing portion of the corpus in each year the beneficiary fails to exercise her power); Priv. Ltr. Rul. 200104005 (beneficiary's right to withdraw each year the greater of $5,000 or 5% of the trust corpus causes the beneficiary to become an ever

increasing owner of the trust under section 678 and, to that extent, allows a partial exclusion under I.R.C. § 121 from gross income upon the sale by the trust of the residence used as the beneficiary's principal residence); *see also* Sherwin P. Simmons, *Drafting the Crummey Power*, 15 INST. ON EST. PLAN. ¶ 1713.4 (1981) ("it would seem that the positive act of releasing or modifying a power would not include the passive act of allowing a power to lapse"); Edward W. Turnley, *The Five or Five Power: An Obscure Estate Planning Tool*, 33 WASH. & LEE L. REV. 701, 704 (1976) (similar comment). In any event, note that I.R.C. § 678(b) is phrased in terms of a modification or partial release. *See* Priv. Ltr. Rul. 200404005 (beneficiaries of trust from which distributions could be made in the discretion of the trustee were not considered "owners" under I.R.C. § 678 where court approved substitution of bank with a trust company of which the beneficiaries were directors); Fund v. Comm'r, 185 F.2d 127 (3rd Cir. 1950) (beneficiary who, as trustee, could pay all or a part of net income to herself or her husband, who was settlor of the trust, in accordance with her and her husband's "respective needs" of which she was to be "sole judge," not treated as owner of trust income under predecessor provision to I.R.C. § 678). Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

237. *See, e.g.*, Priv. Ltr. Rul. 90-26-036 (but I.R.C. § 678(a) applied to make the beneficiary the owner once grantor dies even though beneficiary's withdrawal right by then would have lapsed); Priv. Ltr. Rul. 93-21-050 (effectively revoking that conclusion in 90-26-036 so beneficiary will not be the owner once grantor dies); Priv. Ltr. Rul. 91-41-027; Priv. Ltr. Rul. 83-26-074. Note that under the grantor trust rules, the term "income," when modified, means taxable income (Treas. Reg. § 1.671-2(b)), but for purposes of ordinary trusts, that is, trusts that are not grantor trusts, it means trust accounting income. Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

238. *See, e.g.*, Priv. Ltr. Rul. 200730011. Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent. *See also* Jonathan G. Blattmachr and Frederick Sembler, *Crummey Powers and Income Taxation*, THE CHASE REVIEW (July 1995).

239. *See, e.g.*, Priv. Ltr. Rul. 200730011 (I.R.C. § 674 applies); Priv. Ltr. Rul. 200729005 (I.R.C. § 675 applies to qualify a trust as a grantor trust for S corporation ownership). Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

240. I.R.C. § 678(d).
241. Grant v. Comm'r, 174 F.2d 841 (5th Cir. 1949); *cf.* I.R.C. §§ 2518, 2045 (relating to disclaimers of gifts and "inheritances," requiring a written refusal within nine months of the later of the day of the transfer or the day the donee or beneficiary becomes twenty-one). *See* Priv. Ltr. Rul. 96-30-034 (disclaimant who makes qualified disclaimer of part of right to income in respect of a decedent under I.R.C. § 2518 does not include such disclaimed part in gross income). Under I.R.C § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.
242. For a contrary view, *see* Milton H. Stern, *A Tax Trap for the Family Trustee,* 33 TAXES 594 (1955). There may be a minimal requirement that the beneficiaries' father have some connection, at least being the trustee, before he will be taxed. *See generally* Harry A. Flannery, *The "Sprinkler Trust" and Its Inherent Federal Income Tax Problems: Fulfilling of Legal Support Obligations*, 54 TAXES 438 (1976); Sydney C. Winton, *Taxation of Nongrantors under Trusts for Support of Their Dependents*, 33 TAXES 804 (1955).
243. *See* Stern v. Comm'r, 137 F.2d 43 (2d Cir. 1943); Welch v. Comm'r, 8 T.C. 1139 (1947) (point not raised); Joseph v. Comm'r, 5 T.C. 1049 (1945). *But cf.* Allen v. Nunnally, 180 F.2d 318 (5th Cir. 1950).
244. H.R. REP. NO. 1337, *supra* note 3, at A217, S. REP. NO. 1622, *supra* note 3, at 4719; *cf.* Treas. Reg. § 20.2041-1(c) (donee holds general power of appointment if exercisable (whether or not exercised for post-1942 powers) in discharge of donee's legal obligations).
245. Treas. Reg. §§ 1.678(a)-1(b), 1.678(c)-1(b); *see also* Treas. Reg. § 1.662(a)-4. The Code exception is silent about a power of the specified kind if it is to apply corpus rather than income. The regulations follow the language of the Code, except that there is one broader sentence in Treas. Reg. § 1.678(a)-1(b).
246. Treas. Reg. § 1.678(c)-1(c). This does not fully remove the implication, particularly in view of the cross-reference to Treas. Reg. § 1.662(a)-4. *See also* Rev. Rul. 59-357, 59-2 C.B. 212, discussing Uniform Gifts to Minors Act, and indicating that income is taxable to any person to the extent used towards a support obligation.
247. *See* Treas. Reg. § 1.678(a)-1(b); Rev. Rul. 67-268, 1967-2 C.B. 226 (beneficiary was cotrustee with husband, who as managing trustee had power to distribute income to her: not taxable to either); *cf.* Spies v. United States, 84 F. Supp. 769 (N.D. Iowa 1949), *aff'd*, 180 F.2d 336 (8th Cir. 1950) (before the effective date of the *Mallinckrodt* regulations). T.D. 5488, 1946-1 C.B. 19, 23; Cochran v. United States, 62 F. Supp. 872 (Cl. Ct. 1945).

248. Smither v. United States, 108 F. Supp. 772 (S.D. Tex. 1952), *aff'd*, 205 F.2d 518 (5th Cir. 1953) (support, maintenance, comfort, and enjoyment); *see* May v. Comm'r, 8 T.C. 860 (1947) (nontaxable on portion allocable to education of taxpayer's minor children; the taxpayer, whose husband had a salary income, probably had no support obligation); C.E. Brehm Trust No. 3 v. Comm'r, 33 T.C. 734 (minors could terminate only through a guardian, and none had been appointed, thus no "unfettered command"), *rev'd*, 285 F.2d 102 (7th Cir. 1960) (on ground such appointment is a routine matter). *But see* Rev. Rul. 81-6, 1981-1 C.B. 385; *cf.* Crummey v. Comm'r, 397 F.2d 82 (9th Cir. 1968) (minor's annual power to withdraw $4,000 from trust makes transfers to trust constitute gift of present interest under I.R.C. § 2503, because power to withdraw is equivalent to right to immediate use, possession, or enjoyment, although no guardian was appointed to exercise the power for the minor); *cf. also* I.R.C. § 2652(c) (any income or corpus of a trust that may be used to satisfy a support obligation under state law is ignored for generation-skipping transfer tax purposes if such use is discretionary or is substantially equivalent to Uniform Gifts to Minors Act, even apparently if so used).
249. This section derived in part from Jonathan Blattmachr & Bridget Crawford, *Grantor Trusts and Income Tax Reporting: A Primer*, 13 PROB. PRAC. REP. 1 (MAY 2001).
250. "The trustee of any portion of which is treated as owned by one or more grantors or other persons must report pursuant to this section for taxable years beginning on or after January 1, 1996." Treas. Reg. § 1.671-4(a). *See* Lardas v. Comm'r, 99 T.C. 490 (1992) (the filing of the grantor's income tax return, not that of the trust, starts the statute of limitation for income of a grantor trust that is attributed to grantor under the grantor trust rules); Olson v. Comm'r, T.C. Memo. 1992-711 (same); Bartol v. Comm'r, T.C. Memo. 1992-141 (same); Field Service Advice 2002-07-007 ("case law suggests strongly that the 'return' of a passthrough entity, such as a grantor trust . . . does not start the statute of limitations because [that] statute should apply to the person who pays the tax"). Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.
251. Treas. Reg. § 1.671-4(b)(1).
252. *Id.*
253. Treas. Reg. § 1.671-4(b)(6).
254. Treas. Reg. § 1.671-4(b)(2).
255. Treas. Reg. § 1.671-4(b)(3).

256. It should be noted that for purposes of these regulations, a husband and wife are treated as one person. Treas. Reg. § 1.671-4(b)(8).
257. Treas. Reg. § 1.671-4(e).
258. Treas. Reg. § 1.671-4(b)(1). Form W-9 (or an acceptable substitute) is used when one person with the Service reporting obligations needs to obtain another U.S. person's (or resident alien's) correct taxpayer identification number. A correct taxpayer identification number is needed to report income paid to a particular taxpayer, contributions by the taxpayer to an IRA, mortgage interest paid by the taxpayer, abandonment of secured property, and cancellation of indebtedness. Form W-9 may also be used to certify that a provided taxpayer identification number is correct, to certify that an individual is not subject to backup withholding, and to claim exemption from backup withholding. Note that only U.S. persons may use Form W-9; foreign persons use Form W-8 instead.
259. Treas. Reg. § 1.671-4(e).
260. *Id.*
261. *Id.*
262. Treas. Reg. § 1.671-4(b)(2)(i)(A). To simplify reporting, it may be appropriate to make the grantor a trustee but to limit his or her powers to avoid including any portion of the trust in the gross estate of the grantor for estate tax purposes, if avoiding such inclusion is appropriate. In such a case, and perhaps others, it may be preferable for the grantor's spouse to be trustee or co-trustee.
263. Treas. Reg. § 1.671-4(b)(8).
264. Treas. Reg. § 1.671-4(b)(2)(ii).
265. Treas. Reg. § 1.671-4(b)(2)(ii)(B).
266. Treas. Reg. § 1.671-4(b)(2)(i)(B).
267. Treas. Reg. § 1.671-4(b)(2)(iv), Example 2 (ii)(A).
268. Treas. Reg. § 1.671-4(b)(2)(iii).
269. Treas. Reg. § 1.671-4(b)(5)(i).
270. *See* Treas. Reg. § 1.671-4(b)(5)(ii), Example 2 (ii)(A).
271. Treas. Reg. § 1.671-4(b)(3)(ii).
272. Treas. Reg. § 1.671-4(b)(3).
273. Treas. Reg. § 1.671-4(b)(3)(ii).
274. *Id.*
275. Treas. Reg. § 1.671-4(b)(3)(ii)(B)(1).
276. *Id.*
277. Treas. Reg. § 1.671-4(g).
278. Treas. Reg. § 1.671-4(g)(1).
279. *Id.*

280. Treas. Reg. § 1.671-4(g)(2).
281. Form 1096 is used to transmit paper Forms 1099, among others, to the IRS. This form must be filed by income payers, among others. Other persons required to file this form include a recipient of mortgage interest payments or student loan interest, an educational institution, a broker, a person reporting real estate transactions, and a lender who acquires an interest in secured property or who has reason to know that such property has been abandoned.
282. Note, however, that the regulations do not seem to contemplate a mid-year switch in reporting methods.
283. This section is derived, in part, from Jonathan 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).
284. Rev. Rul. 85-13, 1985-1 C.B. 184. *But see* Rothstein v. United States, 735 F.2d 704 (2d Cir. 1984). In Rev. Rul. 85-13, the Service announced it would not follow *Rothstein.* Taxpayers are permitted to rely on Revenue Rulings. Rauenhorst v. Comm'r, 119 T.C. 157 (2004); Dover Corp. v. Comm'r, 122 T.C. 324 (2004). *See also* Rev. Rul. 2007-13, 2007-11 I.R.B. 684.
285. Rev. Rul. 2004-64, 2004-2 C.B. 7.
286. *See, e.g.*, Michael D. Mulligan, *Sale to a Defective Grantor Trust: An Alternative to a GRAT*, 23 EST. PLAN. 3 (1996); Michael D. Mulligan, *Sale to an Intentionally Defective Irrevocable Trust for a Balloon Note—An End Run Around Chapter 14?,* 32 U. MIAMI PHILIP E. HECKERLING INST. ON EST. PLAN. ¶¶ 1500–11 (1998); Stephen J. Oshins et al., *Sale to a Defective Trust: A Life Insurance Technique,* TR. & EST. MAG., Apr. 1998, at 35; Jerome M. Hesch & Elliot Manning, *Beyond the Basic Freeze: Further Uses of Deferred Payment Sales*, 34 U. MIAMI PHILIP E. HECKERLING INST. ON EST. PLAN. ¶¶ 1600–02 (2000); Milford B. Hatcher, Jr. & Edward M. Manigault, *Using Beneficiary Guarantees in Defective Grantor Trusts*, 92 J. TAX'N 152 (2000).
287. Rev. Rul. 2004-64, 2004-2 C.B. 7.
288. An individual makes a gift only to the extent the taxpayer receives back consideration in money or money's worth that is less than the value of what the taxpayer transferred. I.R.C. § 2512(b).
289. I.R.C. § 1014(a).
290. *See* I.R.C. § 2512.
291. Rev. Rul. 85-13, 1985-1 C.B. 184.
292. *See id.* Also, because the grantor is deemed to continue owning all of the assets in the trust, the provisions in the note calling for payment of interest (inserted to avoid imputed-interest taxable gifts) do not result in income or deduction to the grantor or to the trustee.

293. *See* Treas. Reg. § 1.1001-2, Example 5; *see also* Rev. Rul. 77-402, 1977-2 C.B. 222 (containing the same analysis that is now embodied in that example).
294. The trustee's basis is equal to cost, as it would be in the case of any purchase under section 1012. *See* Treas. Reg. § 1.1015-4(a).
295. *See, e.g.*, Deborah V. Dunn & David A. Handler, *Tax Consequences of Outstanding Trust Liabilities when Grantor Trust Status Terminates*, 95 J. TAX'N 49 (2001). This section is derived from Jonathan G. Blattmachr , Mitchell M. Gans, and Hugh H. Jacobson, *Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor's Death*, 97 J. OF TAX. 149 (Sept. 2002).
296. *See* Rev. Rul. 85-13, 1985-1 C.B. 184.
297. I.R.C. § 691 sets up the basic framework for income in respect of a decedent (IRD).
298. *See* Campbell v. Protho, 209 F.2d 331 (5th Cir. 1954); *see also* Int'l Freighting v. Comm'r, 135 F.2d 310 (2nd Cir. 1943). Of course, if liabilities exceed basis, gain is recognized when inter vivos gifts are made. *See* Diedrich v. Commissioner, 457 U.S. 191 (1982).
299. *See, e.g*., James J. Freeland et al., FUNDAMENTALS OF FEDERAL INCOME TAXATION: CASES AND MATERIALS 18 (11th ed. 2000). *But see* Stanley S. Surrey, *The Supreme Court and the Federal Income Tax: Some Implications of the Recent Decisions*, 5 ILL. L. REV. 779, 791 (1941); *see also* Bruce Ackerman, *Taxation and the Constitution*, 99 COLUM. L. REV. 1, 52 (1999).
300. *See* INS v. St. Cyr, 533 U.S. 289, 300 (2001) (statutory interpretation that would raise constitutional questions should be avoided where alternative interpretation is "fairly possible").
301. *See* Int'l Freighting Corp. v. United States, 135 F.2d 310 (2nd Cir. 1943); *cf.* Diedrich v. United States, 457 U.S. 191 (1982).
302. *See* Taft v. Bowers, 278 U.S. 470, (1929).
303. *Cf.* Crane v. Comm'r, 331 U.S. 1 (1947).
304. *Id.*
305. Diedrich v. United States, 457 U.S. 191 (1982); *see also* Ebben v. United States, 783 F.2d 906 (9th Cir. 1986).
306. *See* Treas. Reg. § 1.1001-2 (indicating that a disposition by "gift" triggers the exception and containing several examples that all involve transfers during life). Self-cancelling installment notes (SCINs) present unique issues for estates of decedents. The typical SCIN provides that no payments are due the decedent-seller or the seller's estate after the decedent's death. In Estate of Frane v. Comm'r, 998 F.2d 567 (8th Cir. 1993), *aff'g in part and rev'g in part*, 98 T.C. 341 (1992), The U.S. Court of Appeals for the Eighth Circuit

held that cancelling the installment sale obligation triggered income under section 453B(f).

307. *Id.*
308. *Cf.* I.R.C. § 1022(g)(1), (2) (gain must be recognized under the carryover basis rules effective in 2010 in some cases where a debt-laden asset is bequeathed to a tax-exempt entity).
309. Economic Growth and Tax Relief Reconciliation Act, Pub. L. No. 107-16, 115 Stat. 38 (2001).
310. *See* H.R. REP. NO. 107-84 at 113 (2001), *as reprinted in* 2001 U.S.C.C.A.N. 46,311. Nevertheless, the Committee's "clarification" was not made part of the statute. Moreover, while such a clarification may be determinative regarding future cases, the courts will often refuse to give weight to an opinion offered by a later Congress as to the intent of an earlier one. *See, e.g.*, United States v. Price, 361 U.S. 304, 312–13 (1960). In other words, had Congress embodied the clarification in the statute and explicitly made it effective retroactively, it would unquestionably control the disposition of any pending or future litigation. Nevertheless, the report is consistent with, and therefore confirms the validity of, the widely accepted rule that death does not trigger gain, even where liabilities are in excess of basis.
311. *See* Rev. Rul. 85-13, 85-1 C.B. 184.
312. *See id.*
313. *See* Treas. Reg. § 1.1001-2, Example 5.
314. *See id.*
315. For a case reaching the same conclusion even before the promulgation of the regulations, *see* Madorin v. Comm'r, 84 T.C. 667 (1985); *see also* Rev. Rul. 77-402, 1977-2 C.B. 222.
316. *See* Treas. Reg. § 25.2511-2(b).
317. *See* Treas. Reg. § 25.2511-2(f).
318. DiMarco v. Comm'r, 87 TC. 653 *acq.*, 1990-2 C.B. 1.
319. It may be appropriate to note that the regulation at issue in *DiMarco* (Treas. Reg. § 25.2511-2) does state that transfers deemed to occur at death are not subject to the gift tax. Although there is no comparable provision in the regulations under section 1001 explicitly stating that termination of grantor trust status at death should not be subject to the income tax, the section 1001 regulations do, as previously indicated, implicitly take this position.
320. *See* H. REP. NO. 105-220, (1997), *as reprinted in* 1997 U.S.C.C.A.N. 1129.
321. *See* Treas. Reg. § 1.684-2(e).
322. *See id.*
323. *See* Treas. Reg. § 1.684-2(e)(2), Example 2. It may be noted that this is not only inconsistent with the rule under the I.R.C. § 1001 treasury regulations,

but may well be inconsistent with I.R.C. § 684 itself. For, under subsection (b), no gain is to be recognized as long as the trust remains a grantor trust. And since immediately before the grantor's death the trust is still a grantor trust, it would appear that the fiction cannot be applied in the case of death without violating subsection (b).

324. *See* T.D. 8956; 2001-32 C.B. 112.
325. *See id*.
326. *See* Treas. Reg. § 1.684-3(c). Note that even where the assets in the trust are encumbered by a liability in excess of their basis, no gain is recognized under the I.R.C. § 684 treasury regulations if I.R.C. § 1014 determines the basis of the assets in the hands of the trustee after the death of the grantor.
327. Frane v. Comm'r, 98 T.C. 341 (1992), *aff'd in part and rev'd in part*, 998 F.2d 567 (8th Cir. 1993).
328. *See id*. at 351.
329. *See* section 2:3.1 and accompanying text for a discussion of IRD and *Frane*.
330. Treas. Reg. § 1.691(a)-1. For a detailed discussion of IRD, see chapter 2.
331. *See, e.g.*, Rollert v. Comm'r, 80 T.C. 619 (1983) (indicating the estate's distribution of the right to receive IRD makes the recipient taxable at the time of ultimate collection of the IRD item).
332. Crane v. Comm'r, 331 U.S. 1 (1947).
333. I.R.C. § 2033.
334. Treas. Reg. § 1.691(a)-1.
335. *See* Treas. Reg. § 1.691(a)-2(b), Example 4 (indicating that gain on the sale of stock under a buy-sell agreement is not IRD because the sale is not consummated until the decedent's death).
336. *See* Estate of Peterson v. Comm'r, 74 T.C. 630, 641 (1980). Although the court in *Peterson* does indicate that its definition of IRD is not "ironclad," *id*. at 639 n.9, its discussion of the rule that a sale that is consummated at death does not create IRD suggests that the rule is not a flexible one. Indeed, the court reads the treasury regulation as creating a per se limitation on the IRD concept. *Id*. at 641.
337. If the executor elects to use alternate valuation under I.R.C. § 2032 for federal estate tax purposes, value will be determined on the alternate valuation date.
338. *See* Treas. Reg. § 1.1015-4 (providing the basis rule for a part sale/part gift).
339. *See* Treas. Reg. § 1.1014-2(a)(1).
340. Subchapter K of the Code provides the fundamental income tax rules for partnerships and their partners.
341. Rothstein v. United States, 735 F.2d 704 (2d Cir. 1984).
342. *Cf*. Farid-Es-Sultaneh v. United States, 160 F.2d 812, 815 (2d Cir. 1947) (indicating that the presence of consideration suggested that the transaction

should be viewed as a purchase, rather than a lifetime gift, for purposes of determining basis).

343. *See* Treas. Reg. § 1.1274-5(d).
344. Whichever approach is followed, there should, in addition, be an adjustment for gift tax paid under I.R.C. § 1015(d).
345. *See* Malone v. United States, 326 F. Supp. 106, 113–14 (N.D. Miss. 1971), *aff'd*, 455 F.2d 502 (5th Cir. 1972) (indicating that section 1015(a) only applies in the case of a "pure gift" and that, where a trustee acquires an asset that is encumbered by a liability, it is not a pure gift and, therefore, I.R.C. § 1015(b) governs).
346. *See* Treas. Reg. § 1.167(g)-1.
347. I.R.C. § 1015; Treas. Reg. § 1.1015-1(c).
348. *See* Newman v. Comm'r, 4 T.C. 226 (1944) (discussing the government's argument that a distribution from a grantor trust to the grantor's child should be viewed as effecting a gift to the child on the date of the distribution, thus, making the fair market value on that date determinative for purposes of computing loss).
349. As indicated in note 345, *supra*, in *Malone*, the court concluded that, because the trustee acquired the asset by undertaking to pay an encumbering liability, it was not, in the language of the court, a "pure gift." As a result, the court held, subsection (b) of I.R.C. § 1015 controlled the determination of the trustee's basis—the court indicating that all transfers in trust fall under subsection (b) unless they constitute a "pure gift" (*i.e.*, no consideration). It could, however, be maintained that court's analysis was flawed, as the court indicated that, were it not to apply subsection (b), it would create an unsatisfactory result as a matter of policy in that the trustee's basis would not be increased by the amount of gain recognized by the grantor on the transfer. In making this assumption, however, the court failed to appreciate (or even cite) Treas. Reg. § 1.1015-4, under which the trustee's basis would reflect the gain recognized by the grantor. In other words, contrary to the court's assumption, the correct result in terms of policy could have been reached without invoking subsection (b).
350. I.R.C. § 267(b)(4) (denying loss deduction on sale between grantor and fiduciary); Treas. Reg. § 1.671-2(e) (implying that a person who creates a trust but who does not fund it should nevertheless be viewed as a grantor).
351. *See* Treas. Reg. § 1.1015-4.
352. *See id*.

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