

**NOW YOU SEE IT, NOW YOU DON'T —
PRACTICAL MAGIC USING GRANTOR TRUSTS**

Estate Planning Council of Birmingham, Alabama

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NOW YOU SEE IT, NOW YOU DON'T— PRACTICAL MAGIC USING GRANTOR TRUSTS

C. Fred Daniels*

In 1934, George and Virginia Clifford had a tax problem. Income tax rates ranged from 4% to 63%, and the concept of married filing joint returns would not be invented until twelve years later. But George was creative. He contributed his securities to a five-year trust naming Virginia as the income beneficiary. George was trustee, and he determined the timing of income disbursements to Virginia. At the end of five years, the corpus was returned to George, and any undistributed income belonged to Virginia. George's apparent goal was to split his taxable income with Virginia and take advantage of Virginia's lower tax brackets while retaining control of his securities. In a split decision, the Supreme Court "irresistibly" held that George, not the trust, continued to own the securities within the meaning of the Revenue Act of 1934. *Helvering v. Clifford*, 309 U.S. 331 (1940). A majority of the justices believed that George's retained bundle of rights were so substantial that he should be treated as the owner of the corpus notwithstanding the formality of the trust. The Court focused on the short duration of the trust, the fact that George's wife was the beneficiary, and George's retention of dominion and control over the corpus. The Court did not reach the question of whether the assignment of income doctrine applied. From this beginning, taxpayers are now subject to the grantor trust rules set forth in §§ 671 thru 679. At first, the goal of most tax planners was to avoid grantor trust status. Tax planners now recognize that there can be favorable consequences when a trust is a grantor trust.

The Alabama Department of Revenue previously contended that *Clifford* did not apply in Alabama notwithstanding that Alabama's definition of income was copied from the Revenue Act of 1934. This issue was resolved upon enactment of the Subchapter J and Business Conformity Act, Ala. Act 2006-114, which adopted substantially all of the federal grantor trust rules, generally effective January 1, 2005.

* Unless otherwise indicated—

Section references refer to the Internal Revenue Code of 1986, as amended; and Regulation references refer to sections of the Treasury Regulations.

The author gratefully acknowledges the assistance of his partners, David S. Dunkle and Anna Funderburk Buckner, in the preparation of this outline.

PART ONE — BASIC PRINCIPLES

I. ***BASIC PRINCIPLES.***

If a person creating a trust (the “grantor”) retains certain specified powers or ownership benefits, the grantor is treated as the actual owner of some or all of the trust for income tax purposes — as if the trust did not exist. § 671, *et seq.* In general, the grantor portion of the trust is ignored for income tax purposes, and the grantor directly reports the income, deductions and credits of the trust. Although the grantor trust rules supposedly do not apply for estate, gift or generation-skipping transfer tax purposes, the IRS has mentioned the § 672(c) definition of a “related or subordinate party” in some recent estate and gift tax revenue rulings. *See, e.g.*, Rev. Rul. 2004-64; 2004-2 C.B. 7; Rev. Rul. 95-58, 1995-2 C.B. 1.

A. ***Some Uses of Intentionally Defective Grantor Trusts.***

Initially, grantor trust treatment was viewed negatively, with undesirable impact. However, there are opportunities to achieve favorable tax results by intentionally causing certain trusts to be grantor trusts (an “intentionally defective grantor trust” or “IDGT”). Examples include the following:

- *Crummey Kids Trusts.*
- *Lower Bracket Trusts.*
- *Sales to Intentionally Defective Grantor Trusts.*
- *Grantor Retained Annuity Trusts.*
- *Leveraged Gift Trusts.*
- *Subchapter S Trusts.*
- *S Corporation Leveraged Accumulation Trusts.*
- *Life Insurance Trusts.*

In other circumstances, such as Delaware Incomplete Gift Trusts, benefits can be obtained by carefully avoiding grantor trust status.

B. ***General Classification Rules.***

A general itemization of the rules for classifying a trust as a grantor trust is as follows:

1. ***Retention of Reversionary Interests.*** A trust is a grantor trust if the grantor has a reversionary interest in either the income or corpus worth more than 5% of the value of the trust at the trust’s inception. § 673.

2. ***Power to Control Beneficial Enjoyment.*** A trust is a grantor trust if the grantor retains certain powers to control the beneficial enjoyment of the income or principal of the trust. § 674.
3. ***Administrative Powers.*** A trust is a grantor trust if the grantor has certain administrative powers. § 675. Some of the powers are those related to—
 - (a) The power to deal for less than adequate and full consideration,
 - (b) The power to borrow without adequate interest or security,
 - (c) The actual borrowing of money, and
 - (d) Powers of administration held in a non-fiduciary capacity—
 - (i) To vote stock or securities of a corporation in which the holding of the grantor and the trust are significant,
 - (ii) To control the investment of the trust funds to the extent that the trust funds consist of stocks or securities of a corporation in which the holdings of the grantor and the trust are significant, and
 - (iii) To reacquire trust property by substituting other property of an equivalent value. § 675(4),
4. ***Power to Revoke.*** A trust is a grantor trust if the grantor retains the power to revest the trust in the grantor. § 676.
5. ***Income for Benefit of the Grantor.*** A trust is a grantor trust if the income may be (a) distributed to the grantor or the grantor's spouse or (b) held or accumulated for future distribution to the grantor or the grantor's spouse. § 677. This also includes the ability to apply a trust's principal and income to pay insurance premiums on the life of the grantor or the grantor's spouse.
6. ***Non-Grantors.*** A person who is not the grantor may be treated as the owner of the trust if (a) the grantor is not taxed as the owner and (b) the non-grantor has or had the power alone to vest the trust income or corpus in himself. § 678.

7. ***Certain Foreign Trusts.*** A foreign trust is a grantor trust if a United States person transferred property to the foreign trust and there is a United States beneficiary of any portion of the trust. § 679.

C. *Special Definitions*

1. ***Adverse and Non-Adverse Parties.*** An “adverse party” is a person who has a substantial beneficial interest in the trust which would be adversely affected by the exercise or non-exercise of the power which the person possesses. § 672(a). A general power of appointment over trust property is a beneficial interest in the trust. *Id.* A non-adverse party is anyone who is not an adverse party. § 672(c).
2. ***Related or Subordinate Parties.*** “Related or subordinate party” refers to a subclass of non-adverse parties. They are the grantor’s spouse if living with the grantor; the grantor’s father, mother, issue, brother or sister; an employee of the grantor; 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; a subordinate employee of a corporation in which the grantor is an executive. § 672(c). Lawyers are not related or subordinate parties. *Estate of Goodwyn v. Comm’r.*, 35 T.C.M. (CCH) 1026 (1976).
3. ***Powers Held by Persons Subservient to the Wishes of the Grantor.*** A related or subordinate party is presumed to be subservient to the grantor for purposes of the rules governing powers to control beneficial enjoyment, administrative powers, and foreign trusts, with respect to the exercise or non-exercise of the powers conferred on the party unless a preponderance of the evidence shows that the party is shown not to be subservient. § 672(c). This requires a finding that the trustee is not acting in “accordance with the grantor’s wishes.” S. Rep. No. 1622, 83d Cong. 2d Sess. 87 (1954).
4. ***Conditions Precedent.*** A person is charged with a prescribed power even if notice must be given or exercise of the power only takes effect after a certain period of time. § 672(d).

D. *Powers Held by the Grantor’s Spouse.*

A grantor is charged with powers and interests held by the grantor’s spouse. § 672(e)(1). If an individual becomes the grantor’s spouse after the creation of the power or interest, the rule only applies after the individual

becomes the grantor's spouse. *Id.* An individual is not considered to be married if the individual is legally separated from his or her spouse under a decree of divorce or of separate maintenance. § 672(e)(2).

1. A trust should be a grantor trust in its entirety if the grantor's spouse is a permissible beneficiary and distributions to the spouse of income and principal can be made without the consent of an adverse party. § 677(a)(1) and (2).
 - (a) This structure results in flexibility even if the primary beneficiaries are children and more remote beneficiaries.
 - (b) To avoid potential problems under § 2036 (Retained life estates), the trust should provide that distributions to the spouse cannot be used to satisfy the grantor's legal obligation to support the spouse.
2. Grantor trust status is lost if there is a divorce or legal separation, or the spouse dies, unless another provision results in grantor trust status. Reg. § 1.677(a)-1(b)(2).
3. Section 2513 spousal gift splitting may be unavailable if the grantor's spouse is a permissible beneficiary. Reg. § 25.2513-1(b).

II. ***SPECIAL RULES.***

A. ***Transactions Between the Grantor and the Trust.***

One of the most important authorities affecting grantor trusts is Rev. Rul. 85-13, 1985-1 C.B. 184, which held that a grantor's acquisition of trust corpus in exchange for the grantor's unsecured promissory note is not a sale for federal income tax purposes to the extent grantor is treated as owner of the trust. Any doubt regarding the extent of Rev. Rul. 85-13 was resolved by Situation 1 of Rev. Rul. 2007-13, 2007-11, I.R.B. 684. It holds that the sale of a life insurance policy from a "wholly-owned" grantor trust to a "wholly-owned" grantor trust is not a transfer for income tax purposes because Rev. Rul. 85-13 treats the grantor as the owner of the assets of both trusts.

B. *Payment of the Grantor's Income Taxes.*

The IRS confirmed in Rev. Rul. 2004-64; 2004-2 C.B. 7, that the grantor's payment of the income tax attributable to the inclusion of the trust's income in the grantor's taxable income is not taxable income.

1. ***No Estate Tax if Reimbursement is Discretionary with the Trustee.*** If the trust's governing instrument or local law gives the trustee the *discretion* to reimburse the grantor for the grantor's income tax liability, that discretion, by itself, does not cause the trust's assets to be includable in the grantor's gross estate. However, the full value of the trust's assets is includable in the grantor's gross estate if the trust's governing instrument or local law *requires* the trust to reimburse the grantor for the income tax attributable to the trust's income. § 2036(a)(1); Rev. Rul 2004-64, 2004-2 C.B. 7.
2. ***Possible Need for Independent Trustee.*** The facts in Rev. Rul. 2004-64 state that the governing instrument required that the trustee be a person not related or subordinate to the grantor within the meaning of § 672(c). It also qualified its holding regarding estate tax exclusion with an assumption that there is no understanding, express or implied, between the grantor and the trustee regarding the trustee's exercise of discretion. The ruling further states that the discretion to reimburse the taxes combined with other facts (such as an understanding or pre-existing arrangement between the grantor and the trustee regarding the trustee's exercise of the discretion; a power retained by the grantor to remove the trustee and name the grantor as successor trustee; or applicable local law subjecting the trust assets to the claims of the grantor's creditors) could result in estate tax inclusion.

C. *Toggle Switches.*

Grantors are sometimes concerned about perpetual liability for income taxes attributable to grantor trust income that they will not receive. Thus, it is often desirable to provide a mechanism to terminate grantor trust status.

1. ***Release of Powers.*** There should be few problems if the grantor has the right to release a power held by the grantor.
2. ***Power to Amend.*** A grantor is treated as the owner of the trust from its inception if the grantor has a power broad enough to permit an

amendment causing the grantor to be treated as the owner of the portion of the trust under § 675. Reg. § 1.675-1(a).

3. ***Toggling On and Off by Grantor.*** It is difficult to provide that the grantor can simply release a power to turn off tax liability and then reacquire the power to turn the liability back on. Moreover, the power to toggle the liability back on might be viewed as a § 2036(a)(2) right that triggers estate tax inclusion. It is better if the power is held by a third party.
4. ***Granting Toggle Power to Adverse or Non-Adverse Party.*** The status as a non-adverse party is only important with respect to a person who holds a trust power, not who has authority to relinquish or reinstate that power. Thus, toggling on and off can be achieved by giving the power to relinquish or reinstate the power to a third party who is either adverse or non-adverse. *See* PLR 9010065 (adverse parties (*i.e.*, trust beneficiaries) had the power to terminate the trustee's grantor trust power).
5. ***Give Power to Grantor's Spouse.*** The grantor's spouse is often given the grantor trust power (*e.g.*, a § 675(2) power to borrow without adequate security) to avoid questions as to estate tax inclusion. This might not be an effective way to permit toggling on and off because powers held by a spouse are deemed to be held by the grantor. § 672(e).
6. ***Transactions of Interest.*** In Notice 2007-73, 2007-36 I.R.B. 545, the IRS identified certain toggling grantor trust transactions used to avoid recognition of a gain or to recognize a loss greater than the actual economic loss as reporting transactions of interest for purposes of § 6111, § 6112 and Reg. § 1.6011-4(b)(6). In the transaction described in the Notice, the grantor funds a trust with gain options or securities, loss options or securities and a small amount of cash. A beneficiary has a unitrust interest, and the grantor has a remainder interest. The grantor has a power that becomes effective at a later date to reacquire trust corpus. The grantor toggles off grantor trust status by selling the remainder interest to a buyer for the fair market value of the options or securities claiming there is no gain on the sale. Once the substitution power becomes effective, the grantor trust status is toggled back on. The loss options are closed out or the loss securities are sold, and the grantor recognizes the losses. The buyer then purchases the unitrust interest for an amount based upon the value of the gain options or securities, and the trust

terminates due to the merger of the unitrust and remainder interests. The Notice identifies these as transactions of interest requiring reporting for purposes of § 6111, § 6112 and Reg. § 1.6011-4(b)(6). Reporting is not required if there is no toggling back on.

7. ***Removal and Replacement of Trustees.*** Grantor trust status is achieved if more than one-half of the trustees are related or subordinate parties and they have the power to make discretionary distributions not subject to a reasonably external standard. Toggling might be achieved by giving a third party the power to remove and replace trustees. The trust will be a grantor trust when more than one-half the trustees are related or subordinate and a non-grantor trust when they are not. To satisfy the safe harbor in Rev. Rul. 95-58, 1995-2 C.B. 191, the power should not be held by the grantor unless the successor must be someone who is not a related or subordinate party.
8. ***Third Party Authorized to Cancel and Reinstate Substitution Power.*** Toggling can be achieved by giving a third party the authority to revoke and reinstate a § 675(4)(C) power to substitute assets of equal value.
9. ***Loans to Grantor Without Adequate Security.*** Grantor trust status can be toggled off by giving the authority to relinquish the trustee's power to make loans to the grantor or the grantor's spouse without adequate security. Someone other than the grantor could then be given the authority to reinstate the power to make such loans.
10. ***Power to Add Beneficiaries.*** If a person is given the power to add beneficiaries, the person could also be given the right to relinquish the power. Another person might then be given authority to reinstate the power to add beneficiaries.

III. GAIN RECOGNITION WHEN GRANTOR TRUST STATUS ENDS.

Grantor trust status can end during life, or it can continue until the grantor's death. The effect of the termination of grantor trust status has recently been the subject of much discussion.

A. *Gain Recognition if Grantor Trust Status Ends During the Grantor's Lifetime.*

Madorin v. Comm'r., 84 T.C. 667 (1985), examined the income tax consequence when a trust changed from a grantor trust to a non-grantor trust while owning a partnership interest. If the partnership interest had been transferred to a third party, the trust would have been treated as though it had received an amount of cash equal to the trust's share of the partnership's liabilities. § 752(a). Gain would have been recognized to the extent that the hypothetical cash distribution exceeded the trust's basis in the partnership. § 731(a)(1). Reg. § 1.1001-2(c), example (5) addresses this fact pattern and holds that the change in the trust's status is treated the same as a transfer of the partnership interest from the trust to a third person. The Tax Court upheld the regulation and found that a "disposition" had occurred that was analogous to cases that dealt with part-sale, part-gift transactions.

1. The result is the same as the disposition of any other property subject to a liability in excess of basis. *See Crane v. Comm'r.*, 331 U.S. 1 (1947). *Crane* holds that the disposition of property subject to debt, even if it is not sold, is treated for gain recognition purposes as though it was sold for the amount of the debt.
2. *Madorin* does not appear to stand for the proposition that there is a sale or exchange. There seems to be no justification for gain or loss recognition with respect to trust assets that are not subject to liabilities because there is no amount realized when there is no debt relief.
3. In IRS Legal Memorandum (ILM) 200923024 (June 5, 2009), the Senior Counsel opined that the conversion of a non-grantor trust to a grantor trust is not a transfer for income tax purposes of the property held by the non-grantor trust to the owner of the grantor trust that requires recognition of gain to the owner.¹

B. *Termination of Grantor Trust Status Upon the Grantor's Death.*

There is some disagreement whether income is triggered upon termination of grantor trust status when the grantor dies. A recognition of gain at death

¹ An ILM is a Chief Counsel Advice, and it cannot be used or cited as precedent. ILM 200923024 also opined that grantors of the trusts are not considered to have indirectly borrowed the trust property by selling partnership interests to the trusts in exchange for unsecured annuities, thus becoming the owners of the trusts under § 675(3) and causing the sale to be disregarded for federal income tax purposes.

argument appears inconsistent with the Supreme Court's treatment of the liability in *Crane, supra*. There, a beneficiary inherited the decedent's real property subject to a mortgage. Applying the predecessor to § 1014, the Court held that the beneficiary acquired a stepped-up basis in the property equal to its unencumbered value, not a basis equal to the equity in the property. *See also* Rev. Rul. 73-183, 1973-1 C.B. 364 (Transfers at death are not realization events for income tax purposes, even if the transferred property is subject to an encumbrance such as an unpaid installment note). This seems to negate the Tax Court's analogy in *Madorin* to cases dealing with a part-sale, part-gift transactions.

IV. BASIS STEP-UP FOR GIFT TAX PAID.

Another area of uncertainty is whether property transferred by a grantor to a grantor trust receives a § 1015(d) basis step up for gift tax paid, if any, on the transfer. There are at least three reasonably respectable, but inconsistent, arguments:

- Under Rev. Rul. 85-13, , 1985-1 C.B. 184, there has been no transfer for income tax purposes because the grantor continues to own the assets for income tax purposes irrespective of the gift taxation of the transfer. Thus, there can be no basis step-up with respect to the gift tax paid because there is no event.
- Although Rev. Rul. 85-13 applies for purposes of gain recognition, the transaction is a completed gift to a trust that happens to be a grantor trust. As such § 1015(d) governs basis calculations, and there is a basis step-up.
- Once grantor trust treatment stops, the taxpayer changes from the grantor to the trust as a third party, and the third party trust acquired the property by gift. Although there would be no basis step-up while the trust is a grantor trust, § 1015(d) should govern basis calculations after grantor trust status ends, thereby resulting in a step-up under § 1015(d) at that time.

V. EGTTRA GIFTS DURING 2010.

One impact of the failure to address estate taxes before the end of 2009 is that § 2511(c) became effective on January 1, 2010. Section 2511(c) was included in EGTTRA of 2001 due to a concern that, if there were no estate tax, trusts might be

used to shift income to lower income tax bracket taxpayers. This is important because the gift tax is not repealed for 2010, although the estate tax is repealed. Section 2511(c) attempts to address the income tax concern by providing as follows:

(c) Treatment of certain transfers in trust

Notwithstanding any other provision of this section and except as provided in regulations, a transfer in trust shall be treated as a transfer of property by gift, unless the trust is treated as wholly owned by the donor or the donor's spouse under subpart E of part I of subchapter J of chapter 1.

26 U.S.C. § 2511(c).

A. *Effect of § 2511(c).*

Transfers to non-grantor trusts during 2010 will be gifts although they might not have been gifts in 2009. Presumably the gifts can qualify for the annual gift tax exclusion.

B. *Some Unanswered Questions.*

Section 2511(c) creates confusion. Perhaps transfers to grantor trusts that are wholly owned by the donor or the donor's spouse will not be gifts, but this is not addressed by the statute, and it seems to be an unlikely result. There is no explanation whether the "non-gift" suddenly becomes a gift if the trust later ceases to be a grantor trust. There is no explanation as to what happens on January 1, 2011 when there is a reversion to the 2000 law.

PART TWO — USES OF GRANTOR TRUSTS

VI. *SALES TO INTENTIONALLY DEFECTIVE GRANTOR TRUSTS.*

A sale to an intentionally defective grantor trust (an "IDGT") has much in common with a grantor retained annuity trust (a "GRAT"). Both typically are transfers of business or investment interests to lower level generations with minimal estate tax or gift tax consequences.

A. *The Technique.*

Assets are often sold to family members using installment sales, which freezes the value of the assets. In an outright sale, the seller generally realizes capital gain when principal payments are received and realizes ordinary income from the interest payments. Capital gain and interest income, however, are not realized if the sale is to a grantor trust that is wholly taxed to the seller as grantor. See Reg. § 1.1001-2(c), Ex. 5; Rev. Rul. 2007-13, *supra*; Rev. Rul 85-13, *supra*. Thus, a grantor can create an irrevocable grantor trust to benefit the intended objects of the grantor's bounty and then sell a business interest to the trust without the recognition of gain.

B. *Illustration.*

Assume that Dad owns Success, Inc., an S corporation with a \$10,000,000.00 freely traded value. The company's taxable income is \$1,000,000.00 per year, which results in a \$380,000.00 income tax paid by Dad. The company pays a tax dividend of \$95,000.00 per quarter which Dad uses for estimated tax payments, and it pays a profits dividend of \$300,000 at the end of each year. Dad receives a salary of \$20,000.00 paid on the 15th of each month, which results in take-home pay of \$12,000.00 per month and \$8,000.00 in tax withholding.

In December 2009, Dad recapitalized the company receiving 100 shares of voting common stock and 99,900 shares of non-voting common stock. He also created an irrevocable Descendants' Trust to benefit his children and their descendants, and he funded the trust with a cash gift of \$630,000.00.

Assuming typical discounts, the fair market value of the non-voting stock is calculated as follows:

Freely traded value of all stock	\$10,000,000.00
Non-voting stock percentage	<u>99.9%</u>
Freely traded value non-voting stock	9,990,000.00
30% marketability discount	<u>[2,997,000.00]</u>
	6,993,000.00
10% minority/non-voting discount	<u>[699,300.00]</u>
Fair market value non-voting stock	<u>\$ 6,293,700.00</u>

On January 1, 2010, Dad sold the non-voting stock to the Descendants' Trust for \$6,293,700.00, receiving a down payment of \$630,000.00 and a nine year, promissory note for \$5,663,700.00 that bears interest at 2.45% per annum (the January 2010 mid-term AFR rate). The note is interest only

for nine years, a balloon payment of principal at the end of the term, and the right of prepayment. The note is secured by the stock.

The trustees of the Descendants' Trust intend to repay Dad in a manner that preserves the same cash flow that he had before the sale, and the corporation is willing to pay dividends to the trust that will facilitate the loan payments. A table showing what is required in order to preserve the same cash flow to Dad is as follows:

	<u>Payments if sale is not made</u>	<u>Dividends Followed by Loan Payments</u>
1/15 Take home pay	\$12,000.00	\$12,000.00
Tax Withholding	8,000.00	24,000.00
Tax Dividend	95,000.00	95,000.00
2/15 Take home pay	\$12,000.00	\$12,000.00
Tax Withholding	8,000.00	
3/15 Take home pay	\$12,000.00	\$12,000.00
Tax Withholding	8,000.00	
4/15 Take home pay	\$12,000.00	\$12,000.00
Tax Withholding	8,000.00	24,000.00
Tax Dividend	95,000.00	95,000.00
5/15 Net salary	\$12,000.00	\$12,000.00
Tax Withholding	8,000.00	
6/15 Take home pay	\$12,000.00	\$12,000.00
Tax Withholding	8,000.00	24,000.00
Tax Dividend	95,000.00	95,000.00
7/15 Take home pay	\$12,000.00	\$12,000.00
Tax Withholding	8,000.00	
8/15 Take home pay	\$12,000.00	\$12,000.00
Tax Withholding	8,000.00	
9/15 Take home pay	\$12,000.00	\$12,000.00
Tax Withholding	8,000.00	24,000.00
Tax Dividend	95,000.00	95,000.00
10/15 Take home pay	\$12,000.00	\$12,000.00
Tax Withholding	8,000.00	
11/15 Take home pay	\$12,000.00	\$12,000.00
Tax Withholding	8,000.00	
12/15 Take home pay	\$12,000.00	\$12,000.00
Tax Withholding	8,000.00	
12/31 Profits Dividend	\$300,000.00	\$300,000.00

Cash flow if sale is not made:

Take home pay	\$ 144,000.00
Withholding	96,000.00
Tax dividends	380,000.00
Profits dividend	<u>300,000.00</u>
Cash flow	<u>\$ 920,000.00</u>

Taxable Income:

Gross salary	\$ 240,000.00
Corporate taxable income	<u>1,000,000.00</u>
Taxable Income	<u>\$1,240,000.00</u>

Transfer taxes:

Value of company in Dad's estate:	<u>\$10,000,000.00</u>
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Cash flow from making sale:

Dividends	<u>\$ 920,000.00</u>
Cash flow	<u>\$ 920,000.00</u>

Taxable Income:

Pre-sale taxable income	\$1,000,000.00
Add back salary	<u>240,000.00</u>
Taxable Income	<u>\$1,240,000.00</u>

Transfer taxes:

Value of taxable gift:	<u>\$ 630,000.00</u>
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Assuming the above dates and amounts of loan repayments, the note will be paid in full on June 15, 2017, which is a year and one-half prior to maturity.

C. *Typical Steps.*

The typical steps in an installment sale to a grantor trust are as follows:

1. ***Step One — Create the Trust.*** The first step is for the seller to create a trust that includes one or more grantor trust features to result in the seller being taxed as the owner. It is also structured not to be “owned” for estate tax purposes.
 - (a) ***Crummey Withdrawal Rights.*** *Crummey* withdrawal rights are generally not included because they can result in the beneficiary, not the seller, being treated as the owner.

- (b) **Use of Follow-On GRAT Trusts.** If a GRAT also is being considered, it can provide that the GRAT remainder will be paid to a follow-on grantor trust. If the GRAT is successful, the follow-on trust can be used as the grantor trust for future purchases, and the remainder received from the GRAT will fund the seed money for the installment sale. *See* below.
- (c) **Use Non-Voting Stock.** If the retained right that creates the grantor trust is a § 675(4)(C) power to substitute assets of equal value (discussed *infra*), it might be better to use non-voting stock in lieu of voting stock to avoid a possible argument that the stock is included in the seller's gross estate under § 2036(b) (which concerns retained voting rights of a controlled corporation).

2. **Step Two — Seed the Trust.** To make the trust credit-worthy and to avoid debt versus equity issues that might result in estate tax inclusion, the trust should own significant assets before it purchases the asset.

- (a) **Rule of Thumb.** A popular rule of thumb is that the trust should have pre-sale assets of at least 10% of the value of the assets to be purchased. *See, e.g.*, PLR 9535026 (IRS insisted on a 10% floor). This is not an absolute safe harbor, and there are practitioners who argue that more is required, and there are practitioners who argue that less is enough.
- (b) **Guarantees.** It might be possible to provide seeding by using a guarantee by a beneficiary or a third party. The trust should pay a fair price for the guarantee so that the guarantor is not treated as making an indirect contribution to the trust. *But see Bradford v. Comm'r*, 34 T.C. 1059 (1960), *acq.* 61-1 C.B. 4. Guarantor's fees often are between 1% and 2%.
- (c) **Avoid Step Transaction.** To avoid step transaction arguments, it is preferable to avoid making the gift and the sale on the same date.
- (d) **Bona Fide Debt.** A concern often expressed when structuring a sale to an IDGT is not so much the commercial reasonableness of the transaction but whether the debt will be considered "bona fide debt." *See Miller v. Comm'r*, 71

T.C.M. 1674 (1996), *aff'd*, 113 F.3d 1241 (9th Cir. 1997) for criteria that may be considered with regard to this issue.

(e) ***The IRS Challenge in Karmazin.*** In an audit of a transaction that was compromised and settled on a very favorable basis to the taxpayer, the IRS argued in *Karmazin v. Comm'r*, T.C. Docket No. 2127-03, that the note was de facto equity. The argument was that the only trust assets were FLP interests sold to the trust which were the only source of interest and principal payments.

3. ***Step Three — Make the Sale.*** The asset is sold to the trust for fair market value in return for a down payment and an installment note. The note typically is secured by the purchased asset with full recourse against the trust.

(a) ***Interest Rate.*** The AFR rate is used instead of the higher § 7520 rate (assuming nine-year term or less) thereby maximizing the transfer. The § 7872 AFR rates address income and gift tax consequences of below market interest loans and gifts in intra-family loan transactions.

(i) The federal mid-term rate AFR is used if the note is for a nine-year term. The January 2010 mid-term rate for annual payments was 2.45%, while the higher § 7520 rate was 3.0%. If a note term exceeded nine years, it would have to use the January 2010 long-term AFR rate, which was 4.11% for annual payments.

(ii) Although § 1274(d) provides that the lowest rate of the rates for the month of the sale and the preceding two months can be used, using a rate from the preceding two months might raise an issue because a sale to a grantor trust theoretically is not a “sale” for income tax purposes.

(iii) The lower rate under § 483 probably should not be used because the IRS has argued that § 7872 governs for gift tax valuation of a promissory note. *See Krabbenhoft v. Comm'r*, 94 T.C. 887 (1990), *aff'd*, 939 F.2d 529 (8th Cir. 1991); *Frazee v. Comm'r*, 98 T.C. 554 (1992); PLR 9535026; PLR 9408018.

(b) **Term.** To avoid a risk that § 2036 applies, the note term should not exceed the seller's life expectancy. Prepayment generally should be authorized.

4. **Step Four — Plan to Pay the Note in Full During the Grantor's Lifetime.** There may be gain recognition if the note is not paid in full during the seller's lifetime. The Tax Court in *Estate of Frane v. Comm'r.*, 98 T.C. 341 (1992) (reviewed decision), *aff'd in part and rev'd in part*, 998 F.2d 567 (8th Cir. 1993), held that unrecognized gain was recognized by the decedent upon the cancellation of an installment note at the decedent's death. Although the Eight Circuit reversed, it held that the unrecognized gain was recognized by the decedent's estate as income in respect of a decedent. Neither result is desirable, and neither result is based upon a non-recognized sale to a grantor trust.

(a) Several highly respected authors have identified persuasive arguments that gain is not recognized upon the death of a grantor-seller with respect to the unpaid portion of an installment note that the grantor-seller received upon a sale to an IDGT. Jonathan G. Blattmachr, Mitchell M. Gans & Hugh H. Jacobson, *Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor's Death*, 97 J. TAX'N 149 (Sept. 2002); Joy Elizabeth Hodge, *On the Death of Dr. Jekyll—The Disposition of Mr. Hyde: The Proper Treatment of an Intentionally Defective Grantor Trust at the Grantor's Death*, 29 ESTATES, GIFTS AND TRUSTS JOURNAL 275 (Nov. 2004); Laura H. Peebles, *Death of an IDIT Noteholder*, TRUSTS AND ESTATES, Aug. 2005, at 28; David Handler and Deborah D. Dunn, *Tax Consequences of Outstanding Trust Liabilities When Grantor Trust Status Terminates*, 95 J. TAX'N 49 (July 2001).

(b) A persuasive argument is that the note is not income in respect to the decedent because the decedent would not have recognized income under Rev. Rul. 85-13 if the note had been paid during the decedent's life. Under § 691(a)(3), the existence, amount and character of IRD are determined as if "the decedent had lived and received such amount."

(c) To avoid the issue, the installment note is sometimes in the form of a self-canceling installment note (a "SCIN"). A SCIN is a note that cancels upon the maker's death unless

sooner paid in full. It includes an interest or principal premium to compensate for the self canceling feature.

- (i) A transfer to a son in exchange for an eleven year SCIN was held initially by the Tax Court in *Estate of Costanza v. Comm'r*, 81 T.C.M. (CCH) 1693 (2001), *rev'd* 320 F.3d 595 (6th Cir. 2003), to be a taxable gift because the son was inconsistent in making note payments and there was no showing that either the decedent or the son intended to enforce the note's payment provisions. The Sixth Circuit reversed stating that the presumption that intra-family transactions are not bona fide can be rebutted by an affirmative showing that there was a real expectation of repayment and an intent to enforce the collection of the indebtedness existed at the time of the transaction. The seller's death within months of the transaction was not determinative where the seller died unexpectedly and medical experts testified that he was expected to live somewhere between 5 and 13.9 years at the time of the transaction. Furthermore, the SCIN was fully secured by a mortgage on the properties.
- (ii) If a SCIN is used, the principal and interest payment probably should be made in level payments.
- (iii) Some practitioners make an express reference in the SCIN to the premium being paid for the termination feature. Language for this purpose might be as follows:

THE PARTIES INTEND THIS TO BE A CONTINGENT PAYMENT SALE. The purchase price of the stock is variable, and will be somewhere between \$0 and \$141,050, depending upon how long seller lives. A condition precedent to each contingent payment is that the seller be alive on the scheduled potential payment date. Consequently, if seller dies before any scheduled potential payment, the obligation to make such payment does not come into existence.

(d) ***Borrow the Funds Necessary to Pay the Installment Note.*** A grantor who is unlikely to survive the note term might make a loan to the trust, which the trust can use to pay the installment note before the grantor's death. Better yet, the trust might be able to borrow the funds from someone other than the grantor.

5. ***Step Five — Consider Electing Out of Installment Reporting.*** If the seller elects out of the installment method, there theoretically will be no income recognition due to Rev. Rul. 85-13. This may avoid gain recognition issues if the grantor-seller dies before the note is fully paid.

6. ***Step Six — Make the Installment Payments.*** Typically, the asset purchased by the trust is an interest in a pass-through entity (*e.g.*, an S corporation, limited liability company, limited partnership) that makes tax distributions.

(a) The tax distributions may provide the cash to make payments on the note in addition to payment of the grantor's income taxes.

(b) If the trust does not have adequate funds to make a payment, however, the trust might distribute trust assets to satisfy a payment with an in-kind distribution of assets. The payment will be a non-event with regard to the grantor.

D. ***Estate Taxes.***

The impact on estate taxes includes the following:

1. ***Estate Tax Inclusion.*** The unpaid balance of the installment note and accrued interest is included in a deceased seller's gross estate.

2. ***Sold Assets Excluded.*** The assets sold to the trust should be excluded from the deceased seller's estate, unless the note is successfully recharacterized as equity and not debt. As mentioned *supra*, there may be an argument for a § 2036(b) estate inclusion of voting stock if the retained right creating the grantor trust is a § 675(4)(C) power to substitute assets of equal value (discussed *infra*). Also, TAM 9251004 held that stock was included in a grantor's gross estate by reason of § 2036 (and § 2035) where the IRS

concluded that the deceased grantor's sale of closely-held corporate stock to a trust in exchange for a promissory note was the retention of a priority right to a major share (if not all) of the trust income in the form of note interest payments that apparently had to be paid from the first dividends paid by the corporation.

3. ***Estate Tax Return Question.*** The October 2006 version of the federal estate return added Question 12e to Part 4 to ask "Did decedent at any time during his or her lifetime transfer or sell an interest in a partnership, limited liability company, or closely held corporation to a trust described in question 12a or 12b?" Interestingly, there is no disclosure if the trust terminates prior to the grantor's death because Questions 12a and 12b refer to trusts in existence at the decedent's death.

E. *Gift Taxes.*

The impact on gift taxes includes the following:

1. ***The Seed Gift.*** The seed gift is a taxable gift. If the seeding comes from a remainder distribution from a GRAT that was distributed to a follow-on grantor trust, there will not be a taxable gift.
2. ***The Sale.*** The sale is not a taxable gift unless the assets are undervalued or the trust has insufficient equity to support the installment note.

F. *Generation-Skipping Transfer Tax.*

If the sale is for the full value of the asset there should be no further generation-skipping transfer tax impact beyond the GST exemption allocated at the time of the seed money gift. If there is an estate tax defect (such as one that results in inclusion under § 2036), the GST exemption cannot be allocated until the end of the estate tax inclusion period ("ETIP").

G. *Some Factors to Consider.*

Sales to intentionally defective grantor trust have many similarities to GRATs.

1. ***Advantages.*** Advantages over GRATs include the following:

- (a) **Interest Rate.** Sales to IDGTs use the applicable AFR for the installment note term without the 20% add-on for the § 7520 rate that is used for GRATs.
 - (b) **Flexible Payment Schedule.** Payments can be accelerated thereby creating flexibility. Payments from GRATs are made on an inflexible schedule.
 - (c) **Annual Valuations.** Each time that the GRAT uses a non-publicly traded or other hard to value asset to make all or part of an annuity payment, the asset must be reappraised.
 - (d) **Mortality Risk.** Unlike a GRAT, the estate freeze is completed without the requirement for survival for a designated period. In contrast, the IRS may argue that most or all of the GRAT is included in the grantor's estate if the grantor dies during the GRAT term.
 - (e) **GST Planning.** The trust used to make the purchase can be designed for maximum GST skipping. GST skipping is not practical for GRATs due the ETIP restrictions. See § 2642(f)(3).
2. **Disadvantages.** Among the disadvantages as compared to GRATs is that GRATs can have significant audit protection against the possibility of a revaluation of the gift. An increase in the value of the interest transferred to a GRAT merely increases proportionally the value of the GRAT remainder interest, which usually is nominal. An increase in the value of an interest sold to an IDGT results in a gift equal to the full increase in value.

VII. LIFE INSURANCE TRUSTS.

Gross income generally does not include death proceeds of life insurance. § 101(a)(1). However, death proceeds are subject to income tax if the policy is transferred for consideration to the extent the proceeds exceed the consideration paid for the policy and premiums or other amounts paid by the purchaser of the policy. § 101(a)(2). There are exceptions if the policy is transferred to the insured, a partner of the insured, a partnership of which the insured is a partner, or a corporation in which the insured is a shareholder or officer. § 101(a)(2)(B).

A. *Transfer to Grantor Trust Treated as Transfer to Insured.*

Prior to issuing Rev. Rul. 2007-13, 2007-1, C.B. 684, the IRS ruled in various rulings that a transfer of a life insurance policy between grantor trusts did not trigger the transfer for value rule because the exchange of a policy between grantor trusts is not a taxable event. Instead, the transfer to a grantor trust for which the insured is treated as the owner is deemed to be a transfer to the insured. PLRs 200606027, 200518061, 200514001 and 200514002. Some of the rulings also rely on the “same basis” exception in the transfer for value rule. *See* § 101(a)(2)(A). Rev. Rul. 2007-13 confirms the analysis in the private letter rulings.

B. *Situations Addressed.*

Rev. Rul. 2007-13 addressed two situations and treated them as transfers to the insured that are exempt from the transfer for value rule.

1. ***Situation 1 — Transfer from Grantor Trust to Grantor Trust.*** Rev. Rul. 2007-13 holds that the sale of a policy from one grantor trust that was treated as “wholly-owned” by the insured to another “wholly-owned” grantor trust is not a transfer for consideration for gain recognition purposes within the meaning of § 101(a)(2) income tax purposes.
2. ***Situation 2 — Transfer from Non-Grantor Trust to Grantor Trust.*** Rev. Rul. 2007-13 holds that the sale of a policy from a non-grantor trust to a grantor trust that was treated as “wholly-owned” by the insured is a “transfer” for income tax purposes, but it is a transfer to the insured. Thus, the § 101(a)(2) “transferred to the insured” exception to the transfer for value rule applies.

C. *Avoidance of § 2035.*

The three-year rule of § 2035(a)(2) does not apply if the life insurance policy is transferred for full consideration. Thus, the sale of a life insurance policy within three years of death to a grantor trust whose owner is the insured should be excluded from the grantor-insured’s gross estate.

1. The purchase price needs to be at fair market value. The regulations under § 2042 refer to the cost of a comparable policy. The life settlement industry might suggest higher prices than just the cash surrender value.

2. The IRS might argue that the full consideration exception only applies if the amount of the consideration is the amount that would otherwise have been included in the grantor's gross estate based upon *United States v. Allen*, 293 F.2d 916 (10th Cir. 1961). Without citing *Allen*, however, the IRS has ruled that the sale of a policy for its gift tax value does not require inclusion in the gross estate if the insured dies within three years of the sale. See, PLR 9413045.

D. *Practical Modification of an Existing Irrevocable Life Insurance Trust.*

If an insured wants to modify an existing irrevocable life insurance trust, a result similar to an amendment can be achieved by the existing trust selling the policy to a new grantor trust. The trustee of the selling trust needs to exercise diligence to assure that the trust is receiving full value for the policy in order to avoid tax issues as well as fiduciary liability. Not only does this continue the estate tax exclusion, the transfer does not trigger the transfer for value rule.

E. *Achieving Grantor Trust Status for a Life Insurance Trust.*

Care should be exercised in selecting the provision that results in grantor trust treatment for a trust that will own life insurance.

1. ***Power to Purchase Life Insurance.*** One technique to create a grantor trust may be to provide that both income and principal can be used to pay life insurance premiums on the life of the grantor and the grantor's spouse. See § 677(a)(3), discussed *infra*. While the authorization to apply income to the purchase of insurance on the life of the grantor arguably is adequate to create a grantor trust, there is significant authority that it might not result in a grantor trust. See discussion of § 677(a)(3). There are also arguments that the purchasing trust is a grantor trust only with respect to income, but not corpus, and only to the extent that income is actually used to pay premium. See discussion of § 677, *infra*,

2. ***Administrative Powers.*** Powers based upon rights to borrow or non-fiduciary powers to substitute property of equivalent value can result in grantor trust status. See discussion of § 675, *infra*. If held by the grantor, such powers might cause concern as to whether the grantor possesses a § 2042(b) incident of ownership.

- (a) *Estate of Jordahl v. Comm'r*, 65 T.C. 92 (1975), *acq.* 1977-1 C.B. 1, held that policies of life insurance were not included

in the decedent's gross estate although the decedent retained the power in a fiduciary capacity to substitute securities, property, and policies "of equal value" for those in the trust.

- (b) Rev. Rul. 2008-22, 2008-16 I.R.B. 796, discussed *infra*, extended the *Jordahl* exclusion for purposes of § 2036 and § 2038 to powers of substitution held in a non-fiduciary capacity, but it did not mention § 2042.
- (c) Rev. Rul. 82-5, 1982-1 C.B. 131, held the same as the *Jordahl* exclusion, stating:

While the Service takes no position on whether the survivor's loss benefits are classifiable as life insurance proceeds, nonetheless, the proceeds would not be includible in the decedent's gross estate because the decedent did not possess any incidents of ownership. Neither the power to cancel the policy and relinquish the motor vehicle registration nor the power to substitute a policy with identical survivor's benefits constitutes an incident of ownership within the meaning of section 2042.

- (d) Notwithstanding the foregoing, paragraph 16 of the Gifts and Estates and Trusts section of the Department of the Treasury 2009-2010 Priority Guidance Plan issued November 24, 2009 provides that they intend to issue "guidance on whether a grantor's retention of a power to substitute trust assets in exchange for assets of equal value, held in a nonfiduciary capacity, will cause insurance policies held in the trust to be includible in the grantor's gross estate under § 2042.

- 3. ***Give Powers to Spouse.*** Because the grantor is deemed to have any power held by the grantor's spouse, grantor trust status can be achieved without the risk of § 2042 estate tax inclusion by giving the grantor's spouse the power to borrow without adequate security. *See* § 675(2), discussed *intra*. Another power that could be given to the grantor's spouse is the power to reacquire trust property by substituting other property of an equivalent value. *See* 675(4), discussed *intra*. If these powers are held by the grantor's spouse, they are attributable to the grantor for income tax purposes. § 672(e). However, they are not attributable to the grantor for estate taxes

purposes because § 2042(b) does not have a spousal rule similar to § 672(e).

F. *“Cleansing” Prior Transfers for Value.*

The transfer of a policy to the insured cleanses all prior transfers for value. Reg. §§ 1.101-1(b)(3)(ii) and 1.101-1(b)(5)(Ex. 7). If there has been a transfer for value “hiccup” in the history of the policy, the problem can be cleansed by a transfer to a grantor trust.

G. *Self-Funding Life Insurance Trusts.*

Many grantor trusts acquiring business or other income producing assets are useful in purchasing life insurance. Common examples are intentionally defective grantor trusts that make installment purchases of business interests and follow-on trusts that receive distributions of remainder interests upon termination of GRATs. These trusts can be used to purchase life insurance, but care must be exercised when selecting a provision to make them into a grantor trust.

VIII. *DELAWARE INCOMPLETE NON-GRANTOR (“DING”) TRUSTS.*

Delaware trusts can be used by individuals residing in certain states (*e.g.*, New York, New Jersey, Kentucky, Massachusetts, Michigan and Missouri) to avoid or minimize state income taxes. The key is that Delaware does not tax non-Delaware beneficiaries nor does it Delaware trusts that benefit non-Delaware residents. In addition to the exemption from Delaware income tax, states such as the ones listed above do not tax a Delaware trust’s income if the trust is a non-grantor trust. It may be possible that an Alabama grantor can create a Delaware trust that is designed to temporarily avoid Alabama income taxation yet ultimately benefit its Alabama grantor.

A. *Possible Structure of a “DING” Trusts.*

Features that might be in a typical Delaware Incomplete Non-Grantor Trust that is used to sell an asset with a significant gain and possibly avoid Alabama income taxes are as follows:²

² Most of these features are based upon the facts in PLR 200715005, which is typical of several private letter rulings that have addressed DING trusts.

1. ***Delaware Trust with a Delaware Trustee.*** The grantor creates a trust that is governed by Delaware law. A Delaware corporation is designated as trustee. To avoid Alabama taxation, it is necessary that there not be an Alabama co-trustee.
2. ***Not a Grantor Trust.*** There are no features that cause the trust to be a grantor trust.
3. ***Distribution Committee.*** The trust provides that for a Distribution Committee during Grantor's lifetime that will be comprised of beneficiaries of the Trust who are not the Grantor or the Grantor's spouse. The Distribution Committee in PLR 200715005 initially consisted of Grantor's Brother and Grantor's Child.³
 - (a) If Brother or Child is unable to act, Grantor's son will be the first beneficiary to fill the vacant position on the Distribution Committee.
 - (b) Thereafter, the then eldest beneficiary of the Trust will fill any vacant position on the Distribution Committee.
 - (c) If at any time, there are less than two adult beneficiaries, the parent or guardian of the next eldest beneficiary will fill any vacant position on the Distribution Committee.
 - (d) If all of Grantor's descendants predecease Grantor, the Distribution Committee's powers will vest in the Trustee.
4. ***Distributees.*** During Grantor's lifetime, the Trustee may distribute income and principal, equally or unequally, to Grantor, Grantor's Brother, and Grantor's descendants.
 - (a) The decision to make a distribution is determined by either (i) the unanimous agreement of the Distribution Committee or (ii) any one member of the Distribution Committee coupled with Grantor's consent to each distribution.
 - (b) DING trusts often include the grantor's spouse and charities as permissible distributees.

³ CAUTION: As a result of IR-2007-127, July 9, 2007, discussed *infra*, the distribution committees in the future should have at least three members to minimize the issue of whether the members of the distribution committee have general powers of appointment.

- (c) To avoid Alabama taxation at the time of the sale of the appreciated asset, neither the Alabama grantor nor any other possible Alabama distributee should be a permitted distributee for a few years. This is to avoid having an Alabama person as a beneficiary to whom distributions currently may be made during the tax year of the sale.

5. *Testamentary Limited Power of Appointment.* Upon Grantor's death, Grantor has a limited power of appointment in favor of anyone other than Grantor, Grantor's creditors, Grantor's estate or creditors of Grantor's estate. This is intended to avoid a completed gift due to Grantor's retention of dominion and control. *See* Reg. § 25.2511(c)(2).

- (a) Grantor has the right to release the limited power of appointment or to further limit the persons or entities in whose favor the power may be exercised.
- (b) Any unappointed property will be divided at the Grantor's death into shares for Grantor's then living descendants, *per stirpes*.
- (c) Because of the effect of § 2511(c) while the 2010 estate tax repeal is in effect, a gift to a trust during 2010 that is not a wholly owned grantor trust with respect to the grantor or the grantor's spouse will be a taxable gift. Because DING trusts are non-grantor trusts, , DING trusts may not be useful until the estate tax is restored and § 2522(c) becomes a nullity.

6. *Asset Protection Requirement.* In addition to the foregoing outline of the trust described in PLR 200715005, a DING trust must also be an asset protection trust. In accordance with the Delaware Qualified Dispositions in Trust Act, 12 DEL. CODE ANN. § 3570–76, the provisions required to be in a Delaware asset protection trust include the following:

- (a) A Delaware individual or corporation must serve as one of the trustees.
- (b) The trust must contain a spendthrift clause.
- (c) The trust must be irrevocable.

- (d) The trust must incorporate Delaware law to govern validity, construction and administration of the trust.
- (e) The grantor cannot have any retained interest in the trust other than certain interests set forth in 12 DEL. CODE ANN. § 3570.
- (f) The trust must satisfy Delaware trust validity requirements.
- (g) The trustee must perform at least one of the following functions in Delaware:
 - (i) Maintain or arrange for custody of some or all of the trust property in Delaware.
 - (ii) Maintain trust records on an exclusive or non-exclusive basis in Delaware.
 - (iii) Prepare or arrange for preparation of fiduciary income tax returns in Delaware.
 - (iv) Otherwise materially participate in the administration of the trust in Delaware.

B. *Delaware Taxation of Trusts.*

Delaware treats a trust as a Delaware resident trust if the trust has at least one trustee located in Delaware. 30 DEL. CODE ANN. § 1601(8)). Delaware resident trusts deduct both the federal distributable net income that is actually distributed (30 DEL. CODE ANN. § 1635) and the amount of the federal taxable income that is set aside for future distribution to nonresident beneficiaries. 30 DEL. CODE ANN. § 1636. If the settler is domiciled in certain states (*e.g.*, Connecticut, Ohio and the District of Columbia), the settler's home state will tax the trust's income. Others states will not.

1. Some states tax trusts created by settlors who were domiciled in the state at the time of death or when the trust became irrevocable. Many such states impose a tax on the trust's income throughout the trust's existence, even if the trustee, all of the beneficiaries and the trust assets are located outside the state.

2. Some states require a significant, current connection between a trust and the state to subject it to state income tax.

C. *Alabama Taxation of Trusts.*

Alabama generally imposes an income tax on all income of an Alabama resident trust. The tax is paid either by the trust or by its beneficiaries, depending on whether distributions are made or are required to be made during the tax year. ALA. CODE § 40-18-25(a) and (b) (2008 Repl.).

1. ***Alabama Definition of Non-Resident and Resident Trusts.*** Alabama non-resident and resident trusts are defined as follows:

Section 40-18-1. Definitions.

For the purpose of this chapter, the following terms shall have the respective meanings ascribed by this section:

* * * * *

(22) NONRESIDENT TRUST. A trust other than a resident trust of this state.

* * * * *

(33) RESIDENT TRUST. A trust is a resident trust for a taxable year if it is a trust which meets both a. and b.:

a. The trust is created by the will of a decedent who was an Alabama resident at death or by a person who was an Alabama resident at the time such trust became irrevocable; and

b. For more than seven months during such taxable year, a person, as defined in this section, who either resides in or is domiciled in Alabama is either a fiduciary of the trust or a beneficiary of the trust to whom distributions currently may be made.

ALA. CODE § 40-18-1 (2008 Repl.).

2. ***Possible Design of a Temporary Non-Resident Trust.*** An aggressive approach that might be utilized by an Alabama resident to sell

an asset with a substantial gain is to create a Delaware trust that provides for discretionary distributions that can only be made to non-Alabama beneficiaries for the first few years. The appreciated assets can then be contributed to the trust to be sold. Because the trust does not initially have a current Alabama beneficiary, it likely does not become a resident Alabama trust until later years when distributions to Alabama beneficiaries will then be authorized. No state income tax will be paid if the trust satisfies Delaware trust requirements and it is a non-grantor trust.

D. *Avoid Grantor Trust Status.*

A grantor trust cannot be employed to avoid income taxes imposed by the grantor's home state because grantors have to report the income of such trusts on their state income tax returns. Thus, the trust must be designed to be a non-grantor trust.

1. ***Alabama Grantor and Non-Grantor Trusts.*** Alabama's law on grantor and non-grantor trust status is based upon Federal grantor and non-grantor trust law. See Ala. Code § 40-18-25(g) and (j) (2008 Repl.). If the trust is not a Federal grantor trust, it is not an Alabama grantor trust.
2. ***The Need for Asset Protection.*** A trust is a grantor trust if the income is, or in the discretion of the grantor or a nonadverse party, or both, may be applied in discharge of a legal obligation of the grantor or the grantor's spouse. Reg. § 1.677(a)-1(d). Under the laws of most states, if a trustee has the power, in the exercise of its sole discretion, to distribute trust assets to the settlor, the settlor's creditors may claim all of the trust assets to satisfy the settlor's debts. Thus, self-settled trusts formed under most states' laws cannot be employed to avoid state income taxes in the settlor's home state. However, if the settlor's creditors cannot attach the assets of the trust — *e.g.*, a Delaware asset protection trust — the trust will not be a grantor trust on that basis. The requirements for a Delaware asset protection trust are found at 12 DEL. CODE ANN. § 3570, *et seq.*
3. ***Discretionary Distributions to Grantor May be Permitted.*** Section 673 provides that a trust is a grantor trust if the grantor retains a reversionary interest that exceeds five percent (5%) in present value. See discussion of § 673, *infra*. Eligibility to receive discretionary distributions, however, does not seem to be a reversionary interest as the term is commonly understood, and the IRS agreed in PLR

200148028. See also PLRs 200502014; 200247013; and 200612002. It is critical, however, that the scrivener of a trust intended to avoid grantor trust treatment provide that no portion of the trust will ever revert to the settlor or the settlor's spouse.

4. ***Power of Disposition to the Grantor Held by Persons with Beneficial Interests.*** Section 674 generally provides that a trust is a grantor trust if the beneficial enjoyment of the trust property is subject to a power of disposition exercisable by the grantor or a non-adverse party or both, without the approval or consent of any adverse party. See discussion of § 674, *infra*. The grantor, however, is not taxed as the owner of any portion of the trust pursuant to § 674 if both of the following conditions are met:

- (a) The trust income and principal may be distributed or accumulated in the trust only with the consent of the members of a "distribution committee," each of whom is an adverse party within the meaning of § 672(a); and
- (b) The settlor's only power to control beneficial enjoyment is a testamentary limited power of appointment.

5. ***Avoidance of Power to Revoke or Income for Benefit of Grantor.*** To avoid classification as a grantor trust pursuant to § 676 (power to revoke) or § 677 (income for benefit of grantor or grantor's spouse), the trust should provide that the trustee has no power to make any distribution of net income or principal to or for the benefit of the grantor or the grantor's spouse during the grantor's life unless the distribution is made at the direction of a distribution committee comprised of adverse persons (*i.e.*, beneficiaries).

- (a) Each member of the distribution committee must be eligible to receive distributions out of the trust estate. Each member of the distribution committee also should have the power, acting in a nonfiduciary capacity, to participate in deliberations concerning, and to vote in favor of, distributions to, or for the benefit of, such distribution committee members personally. Members of the distribution committee then will be "adverse persons" with respect to the grantor and the grantor's spouse for purposes of the grantor trust rules.
- (b) In the forms of trust agreements on which the IRS has ruled, all rights and powers conferred on the distribution committee

were exercisable only by unanimous action of all members of the committee except that any member of the committee acting alone could direct the trustee to make one or more distributions upon obtaining the grantor's prior written consent to the distribution. It should be possible to achieve the same goal with a different design, providing the non-grantor trust with other mechanisms for distribution committee action.

6. ***Limit Spousal Powers.*** Although the settlor's spouse may be a discretionary distributee, a Delaware non-grantor incomplete gift trust should not provide the grantor's spouse with an interest that would result in a grantor trust if held by the grantor. Under § 672(e), the grantor is treated as holding any power or interest held by the grantor's spouse. A QTIP trust, for example, would likely cause the settlor to be deemed to possess a reversionary interest that would cause the trust to be a grantor trust under § 673. The grantor, however, may retain and exercise a testamentary limited power of appointment in favor of the spouse either outright or in favor of a QTIP trust or in some other type of trust in which the spouse holds an interest.

E. *Avoid a Completed Gift by the Grantor.*

The Internal Revenue Service ruled that it is possible to create a self-settled non-grantor trust without triggering gift tax. See PLRs 200148028; 200247013; 200502014; 200612002; 200637025; 200647001; 200715005; 200731019; and 200729025. (It is actually possible to create four types of Delaware asset protection trusts: (i) non-grantor/incomplete gift, (ii) non-grantor/completed gift, (iii) grantor/incomplete gift, and (iv) grantor/completed gift. Each variation can have very beneficial attributes to settlors with specific planning needs.).

1. ***Use of Testamentary Limited Power of Appointment.*** A gift in trust is incomplete if, and to the extent that, a reserved power gives the grantor the power to name new beneficiaries or to change the interests of the beneficiaries as between themselves, unless the power is a fiduciary power limited by a fixed or ascertainable standard. Reg. § 25.2511-2(c). Thus, a contribution to a trust is not a completed gift if the trust gives the grantor a testamentary limited power of appointment over all of the trust property. A taxable gift will occur when the grantor's power to change the trust interests is released or extinguished. Thus the gift will be complete (and hence taxable)

upon the occurrence of any action by the distribution committee that effectively terminates the grantor's power of appointment with respect to any part of the trust property, including the distribution of income or principal to anyone other than the grantor.

2. ***Gift Problem Due to EGTTRA of 2001.*** A transfer to a non-grantor trust automatically will be a taxable gift commencing January 1, 2010 until the provisions of EGTTRA of 2001 enacting § 2511(c) are addressed by Congress or the 2000 law is reestablished.

F. *The Gift by Members of the Distribution Committee Issue.*

The IRS announced in IR-2007-127 (July 9, 2007) that it was reconsidering its position in the private letter rulings to the effect that the joint distribution power held by the members of the distribution committee does not result in the committee members holding a general power of appointment. See Lawrence I. Richman, *The IRS Reconsiders Its Rulings on Incomplete Gift Nongrantor Trusts*, JOURNAL OF PASSTHROUGH ENTITIES, Jan.–Feb., 2008, at 9. In addition, the IRS will no longer rule on DING trusts.

1. ***Holdings in the Private Letter Rulings.*** In the private letter rulings, the IRS concluded that the distribution committee members had substantial adverse interests to each other for § 2514 powers of appointment purposes. See PLRs 200148028; 200247013; 200502014; 200612002; 200637025; 200647001; 200715005; 200731019; and 200729025. Therefore, the committee members did not possess general powers of appointment. Accordingly, distributions were not gifts by the distribution committee members.

(a) The private letter rulings relied in part upon § 2514(c)(3)(B), which provides that a power is not a general power of appointment if the power can only be exercised by its possessor in conjunction with a person with a substantial interest that is adverse to the exercise of the power in favor of the possessor.

(b) The private letter rulings also cite Reg. § 25.2514-3(b)(2), which provides that a co-holder of a power of appointment does not have an adverse interest simply because the co-holder is a joint possessor of a power of appointment and is a permissible appointee unless the co-holder will possess the power after the possessor's death and at that time may exercise it in favor of himself, his estate, his creditors or the

creditors of his estate. This might occur with respect to the last co-holder following the death of the other co-holders, unless deceased co-holders are replaced.

2. ***The Revenue Rulings.*** IR-2007-127 solicits comments on how the PLR holdings are affected by Rev. Rul. 76-503, 1976-2 C.B. 275, and Rev. Rul. 77-158, 1977-1 C.B. 285. These revenue rulings indicate that the committee members might be treated as possessing general powers of appointment over the trust corpus because they are replaced if they resign or die.
- (a) Rev. Rul. 76-503 and Rev. Rul. 77-158 held that distribution committee powers were taxable general powers of appointment because the distribution committee members were replaced if they resigned or died.
 - (b) Rev. Rul. 76-503 explains that, if three people jointly hold a power of appointment, they are adverse to its exercise if upon the death of one of the co-holders, the surviving co-holders will be able to exercise the power in their own favor by themselves.
 - (i) When three people hold the power, the IRS reasons that it is in the economic interest of whoever will be the survivor or survivors not to exercise the power in favor of the other powerholders during their lifetimes because the last survivor can receive everything.
 - (ii) If a powerholder is replaced upon ceasing to act, the other powerholders are not necessarily in a better position after the original powerholder ceases to act. Accordingly, if co-holders of a power of appointment must continue to share their power with a replacement holder upon the death of a current holder, they lack a substantial interest in property that is adverse to the exercise of the power in favor of any other co-holder.
 - (iii) Because a co-holder is a permissible appointee, the IRS ruled that a portion of the trust estate is includible in the co-holder's gross estate based upon the fair market value of the trust estate divided by the number of co-holders of the power.

(c) Rev. Rul. 77-158 added that it is irrelevant whether the three co-holders were required to vote unanimously or by majority vote in order to effect a distribution, unless a powerholder is in a better economic position after the death of a powerholder.

3. ***Shrinking Distribution Committee.*** A shrinking distribution committee of three members falls squarely within Reg. § 25.2514-3(b)(2) and should address the concerns that the IRS raised in IR 2007-127. However, a shrinking Distribution Committee raises issues of what happens after one or more members die or resign.
4. ***Effect of the Limited Power of Appointment.*** The facts presented in the PLRs appear to be distinguishable from the revenue rulings because the grantors' gifts to the trusts in the PLRs were incomplete due to the grantors' retention of testamentary limited powers of appointment. See, Reg. § 25.2514-1(e), Example (1) and Rev. Rul. 67-370, 1967-2 C.B. 324.

G. *Avoid the Court Holding Issue.*

In *Comm'r v. Court Holding Co.*, 324 U.S. 331 (1945), a corporation negotiated the sale of an apartment building and intended to liquidate immediately after the sale. At the closing, however, the taxpayers were advised that they could avoid double taxation under the tax law then in effect if the corporation was liquidated first and the shareholders made the sale. They immediately restructured the transaction, but the Supreme Court held under these facts that the sale had been made by the corporation and not by the shareholders. Cf. *United States v. Cumberland Public Service Co.*, 338 U.S. 451 (1950) (corporation declined to negotiate a sale but its shareholders agreed to cause a liquidation and then make the sale, with the result that the shareholders were treated as the sellers and double taxation was avoided). Based upon the *Court Holding* principle, the grantor will be taxed on the sale of the appreciated asset if the negotiations for the sale are completed before the asset is transferred to the trust.

IX. *LOWER BRACKET TRUSTS.*

Income tax brackets for estates and trust are severally compressed as compared to other taxpayers. See § 1(a)–(e). For 2009, trusts will reach the top 35% income tax rate with only \$11,150.00 in taxable income. In contrast, individuals do not reach the 35% bracket until \$372,950.00 of taxable income. Grantor trust status

permits the taxable income to be taxed at an individual's tax rates instead of the compressed tax brackets applicable to trusts and estates.

X. LEVERAGED GIFT TRUSTS.

If a grantor desires to maximize non-taxable transfers (*e.g.*, annual exclusion gifts), the transfer tax savings can be enhanced by making the transfer to a grantor trust. This results in the grantor, not the donee, paying tax on the earnings from the gifted property. For example, assume that Granddad creates a trust for Grandbaby at the beginning of the year of Grandbaby's birth, and the gifts, income, growth and taxes thereafter are as follows:

Annual gifts	\$24,000.00
Granddad's income tax rate	35%
Trust's income tax rate	35%
Annual income	4%
Annual growth	8%
Distributions	none

Depending upon whether the trust is a grantor trust, the accumulation in the trust at the end of 21 years will be as follows:

Version A — Trust is a grantor trust and Granddad pays the income tax	\$2,196,062
Version B — Trust is a non-grantor trust and trust pays the income tax	<u>1,826,976</u>
Enhancement if grantor trust	<u>\$ 369,086</u>
Percentage increase	<u>20.20%</u>

XI. SALES OF PRINCIPAL RESIDENCES.

The \$250,000 (\$500,000 for joint returns) exclusion from gain recognition under § 121 with respect to the sale of a principal residence by an individual applies if the residence is owned by a grantor trust because the grantor is deemed to be the actual owner of the assets held in the trust.. See Rev. Rul. 85-45, 1985-1 C.B. 783; PLRs 200124011 and 9118017 (prior § 121 provision excludes gain on sale of residence by individual over age 55 when sale is made by grantor trust).

XII. WHEN BABY NEEDS A NEW TRUST.

Assume that Grandbaby has just been born, and Grandparents want to make \$13,000 annual exclusion gifts. They want Child as trustee to accumulate trust income until Grandbaby has major needs, like college, or until the Grandbaby attains his or her maturity. Their idea of maturity is not age 21. Grandparents are horrified by the thought that Grandbaby's trust might pay a 35% federal income tax. They want the flexibility for the trust to invest in S corporations.

A. Section 2503(c) Trusts for Minors.

Gifts to trusts that can accumulate income generally are future interests that do not qualify for the \$13,000.00 annual present interest gift tax exclusion. Gifts to trusts with certain provisions, however, can qualify as present interest gifts, thus enabling the gifts to qualify for the \$13,000 annual present interest gift tax exclusion. § 2503(c)

1. Requirements. Section 2503(c) has three principal requirements.

- The trust must provide that the income and principal will be expended for the minor's benefit during the term of the trust.
- All accumulated income and undistributed principal must be paid to the minor when he or she attains aged 21.
- If the minor dies prior to age 21, the trust must be paid to the minor's estate or be payable pursuant to a general power of appointment held by the minor.

2. Problems with 2503(c) Trusts. Section 2503(c) trusts are not without problems. The problems include—

- (a) **Distributions.** Section 2503(c) provides that income and principal must be distributed for the minor's "benefit". Standards that are more limited or that give consideration to other resources available to the minor often are desirable. Such restrictive standards, however, can disqualify the trust.
- (b) **Limited to Minors.** There is no provision similar to § 2503(c) that authorizes similar trusts for financially immature persons who are not minors.

- (c) ***Income Taxation.*** Section 2503(c) trusts typically are complex trusts for income tax purposes and are taxed on their undistributed income. In 2009, trusts reached the top 35% tax rate with only \$11,150.00 in taxable income. As discussed hereinafter, it is possible to include a “defect” that taxes the trust’s income to the donor as a grantor trust.
- (d) ***S Corporation Stock.*** Generally, a corporation loses its S election if its stock is acquired by a trust. *See* § 1361(b)(1). The S election is not lost if the trust has a qualified subchapter S trust election or an electing small business trust election. *See* § 1361(d), § 1361(c)(2)(A)(v), and § 1361(e). Some features of these elections are undesirable, but they must be made if a § 2503(c) trust is to own stock in an S corporation, unless the trust is a grantor trust treated as owned by an individual. *See* § 1361(c)(2)(A)(i). Because of the mandatory income distribution requirement for a QSST election, § 2503(c) trusts that are not grantor trusts should make the less favorable ESBT election in order to own S corporation stock.
- (e) ***Termination at Age 21.*** Technically, a § 2503(c) trust must distribute its accumulated income and principal to the child at age 21. In Revenue Ruling 74-43, 1974-1 C.B. 285, the IRS held that a § 2503(c) trust can continue beyond age 21 if it gives the minor a brief time window (*e.g.*, 30 days) at age 21 to demand the distribution. Even this limited right of withdrawal can be undesirable.
- (f) ***Trustee.*** The preferred choice for trustee often is a parent of the child. The IRS’s interpretation of general power of appointment rules, however, may cause inclusion in the parent’s estate if the parent-trustee dies before the § 2503(c) trust terminates because the trust can be used to meet the parent’s duty to support the beneficiary. The § 2503(c) trust in *Upjohn v. United States*, 72-2 U.S.T.C. ¶ 12,888 (W.D. Mich. 1972), avoided this problem by providing that the parent-trustee could not make distributions for the purpose of meeting the trustee’s legal obligation of support.

B. *The Crummey Kid Trust.*

In a *Crummey* Kid Trust, contributions to the trust are subject to withdrawal rights based upon *Crummey v. Comm'r*, 397 F.2d 82 (9th Cir. 1968). The present interest aspect of the *Crummey* type right of withdrawal gives the trust the same annual gift tax exclusion as a § 2503(c) trust for a minor without the § 2503(c) restrictions on design of the trust. Thus, a donor who wants the trust to continue beyond age 21 without having to give the child a withdrawal opportunity at age 21 will prefer the *Crummey* Kid Trust.

1. ***Treatment as a Grantor Trust.*** *Crummey* Kid Trusts are grantor trusts. If they include an intentional grantor trust defect, the income is taxed to the grantor. If they are not taxed to the grantor, then § 678(a)(1) (Person other than grantor treated a substantial owner) provides generally that a person who had the power to vest the corpus or income in himself or herself (*e.g.*, the *Crummey* withdrawal right) and who then releases the power is treated as making a transfer to the trust for purposes of the grantor trust rules. If the person then continues as the trust's beneficiary, § 677 (Income for benefit of grantor) causes the beneficiary to be taxed on the trust's income under the grantor trust rules as though the beneficiary had been the grantor. As result, the beneficiary is treated as the owner of the trust's assets for income tax purposes if the donor is not treated as the owner.
2. ***Typical Provisions.*** Provisions typically found in a *Crummey* Kid's Trust include the following:
 - (a) ***Withdrawal Rights.*** The beneficiary is given the right to withdraw contributions from the trust without limitation as to the dollar amount. This qualifies the gift for the \$13,000 annual gift tax exclusion for present interest gifts. If the beneficiary is a minor, the right can be exercised by the beneficiary's parent. The withdrawal right will lapse if it is not exercised within 30 days of notification of the contribution and the right of withdrawal. If the donor is worried about whether the withdrawal right will be exercised, the donor can make a series of small gifts during the year (*e.g.*, \$3,000 per quarter, or \$1,000 per month), thereby giving the donor the opportunity to cease gift making following exercise of the withdrawal right.

- (b) **Termination.** Trust can terminate at any designated age or continue for the beneficiary's lifetime.
- (c) **General Power of Appointment.** The beneficiary is given a testamentary general power of appointment over the remainder of the trust should the beneficiary die prior to the age for termination.
 - (i) **Avoids Lapse of Power of Appointment Issues.** This avoids problems with the \$5,000.00 and 5% lapse rule that applies for gift tax and estate tax purposes with respect to general powers of appointment. See § 2041(b)(2) and § 2514(e) (lapse of a power of appointment is treated as a transfer by the beneficiary to the extent it exceeds the greater of \$5,000.00 or 5% of the value of the assets out of which the power could have been satisfied).
 - (ii) **Avoids GST Issues.** It also results in a typically desirable direct skip and generation-transfer tax annual exclusion for generation-skipping transfer tax purposes if the beneficiary is a skip person. See § 2642(c)(2)(B) (for transfer in trust to qualify as a direct skip with an inclusion ratio of zero, the trust must be includible in the beneficiary's gross estate if the beneficiary dies before the trust terminates).
- (d) **Upjohn Clause.** An *Upjohn* clause (*i.e.*, parent-trustee cannot make distributions to fulfill the parent-trustee's legal obligation of support; see *Upjohn v. United States*, *supra*) can be included to avoid estate taxation to the child's parent should the child's parent serve as a trustee.
- (e) **Distribution Standards.** The grantor has flexibility in designing the standard for distributions. A common provision in a *Crummey* Kid's Trust that is not available to a § 2503(c) trust for a minor is an instruction for the trustee to consider other resources available to the child. Some *Crummey* Kid's Trusts add incentive trust provisions to limit distributions if the child adopts an inappropriate lifestyle (*e.g.*, substance abuse, indolence).

XIII. GRANTOR RETAINED ANNUITY TRUSTS.

A grantor retained annuity trust (“GRAT”) involves the transfer of property to an irrevocable trust in exchange for an annuity. Whatever remains at termination is paid to the remainder beneficiaries. The amount transferred to the remainder beneficiaries can be substantial if the property grows significantly in value or provides income. Without adequate growth or income, the GRAT will fail to transfer anything to the remainder beneficiaries.

A. *Gift Taxation.*

The amount of the taxable gift is the value of the property transferred to the GRAT minus the value of the annuity interest. The annuity payments can be established at values that reduce the amount of the taxable gift close to zero dollars. If the growth and earnings of the GRAT are at a rate that exceeds the § 7520 rate (*i.e.*, 120% of the mid-term AFR) the remainder is transferred to the remainder beneficiaries at a nominal gift tax cost.

B. *Illustration.*

Assume that \$1,000,000 is transferred to a two-year GRAT during August, 2008 and that the grantor retains the right to receive payments of \$531,700 with the remainder to go to a trust for the grantor’s children. The value of the gift to the children is calculated to be \$31.81. If the asset earns 6% per year and the principal also grows at the rate of 6% per year, the actual remainder interest that will pass to the trust for the grantor’s children will be \$130,274.

C. *GRATs are Grantor Trusts.*

Because the grantor retains the right to have both income and principal used to satisfy the annuity payments, the GRAT should be treated as a grantor trust for income tax purposes.

D. *Importance of Grantor Trust Status.*

It is important that the GRAT be a grantor trust during its term and desirable that any follow-on trust receiving the remainder benefits after the trust terminates also be a grantor trust. Among the benefits of grantor trust status are—

- No gain is recognized upon the transfer of appreciated property to the trust.

- No gain is recognized if appreciated property is distributed to the grantor from the trust in satisfaction of the annuity payments.
- No gain is recognized if the grantor purchases appreciated property from the trust.
- The grantor is taxed on income and realized gains on trust assets thereby enhancing the GRAT's effectiveness.

E. *GRAT Advantages Compared to Sales to Intentionally Defective Grantor Trusts.*

1. ***Gift Tax Audit Risk.*** By defining the annuity payments as a percentage of the initial value of the property contributed to the GRAT, there will be smaller “swings” in the amount of the taxable gift if an audit challenges the valuation of the property contributed to the GRAT. This is particularly useful if the contributed property is not publicly traded or is hard to value. *See Dallas v. Comm’r*, 92 T.C.M. (CCH) 313 (2006) (Value of stock sold to grantor trust exceeded appraised value notwithstanding agreement that parties would be bound by appraised value and value of self-canceling promissory notes were less than their face value).
2. ***“Seed” Gift is not Required.*** There is general concern regarding a sale to an IDGT unless the trust is first funded by an amount equaling or exceeding 10% or 11.1% of the installment sales price or there is a guarantee of the installment note by a creditworthy beneficiary.
3. ***Better Guidance.*** There is a body of law consisting of the statute, regulations, private letter rulings and *Walton v. Comm’r*, 115 T.C. 589 (2000) to guide the structuring of a GRAT. The only “authority” regarding sales to IDGTs is the audit of a transaction which was compromised and settled in *Karmazin v. Comm’r*, T.C. Docket No. 2127-03.

XIV. *SUBCHAPTER S TRUSTS.*

Subject to several exceptions, an election to be an S corporation generally cannot be made or continued if the corporation's stock is owned or acquired by a trust. § 1362(b)(1).

A. *S Stock Owned by Grantor Trusts.*

A trust that is treated under the grantor trust rules as wholly owned by one person is a permitted shareholder of an S corporation. § 1362(c)(2)(A)(i).

1. ***Two-Year Continuation Following Death of Grantor-Owner.*** Upon the death of the grantor-owner, the trust continues to be a permitted shareholder of the S corporation for the two-year period that began on the owner's date of death. § 1362(c)(2)(A)(ii).
2. ***S Corporation Stock Acquired by Will.*** The rule with respect to grantor trusts is similar to the rule that a trust that acquires stock pursuant to the terms of a will can continue to be a permitted S corporation shareholder for the two-year period following the testator's death. § 1362(c)(2)(A)(ii).

B. *Qualified Subchapter S Trusts.*

A beneficiary of a trust with certain features can also make a Qualified Subchapter S Trust ("QSST") election to preserve the S corporation election. § 1362(d).

1. ***QSST Requirements.*** QSST features require the trust to have only one income beneficiary who must elect to be taxed as though the trust was a grantor trust. § 1362(d)(2)(A) and § 1362(d)(3)(A)(i). All fiduciary accounting income of the trust must be distributed currently to the beneficiary. § 1362(d)(3)(B). Corpus distributions, if any, can only be made to the beneficiary. § 1362(d)(3)(A)(ii). All assets must be distributed to the beneficiary if the trust terminates during the beneficiary's lifetime. § 1362(d)(3)(A)(iv).
2. ***Income Taxation.*** If the beneficiary makes the QSST election, the beneficiary is treated as the owner under the grantor trust rules of the portion of the trust that consists of the S corporation stock. § 1362(d)(1). This means that the beneficiary is taxed directly on the trust's share of the S corporation's taxable income, although the beneficiary will receive only the net amount of dividends actually paid. This is the same ownership tax treatment that the beneficiary would receive if the beneficiary was the direct owner of the stock.

XV. *S CORPORATION LEVERAGED ACCUMULATION TRUSTS.*

A QSST election can be used to convert a non-grantor trust into a simulated grantor trust. This can be useful for trusts with only one current beneficiary and the beneficiary does not need nor want to receive the income but is willing to pay the income tax on the trust's taxable income. A typical candidate for this device is a QTIP or general power of appointment marital trust or a credit shelter trust.

A. *Trusts with Potential to become Leveraged Accumulation Trusts.*

The characteristics of a trust to consider for conversion into an S Corporation Leveraged Accumulation Trust are as follows:

1. The trust meets the requirements to be a QSST. Thus, it can only have one current beneficiary. If the trust terminates during the current beneficiary's lifetime, the trust assets must be distributable only to the current beneficiary. The beneficiary must be willing to make the QSST election.
2. The trust typically should be—
 - (a) A trust that mandates the distribution to the current beneficiary of all trust income;
 - (b) A trust that can accumulate trust income but is taxed at top income tax rates when it does so; or
 - (c) A trust that will be exempt from estate tax when the beneficiary dies and the beneficiary desires that the trust accumulate assets to the extent possible, either by not making distributions or by having the beneficiary pay the tax on undistributed taxable income.

B. *Conversion into the Leveraged Accumulation Trust.*

The following steps will convert a trust into an S Corporation Leverage Accumulation Trust:

1. The trustee forms an S corporation to be owned by the trust.
2. The trustee transfers trust assets into the S corporation.

3. The trust beneficiary makes a QSST election within two and one-half months of the formation of the S corporation.
4. Because the S corporation will not have any C corporation accumulated earnings and profits, the S corporation is not be subject to the § 1362(d)(3) and § 1375 S corporation passive income rules.
5. Because the S corporation will never be a C corporation, it is not be subject to the § 1374 double income tax that results from built-in gains of S corporations.

C. *Benefits of the QSST.*

The benefits of the S Corporation Leveraged Accumulation Trust include the following:

1. In a trust that mandates the distribution of all of trust income, the trust's fiduciary accounting income is limited to the dividends, if any, paid by the S corporation. Taxable income retained in the S corporation is not fiduciary accounting income of the trust.
2. The beneficiary will pay the income tax on the S corporation taxable income at the beneficiary's tax rates, whether or not the S corporation taxable income is distributed.
 - (a) The taxable income is taxed at the beneficiary's tax rates which likely are lower than the trust's tax rates.
 - (b) The income tax paid by the beneficiary reduces the beneficiary's gross estate, not the trust corpus.
3. Distributions can be made if the beneficiary needs money to pay the income taxes or to satisfy other needs.

D. *Problems with the QSST.*

Problems to consider before converting to a Leveraged Accumulation Trust income the following:

1. Unlike a true grantor trust owning S corporation stock, the trust will not have a two year grace period following the beneficiary's death during which it can continue to own the S corporation stock without jeopardizing the S election. Thus, either a QSST election or an

electing small business trust election **must** be made within two and one-half months after the beneficiary's death, even if the trust terminates at the beneficiary's death and the stock is to be distributed to individuals immediately thereafter.

2. Care will be required when liquidating the corporation because (i) gain, but not loss, is recognized at the corporate level upon the corporation's distribution of assets in liquidation and (ii) gain or loss is recognized at the shareholder level upon the liquidation. The gain recognized at the corporation level increases the basis in the stock, thereby reducing the gain, or creating or increasing a loss, at the shareholder level.
3. There will be no basis step-up for the assets in the S corporation. This should not be an issue for a credit shelter trust that will not otherwise receive a basis step-up, but it could be an issue for a QTIP or general power of appointment marital trust whose assets will otherwise receive a basis step-up. Notwithstanding, if the S corporation is liquidated, the basis in the distributed assets will be stepped-up to their date of liquidation fair market value.

XVI. SECTION 645 ELECTION FOR TRUST TO BE TAXED AS AN ESTATE.

The Taxpayer Relief Act of 1997 provides that the executor of an estate and the trustee of a qualified revocable trust ("QRT") may elect to treat the QRT as a combined entity taxable as an estate (and not as a separate trust). If there is no estate, the QRT can elect to treat the QRT as an estate.

A. Qualified Revocable Trusts.

A QRT is a trust (or portion thereof) that was treated under § 676 (*i.e.*, a revocable trust) as a grantor trust owned by the decedent on the date of death. Reg. § 1.645-1(b)(1). The power to revoke must have been held by the decedent and not merely charged to the decedent under § 672(e) (which relates to powers held by the decedent's spouse). Treatment as a grantor trust under other sections will not result in a QRT.

B. Advantages of the Election.

The advantages of the election include the following:

1. ***Taxable Years.*** Being part of an estate, the QRT can elect a taxable year other than the calendar year. Reg. § 1.645-1(e)(2)(ii) and (3)(i).
2. ***Subchapter S Election.*** The QRT is treated as an estate for purposes of the subchapter S shareholder requirements of section 1361(b)(1). Reg. § 1.645-1(e)(2)(i) and (3)(i). If the election is not made, the trust can only continue as an S shareholder for two-years after the owner's death, unless it makes a QSST election, an ESBT election or becomes a wholly grantor trust. *See* § 1361(c)(2)(A)(ii).
3. ***Charitable Set Aside Deduction.*** The QRT is an estate for purposes of the § 642(c)(2) deduction for amounts set aside for charitable purposes. Reg. § 1.645-1(e)(2)(i) and (3)(i).
4. ***Rental Real Estate Activities.*** The QRT is an estate for purposes of the special offset for rental real estate activities in § 469(i)(4) concerning passive activities. Reg. § 1.645-1(e)(2)(i) and (3)(i).
5. ***Estimated Tax Payments.*** The two year exception under § 6654(l)(2)(A) relating to an estate's obligation to make estimated tax payments applies to the QRT. Reg. § 1.645-1(e)(4).
6. ***Estimated Tax Penalties.*** Each QRT and the estate are treated as separate taxpayers for purposes the § 6654 penalty for failure to pay estimated taxes. Reg. § 1.645-1(e)(4).
7. ***Separate Share Rule.*** The QRT and the estate are treated as separate shares under § 663(c) for purposes of computing distributable net income ("DNI") and applying the distribution provisions of §§ 661 and 662. Reg. § 1.645-1(e)(2)(iii)(A). If a distribution is made during the taxable year, the distribution provisions of §§ 661 and 662 are applied using the QRT's separately determined DNI.
8. ***Distributions from One Share to Another.*** For purposes of the separate share rule, if a distribution is made from one share to another share the share making the distribution reduces its DNI by the amount of the distribution deduction to which it is entitled and the share receiving the distribution increases its gross income by the same amount. Reg. § 1.645-1(e)(2)(iii)(B).

PART THREE — THE GRANTOR TRUST RULES

XVII. *RETENTION OF REVERSIONARY INTERESTS.*

A trust is a grantor trust if the grantor has a reversionary interest in either the income or corpus that is worth more than 5% of the value of the trust at the trust's inception. § 673. The value of the retained annuity interest in a GRAT necessarily exceeds five percent of the value of the GRAT, thereby resulting in grantor trust status.

XVIII. *POWER TO CONTROL BENEFICIAL ENJOYMENT.*

Subject to certain enumerated exceptions, a trust is a grantor trust if the grantor or a non-adverse party can control the beneficial enjoyment of the income or corpus of the trust through a power of disposition without the approval or consent of an adverse party. § 674(a). Thus, a provision permitting discretionary distributions of current and accumulated income to be sprinkled among beneficiaries can result in grantor trust status. *See* Reg. § 1.674(b)-1(b)(6)(ii)(Ex. 2). Similarly, powers to add beneficiaries, to accumulate income and to distribute principal can result in grantor trusts when they are held by non-beneficiaries.

A. *Statutory Exceptions.*

Powers that do not result in a grantor trust although held by the grantor or a non-adverse party include the following:

- 1. *Income to Support a Dependent.*** The power to apply income to the support of a dependent will not result in a grantor trust. § 674(b)(1). However, to the extent income is actually used to meet the grantor's legal obligation to support a dependent, the income is taxed to the grantor as "income for benefit of grantor." *See* § 677(b), which concerns income for the benefit of the grantor.
- 2. *Power Affecting Beneficial Enjoyment Only After Occurrence of Event.*** A grantor trust does not result from a power that affects beneficial enjoyment only after the expiration of a period if the grantor would not be taxed if the power was a reversionary interest. § 674(b)(2). However, this power will cause the grantor to be treated as the owner after the expiration of the period.
- 3. *Testamentary Powers.*** Powers that are exercisable only by will generally do not result in grantor trusts. § 674(b)(3). A power of

appointment over income accumulated for this purpose, however, will cause the grantor to be treated as owner.

4. *Power to Allocate Among Charitable Beneficiaries or ESOPs.* The power to allocate income or corpus among charitable beneficiaries does not result in a grantor trust if the income or corpus is irrevocably payable for a charitable purpose within the meaning of § 170(c) or to an ESOP. § 674(b)(4).

5. *Power to Distribute Corpus.* A grantor trust will not result from the power to distribute corpus—:

(a) To or for a beneficiary or beneficiaries or a class of beneficiaries if the power is limited by a reasonably definite standard; or

(b) To or for any current income beneficiary, provided that the distribution of corpus is chargeable against the proportionate share of corpus held in trust for the payment of income to the beneficiary.

§ 674(b)(5). This rule does not apply (*i.e.*, the trust might be a grantor trust) if any person can add to the beneficiaries who can receive income or corpus, unless the addition is to add after-born or after-adopted children.

6. *Power to Temporarily Withhold Income.* A grantor trust does not result from the power to withhold income temporarily from the current income beneficiary, if—

(a) Any accumulated income must ultimately be payable to the beneficiary, the beneficiary's estate, or the beneficiary's appointees pursuant to a general power of appointment, or

(b) Any accumulated income must be distributed in shares to the current income beneficiaries in shares upon termination of the trust or in conjunction with a distribution of corpus which augmented by such accumulated income.

§ 674(b)(6). This rule does not apply (*i.e.*, the trust might be a grantor trust) if any person can add to the beneficiaries who may receive income or corpus, unless the addition is to add after-born or after-adopted children.

7. ***Power to Withhold Income During Disability.*** The power to withhold income during a legal disability of the current income beneficiary or the period during which the current income beneficiary is under the age of twenty-one (21) does not result in a grantor trust. § 674(b)(7). This rule does not apply (*i.e.*, the trust might be a grantor trust) if any person can add to the beneficiaries who can receive income or corpus, unless the addition is to add after-born or after-adopted children.
8. ***The Power to Allocate between Corpus and Income.*** The power to allocate between income and corpus does not result in a grantor trust. § 674(b)(8).
9. ***Distribution Powers Limited by Standards.*** A trustee power limited by a reasonably definite external standard to distribute, apportion, or accumulate income does not result in a grantor trust if the trustees do not include the grantor or the grantor's spouse living with the grantor and the power does not require the approval or consent of any other person. § 674(d). This rule does not apply if any person has a power to add to the beneficiaries, unless such action is to provide for after-born or after-adopted children. Applying this rule, it is possible to create a grantor trust by including the grantor's non-beneficiary spouse as the trustee or as a co-trustee and giving the trustees a power to sprinkle income among the beneficiaries using an ascertainable standard.
10. ***Discretionary Distribution Powers.*** A grantor trust does not result from a power to distribute, apportion or accumulate income, or to pay corpus, if held by trustees—
 - (a) None of whom is the grantor (or the grantor's spouse during the period); and
 - (b) No more than half of whom are related or subordinate parties who are subservient to the wishes of the grantor.

§ 674(c). This rule does not apply if any person has a power to add to the beneficiaries, unless such action is to provide for after-born or after-adopted children.

- (i) A trust can be created as a grantor trust by including the grantor's non-beneficiary spouse as the trustee or a

co-trustee and giving a power to add a charity as beneficiary.

- (ii) The same result can be achieved if more than one-half the trustees are related (*e.g.*, the grantor's father, mother, issue, brother or sister) or subordinate parties (*e.g.*, employees) who are subservient to the wishes of the grantor and they have a power to add a charity as beneficiary.

B. *Power to Add Beneficiaries.*

Authorizing a non-adverse party to add beneficiaries without the consent of an adverse party creates a "defect" that results in grantor trust status. § 674(a).

1. ***The Power Holder.*** There are issues regarding who should be the power holder.
 - (a) ***The Grantor.*** The assets may be included in the grantor's estate under § 2036(a)(2) or § 2038 if the grantor holds the power. Also, the transfer to the trust will be an incomplete gift if the grantor has the power to add beneficiaries. Reg. § 25.2511-2(c).
 - (b) ***The Grantor's Spouse.*** The power to add beneficiaries can be held by the grantor's spouse without inclusion of the trust in the grantor's or the grantor's spouse's gross estate. Grantor trust status will end, however, upon the death of the spouse unless there is a successor power holder.
 - (c) ***A Beneficiary.*** If the power is held by a beneficiary, exercise of the power by the beneficiary likely is a deemed gift by the beneficiary. Worst yet, the power holder probably is considered adverse thereby failing to create a grantor trust.
 - (d) ***The Trustee.*** Grantor trust status can be achieved by giving the power to add beneficiaries to the trustee of the trust if the trustee is a non-adverse party. *See* PLRs 199936031 (trustee had power to add charitable organizations to the class of beneficiaries eligible to receive distributions from a CLAT upon the termination date), 9709001 and 9010065 (independent trustee holds power to add charities as beneficiaries).

However, a question might be raised as to whether fiduciary duties limit the trustee's authority to add a beneficiary.

2. ***Classes of Beneficiaries that Might be Added.*** The beneficiaries that might be added include the following:

- (a) ***Individuals.*** In general, there are no limitations on the permissible class of additional beneficiaries. Rather than use a broad power to add any person as an additional member, it is generally desirable to limit the individuals to a specific class, such as a specific type of relative. If the class of possible additional beneficiaries are already remote contingent beneficiaries, there may be an issue as to whether they are being "added" or having their beneficiary status elevated.
- (b) ***Charities.*** The power to add charitable beneficiaries can result in a grantor trust. *See Madorin v. Comm'r*, 84 T.C. 667 (1985); PLRs 199936031 and 9709001. The power can be limited to charitable remainder trusts or charitable lead trusts that designate the grantor's issue as the non-charitable beneficiaries.
- (c) ***The Grantor's Spouse.*** A non-adverse power holder's ability to add a spouse as a beneficiary should suffice, even if the added spouse can only be an income beneficiary. *See Reg. § 1.674(a)-1(b).*
- (d) ***After-Born or After-Adopted Children.*** Notwithstanding the exceptions that otherwise result in a non-grantor trust, the exceptions will not apply if "any person has a power to add to the beneficiary or beneficiaries or to a class of beneficiaries designated to receive the income or corpus except where such action is to provide for after-born or after-adopted children". §§ 674(b)(5), 674(b)(6), 674(b)(7), 674(c), 674(d).

C. ***Powers of Disposition by Related or Subordinate Parties.***

Trusts generally can be designed to be intentional grantor trusts by giving the trustee "spray" powers without having separate shares for the beneficiaries.

- 1. ***Independent Trustees.*** A trust is a grantor trust if a majority of the trustees are related or subordinate and the trustees are authorized to

make discretionary distributions of principal and income without a reasonably definite standard, *e.g.*, the trustees have unlimited sprinkle or accumulation powers. § 674(c).

- (a) ***More than One-Half.*** The grantor can create this “defect” by designating “related or subordinate parties who are subservient to the wishes of the grantor” as more than half of the trustees. The grantor’s spouse (if living with the grantor) as well as descendants, parents, siblings and employees are related or subordinate. § 672(c). The trust will not be a grantor trust status if the trustees are also adverse (*e.g.*, because the related and subordinate party trustees are beneficiaries). § 674(a). A trustee or beneficiary’s right to make discretionary distributions to himself or herself, however, may be a general power of appointment. § 2041(a)(2), (b)(1)(A) and (C)(ii).

- (b) ***Exception for Corpus Distributions.*** A grantor is not charged with a retained power to control beneficial enjoyment as to corpus if there is a reasonably definite standard (§ 674(b)(5)(A)) or if separate shares are created for the respective beneficiaries (§ 674(b)(5)(B)). This separate share exception can be avoided by a spray power that does not charge corpus distributions against the beneficiary’s proportionate share of corpus.

- (c) ***Exception for Income Distributions.*** Stated generally, a grantor is charged with a retained power “if the power is in substance one to shift ordinary income from one beneficiary to another.” Reg. § 1.674(b)-1(b)(6)(i)(flush language). The § 674(b)(6) exceptions provide that the power to distribute or apply income to or for any current income beneficiary or to accumulate the income for the beneficiary will not result in a grantor trust under the following circumstances:
 - (i) The accumulated income ultimately is payable to the beneficiary, the beneficiary’s estate, or the beneficiary’s appointees, which appointees cannot be limited except to exclude the beneficiary’s estate, creditors, or creditors of the beneficiary’s estate. § 674(b)(6)(A).

 - (ii) The accumulated income ultimately is payable upon termination of the trust or in conjunction with a

distribution of corpus that includes accumulated income to the current income beneficiaries in shares which have been irrevocably specified in the trust instrument. § 674(b)(6)(B).

(iii) The accumulated income is payable to the beneficiary's appointees or to one or more designated alternate takers (other than the grantor or grantor's estate) if the beneficiary dies before a distribution date that could reasonably be expected to occur within the beneficiary's lifetime. § 674(b)(6)(flush language).

2. ***Reasonably Definite Standard.*** A § 674(a) power to control beneficial enjoyment will not result in a grantor trust if it is limited by a reasonably definite external standard and neither the grantor or the grantor's spouse is a trustee. § 674(d).
3. ***Spousal Power to Control Distributions Without a Reasonably Definite Standard.*** The trust will be a grantor trust if the grantor's spouse has the power to distribute income or corpus to third parties that is not subject to a "reasonably definite external standard". There should be a careful designation of the successor to this power upon the spouse's death or other ceasing to serve.

D. ***Summary.***

In order to be a grantor trust by avoiding § 674 requires the following:

1. ***Need for Non-Adverse Party.*** To come within § 674(a), a non-adverse party (*i.e.*, a person who is not a beneficiary) should serve as trustee with a power of disposition over trust assets.
2. ***No Reasonably Definite Standard for Distributions.*** To avoid § 674(d), there must not be reasonably definite external standards for distributions.
3. ***Related or Subordinate Parties as Trustees.*** To avoid § 674(c), a majority of the trustees must be related or subordinate parties.
4. ***Spray Power Over Corpus.*** The trustee should have a spray power over corpus distributions without charging corpus distributions against the beneficiary's proportionate share of corpus. § 674(b)(5).

5. ***Discretionary Distributions of Income.*** Discretionary distributions of current and accumulated income should be permitted to be sprayed among beneficiaries. See § 674(b)(6). As an alternative, the trust can last for the lifetime of the beneficiary and not distribute accumulated income to the beneficiary's estate or give the beneficiary a testamentary power of appointment in order to provide separate share for each beneficiary to accumulate income.

XIX. ADMINISTRATIVE POWERS.

The grantor's retention of certain administrative powers results in grantor trust status. § 675.

A. *Power to Deal for Less Than Adequate and Full Consideration,*

A grantor is taxed as the owner of a trust in which the grantor or a non-adverse party, or both, have a power exercisable without the approval or consent of any adverse party that enables the grantor or any person to purchase, exchange, or otherwise deal with or dispose of the corpus or the income therefrom for less than an adequate consideration in money or money's worth. § 675(1). This generally is not a useful power for planning purposes because it generally results in inclusion of the trust in the grantor's estate upon death.

B. *Lending Powers and Loans.*

Two code sub-sections address loans, or the ability to make loans, from a trust to the grantor or to the grantor's spouse.

1. ***Power to Borrow Without Adequate Interest or Security.*** A trust is classified as a grantor trust if the grantor or a non-adverse party has the power to make a loan from the trust to the grantor or the grantor's spouse without charging adequate interest or requiring adequate security, unless it is a general power to make loans to anyone. § 675(2). The power to make a loan to the grantor without charging adequate interest or requiring adequate security may invite inclusion in the grantor's gross estate for estate tax purposes, but it will not if the power is held by the grantor's spouse.

- (a) ***Existence of Power is Sufficient.*** The existence of the power results in a grantor trust irrespective of whether the power is exercised.

- (b) ***Applies to Entire Trust.*** Grantor trust status applies to the entire trust if the power permits borrowing of corpus or income.
- (c) ***Lack of Adequate Security.*** The power to loan results in grantor trust status whether it can be made without adequate security or can be made without adequate interest. Adequate interest should be required to avoid a § 2036 argument that the grantor has retained a beneficial interest. Thus, by requiring adequate interest but not adequate security, the trust will be a grantor trust. PLR 199942017 (trust is grantor trust permitted to own S corporation stock); PLR 9525032 (GRAT is a grantor trust where grantor has non-fiduciary power to borrow without security). The same result is obtained when a non-adverse party has authority to make the loan without adequate security. PLR 9645013 (trust is grantor trust permitted to own S corporation stock where non-adverse party special trustee (bank as successor) has power to make loans to grantor without security).
- (d) ***Avoidance of Estate Tax Risk.*** The IRS might argue that a grantor's power to borrow without security gives the grantor the authority to receive trust assets for less than full and adequate consideration thereby resulting in inclusion in the grantor's gross estate. If the power is held by a non-adverse party other than the grantor, the risk of estate tax inclusion should be minimized.
- (e) ***Sample Language.*** A possible clause for this purpose is:⁴

Power to Borrow. My spouse shall have the power, exercisable by her at any time or from time to time, to borrow any portion of the corpus or income of the Trust Estate. Such loans shall be made without security. If my spouse borrows the principal or income of the trust estate, the trustee shall determine the rate of interest to be charged, which rate shall not be less than a reasonable market rate of interest at

⁴ The reader is cautioned not to rely on any form in this outline "as is" but to determine independently the appropriateness of each form and its compliance with applicable law.

the time the loan is made, but not less than the appropriate Applicable Federal Rate then in effect under § 1274(d) of the Internal Revenue Code. My spouse shall have the right to release this power at any time.

2. **Actual Loans.** A second provision can apply if there is an actual loan of corpus or income from the trust to the grantor or the grantor's spouse. This provision, however, will not result in a grantor trust if the loan is adequately collateralized and provides for adequate interest, provided it is made by a trustee other than the grantor or a related or subordinate trustee subservient to the grantor. § 675(3). The trust will be a grantor trust if the loan is not repaid in full before the beginning of a taxable year. This provision is not particularly useful because grantor trust status does not extend to the entire trust. It only applies to the portion of the trust represented by the loan.

(a) **Outstanding During the Year.** Section 675(3) provides that the loan must be outstanding at the beginning of a taxable year. The IRS has ruled, however, that a trust is a grantor trust when the grantor borrows the entire corpus and repays the loan before the end of the year. Rev. Rul. 86-82, 1986-1 C. B. 253, following *Mau v. United States*, 355 F. Supp. 909 (D. Hawaii 1973). Thus, the purchase of an asset from the trust in exchange for a note results in a grantor trust (but gain or loss recognition is avoided due to Rev. Rul. 85-13, discussed, *supra*).

(b) **Portion Treated as a Grantor Trust.** There is no definitive rule as to the portion of the trust that might have grantor status — all income or corpus, or the amounts actually borrowed and not repaid by the end of the tax year. *Bennett v. Comm'r*, 79 T.C. 470 (1982), holds that where the grantor borrowed less than all of the income, the grantor is taxable on the portion of current year's income that the principal of the loan at the beginning of the year bears to the total trust income from the trust inception. *Benson v. Comm'r*, 76 T.C. 1040 (1981) held that where a grantor borrowed all income of a trust owning real estate; the grantor is taxed on all trust income.

- (c) ***The Borrower.*** The Tax Court holds that loans to corporations are not loans to their grantor–shareholders for purposes of § 675(3). *Bennett v. Comm’r*, 79 T.C. 470, 478 (1982); *Buehner v. Commissioner*, 65 T.C. 723, 741-742 (1976). Loans to a partnership, however, are loans to their grantor–partners for the purpose of § 675(3). *Bennett*, 79 T.C., at 480–81.
- (d) ***Toggling.*** It may be possible to toggle grantor trust status on and off by borrowing. If the trustee is not a related or subordinate party, the borrowing should not require adequate interest or security. If the trustee is a related or subordinate party, the borrowing could provide for adequate interest and security and still result in grantor trust status. The grantor should repay the entire amount of the loan before the end of the taxable year, so that the grantor can make a decision in the following year whether the grantor trust status is desired in the following year.

C. *Certain General Powers of Administration.*

Section 675(4) general powers of administration are the following powers if held in a non-fiduciary capacity—

- To vote stock or securities of a corporation in which the holding of the grantor and the trust are significant,
- To control the investment of the trust funds to the extent that the trust funds consist of stocks or securities of a corporation in which the holdings of the grantor and the trust are significant, and
- To reacquire trust property by substituting other property of an equivalent value.

D. *Non-Fiduciary Power to Substitute Property.*

1. ***Non-Fiduciary Power to Substitute Property.*** Grantor trust status results from a non-fiduciary power held by a grantor or anyone else to reacquire trust property by substituting other property of an equivalent value without the approval or consent of someone in a fiduciary capacity. § 675(4)(C).

2. ***Estate Tax Exclusion.*** The IRS has long conceded that a substitution power held in a fiduciary capacity does not cause inclusion in the decedent's gross estate under § 2036 or § 2038. *See Jordahl v. Comm'r*, 65 T. C. 92 (1975), *acq.*, 1977-2 C.B. 1. Recently, the IRS conceded that there is no estate tax inclusion under § 2036 or § 2038 if the power is held in a non-fiduciary capacity. Rev. Rul. 2008-22, 2008-16 I.R.B. 796.
- (a) ***Merely an Investment Power.*** There previously was some concern in relying upon *Jordahl* because the power in that case was held in a fiduciary capacity whereas § 675(4)(C) powers are held in non-fiduciary capacities. The counter-argument was that a power to exchange an asset for another of equal value is a mere investment power that should not cause inclusion under either § 2036 or § 2038. *Cf. Old Colony Trust v. United States*, 423 F.2d 601 (1st Cir. 1970).
- (b) ***Power Held by Grantor.*** As a result of Rev. Rul. 2008-22 and *Estate of Jordahl v. Comm'r*, 65 T.C. 92 (1975), *acq.* 1977-1 C.B. 1, there should be no estate tax inclusion under § 2036 or § 2038 if the grantor holds the power of substitution.
- (c) ***Trustee Must Have Certain Fiduciary Obligations.*** Rev. Rul. 2008-22 only applies if the trustee has a fiduciary obligation to ensure the grantor's compliance with the trust terms. In most, if not all, instances local law will provide this obligation unless there is a contrary provision in the trust instrument.
- (d) ***Irrevocable Life Insurance Trusts.*** One would think that the power is not an incident of ownership with respect to a life insurance policy in an irrevocable life insurance trust even if it is held by the insured. *Estate of Jordahl v. Comm'r*, 65 T.C. 92 (1975), *acq.* 1977-1 C.B. 1, PLR 9413045 (citing and relying on *Jordahl*) (power of substitution applied to life insurance). However, some practitioners are concerned by the failure of Rev. Rul. 2008-22 to refer to § 2042, but the IRS position in this regard may soon be clarified. Paragraph 16 of the Gifts and Estates and Trusts section of the Department of the Treasury 2009-2010 Priority Guidance Plan issued November 24, 2009 provides that they intend to issue "guidance on whether a grantor's retention of a power to

substitute trust assets in exchange for assets of equal value, held in a nonfiduciary capacity, will cause insurance policies held in the trust to be includible in the grantor's gross estate under § 2042.

- (e) ***Power Held by Non-Adverse Third Party.*** In lieu of the grantor, the power of substitution can be held by a non-adverse third person (*i.e.*, a person who is not a beneficiary). See § 675(4) (power “exercisable in a non-fiduciary capacity by any person”); Reg. § 1.675-1(b)(4)(iii) (reference to non-fiduciary power of administration by “any non-adverse party”); PLRs 199908002, 9713017, 9642039 and 9037011. Allowing a third party to hold the substitution power might create flexibility to “turn off” or to “toggle” grantor trust status. The statute, however, refers to the power to “reacquire” trust corpus, which suggests that only someone (*e.g.*, the grantor) who at one time owned the property in the trust) can hold the power to reacquire the property. PLRs 199908002, 9810019 and 9713017 held that a power to substitute assets given to a third party in a non-fiduciary capacity for a charitable lead trust was sufficient to cause grantor trust treatment for income tax purposes. This was important in PLR 9037011 because, if the grantor of a charitable lead trust held the power of substitution, any exercise of that power would be a prohibited transaction under § 4941(d). PLR 9037011 gave one of the trustees the power to “acquire any property that held in trust by substituting property...” The rulings did not address the statutory requirement of a power to “reacquire” trust assets.
- (f) ***Power Held by Grantor's Spouse.*** The “reacquire” argument does not exist if the substitution power is held by the grantor's spouse. Under § 672(e), any power or interest held by the grantor's spouse is deemed to be held by the grantor.
- (g) ***Holder as Trustee.*** It may not be clear whether the power is held in a non-fiduciary capacity if the individual is also the trustee. The individual in Rev. Rul. 2008-22 was not the trustee.

3. ***Suggested Language.*** The following language can be used to create a power in the grantor, or in the alternative, in the grantor's spouse, to substitute property:

(a) ***Power Held by Grantor.***

Power to Substitute Property. I reserve the power to reacquire some or all the trust corpus by substituting other property of an equivalent value. This power shall be exercisable in a non-fiduciary capacity and may be exercised without the approval or consent of any person in a fiduciary capacity; provided however, that nothing herein shall relieve any of the Trustee's fiduciary obligations under the Trust Instrument or applicable law, such as the obligation to satisfy itself that the properties acquired and substituted by me are in fact of equivalent value, and provided further that this power shall not be exercised in a manner that can shift benefits among the trust beneficiaries, it being my intention that this power be consistent with the provisions of Revenue Ruling 2008-22, 2008-16 I.R.B. 796. I reserve the right to release this power at any time.

(b) ***Power Held by Grantor's Spouse.***

Power to Substitute Property. I hereby grant to my spouse the power, exercisable by her at any time or from time to time, to reacquire some or all of the trust corpus by substituting other property of an equivalent value. This power shall be exercisable in a non-fiduciary capacity and may be exercised without the approval or consent of any person in a fiduciary capacity; provided however, that nothing herein shall relieve any of the Trustee's fiduciary obligations under the Trust Instrument or applicable law, such as the obligation to satisfy itself that the properties acquired and substituted by me are in fact of equivalent value, and provided further that this power shall not be exercised in a manner that can shift benefits among the trust beneficiaries, it being my intention that this power be consistent with the provisions of Revenue Ruling 2008-22, 2008-16 I.R.B. 796. My spouse shall have the right to release this power at any time.

4. ***Fiduciary Capacity.*** “[W]hether the power [of substitution] is exercisable in a fiduciary or non-fiduciary capacity depends on all

the terms of the trust and the circumstances surrounding its creation and administration.” Reg. § 1.675-1(b)(4). The IRS ruling positions, however, have been inconsistent. One position is that whether the grantor holds the power in a non-fiduciary capacity is a question of fact to be determined by the district director after returns have been filed. PLRs 199942017, 9645013, 9525032, 9407014, 9352007, 9352004, 9337011, 9335028, 9248016, 9253010. Other rulings hold that the power to substitute causes the trust to be a grantor trust. See PLRs 9451056, 9352017, 9351005, 9345035, 9248016. Some rulings have applied a compromise approach, stating that the grantor trust determination depends on the facts and circumstances but that, assuming exercise of a § 675(4)(c) power in a non-fiduciary capacity, the trust would be treated as a grantor trust. See PLR 9810019 (charitable lead trust).

XX. *POWER TO REVOKE.*

A trust is a grantor trust if the grantor or a non-adverse party, or both, have the power to revest the trust in the grantor without the consent of an adverse party. § 676.

XXI. *INCOME FOR BENEFIT OF THE GRANTOR.*

A trust is a grantor trust if the income may be (a) distributed to the grantor or the grantor’s spouse or (b) held or accumulated for future distribution to the grantor or the grantor’s spouse. § 677. This also includes the ability to apply income to the payment of insurance premiums on the life of the grantor or the grantor’s spouse, other than insurance irrevocably payable for a § 170(c) charitable deduction purpose. § 677(a)(3).

A. *Application to Corpus.*

The statute implies that both the trust income and corpus is treated under § 677(a) as a grantor trust. § 677(a) (“the owner of any portion of a trust...whose income...is, or...may be” distributed or accumulated for distribution to the grantor or the grantor’s spouse.”). The Regulations, however, imply that the § 677 power only creates grantor trust status for the income portion of the trust, not the corpus. Reg. § 1.677(a)-1(g), Ex. 1. The grantor in the example, however, could only receive income. Several private letter rulings ignore the Regulations and follow the statute by holding that the grantor owns both the income and corpus portion of a grantor

retained annuity trust because the annuity amount in the rulings is payable from principal to the extent that income was insufficient. PLRs 9504021, 9451056, 9449012, 9444033, and 9415012. The IRS has similarly ruled that a charitable remainder unitrust is a grantor trust as to income and corpus under § 677(a) because of the possibility that income allocable to principal could be used to satisfy the unitrust payment. PLR 9501004. In an inconsistent private letter ruling, the IRS held that a retained annuity alone does not confer grantor trust status as to both the income and corpus portion of a grantor retained annuity trust. PLR 9625021.

B. *Payment of Support Obligations.*

A grantor is not taxed as the owner of a trust merely because trust income may be applied or distributed for the support or maintenance of a beneficiary (other than the grantor's spouse) whom the grantor is legally obligated to support or maintain in the discretion of another person, the trustee, or the grantor acting as trustee or co-trustee. § 677(b). However, the grantor is taxed to the extent that trust income is applied or distributed to fulfill the support obligation. If the amount is paid from corpus or accumulated income, the amount is treated under § 662(a)(2) as an amount paid from a complex trust, not a grantor trust.

1. If the grantor's obligation that the trust might satisfy is not an obligation to support or maintain a beneficiary, the grantor is taxed under § 677(a), not § 677(b). Reg. § 1.677-(b)(1)(d).
2. Similarly, § 677(a), not § 677(b), applies if the discretion rests solely in the grantor, or in the grantor in conjunction with other persons, unless in either case the grantor has such discretion as a trustee or co-trustee. Reg. § 1.677-(b)(1)(e).
3. The general rule of section 677(a), and not section 677(b), is also applicable to the extent that income is required, without any discretionary determination, to be applied to the support of a beneficiary whom the grantor is legally obligated to support. Reg. § 1.677-(b)(1)(f).

C. *GRAT Beneficiary Together with Power of Appointment.*

There are rulings concerning GRATs to the effect that combining § 677 and § 674(b)(3) confers grantor trust status as to both income and corpus. Grantor trust status as to income is conferred under § 677 due to the authority to make distributions of the annuity payments. By retaining a

testamentary power of appointment to appoint the trust assets (in the event the grantor dies before the stated termination of the GRAT), there will be grantor trust treatment as to the corpus under §§ 674(a) and 674(b)(3). *See* Reg. § 1.674(b)-1(b)(3) (“if a trust instrument provides that the income is payable to another person for his life, but the grantor has a testamentary power of appointment over the remainder, and under the trust instrument and local law capital gains are added to corpus, the grantor is treated as the owner of a portion of the trust and capital gains and losses are included in that portion”); PLRs 200001013 and 200001015 (grantor trust treatment as to income because trustee had discretion to pay all GRAT income — if any is remaining after payment of the annuity payments — to the grantor; grantor trust treatment as to corpus under section 674(a) because capital gains are accumulated and added to corpus and grantor held general testamentary power of appointment over the accumulated amounts); 9707005 (GRAT is a grantor trust as to income and corpus under §§ 674(a) and 677(a) because grantor will either receive all the trust income or be able to appoint it by will, and qualifies as an S corporation shareholder). PLR 9625021.

D. *Spousal Beneficiary Trust.*

If parents desire to create an *inter vivos* gift trust but retain the possibility of distributions to the parent level, one of the parents can create a trust that includes his or her spouse as a discretionary beneficiary. Although the spouse might receive benefits, the trust should not be included in either spouse’s estate. When using this technique, the benefits for the spouse results in a grantor trust as to the income under § 677 until the spouse dies.

- 1. *No Estate Tax Inclusion.*** Mere inclusion of the spouse as a potential discretionary beneficiary does not cause inclusion in the spouse’s estate for estate tax purposes even if the § 2513 split gift election is made, because the split gift election applies only for gift tax and generation-skipping transfer tax exemption purposes. §§ 2513(a)(1) and 2652(a)(2). There is no analogous estate tax provision. *See, e.g.,* Rev. Rul. 74-556, 1974-2 C.B. 300 (no § 2038 inclusion). The trust should prohibit the use of trust income to discharge the grantor’s obligation of support. Reg. § 20.2036-1(b)(2). Reciprocal trusts should not be created.
- 2. *Toggling.*** There may be gift tax issues if grantor trust status can be toggled by the spouse in this type of trust. The relinquishment of the spouse’s discretionary beneficiary rights will result in a taxable gift.

A technique to toggle off is to give the power to remove the spouse as a discretionary beneficiary to an independent third party.

E. *Life Insurance.*

The authority to use principal and income to pay insurance premiums on the life of the grantor or the grantor's spouse literally should result in grantor trust status. § 677(a)(3). As a result of inconsistent IRS positions, it is difficult to rely on this power to create a grantor trust.

1. ***Early Cases Limit § 677(a)(3) to Actual Payments.*** The IRS acquiesced in two early cases which held that grantor trust status only applies to the extent that trust income (including capital gains) is actually used to pay the premiums. *Moore v. Comm'r*, 39 B.T.A. 808 (1939), *acq.* 1939-2 C.B. 25; *Weil v. Comm'r*, 3 T.C. 579 (1944), *acq.*, 1944 C.B. 29. *See also* *Rand v. Helvering*, 116 F.2d 929 (8th Cir. 1940), *cert. denied*, 313 U.S. 594 (1941); *Corning v. Comm'r*, 104 F.2d 329 (6th Cir. 1939) (mere power to purchase an insurance policy and to pay premiums from income is not sufficient to cause grantor trust status); *Iversen v. Comm'r*, 3 T.C. 756 (1944); PLR 8839008 (actual payment of premium from income causes grantor trust treatment as to income so paid, even though trust instrument prohibited paying life insurance premiums from income); PLR 6406221750A.
2. ***Possible Reversal of Position.*** The IRS then seemingly reversed itself and held in non-precedential rulings that the ability to pay the premiums, not the actual payment, is sufficient to cause a trust to be a grantor trust. *See* PLRs 8852003 and 8103074. Recently, the IRS stated that the matter is under advisement, and it refuses to rule on the issue. *See* Rev. Proc. 2009-3, 2009-1 I.R.B. 107, Sec. 3.01(53). *See also* PLR 9413045. Even more recently, Field Attorney Advice 20062701F (a non-precedential authority) held that the bare power to purchase life insurance on the grantor life, without reference to income or premium payments, is enough to cause grantor trust status.
3. ***Denial of Right to Purchase Life Insurance.*** If the grantor wants to avoid the argument that a trust is a grantor trust even when the trust does not purchase life insurance, it is a good practice expressly to deny the trust the right to purchase insurance on the life of the grantor or grantor's spouse.

4. ***Creating a Grantor Life Insurance Trusts.*** “Safe” techniques to create a grantor trust to own life insurance previously discussed in this outline include the following:
 - (a) Give the insured’s spouse the power to borrow without adequate security.
 - (b) Give the insured’s spouse the non-fiduciary power to substitute assets of equivalent value.
 - (c) Give a non-adverse party the power to add beneficiaries.

XXII. PERSON OTHER THAN GRANTOR TREATED AS SUBSTANTIAL OWNER.

Section 678 provides that a person who is not the grantor is treated as the owner of the trust if the grantor is not taxed as the owner, and

- The non-grantor has the power alone to vest the trust income or corpus in the non-grantor (§ 678(a)(1)); or
- The non-grantor had the power alone to vest the trust income or corpus in the non-grantor and after partially releasing or modifying the power, the non-grantor retains such control as would result in grantor trust status if the non-grantor had been the grantor (§ 678(a)(2)).

A. *Beneficiary as Trustee.*

Trusts (*e.g.*, credit-shelter by-pass trusts, marital deduction trusts) often designate beneficiaries as sole trustees with distribution powers limited by ascertainable standards. Due to the failure of § 678 to mention ascertainable standards, there is confusion as to whether such distribution power is a power alone to vest the trust income or corpus in the trustee–beneficiary.

1. ***Argument that Trust is Not a Grantor Trust.*** The argument that the trust is not a grantor trust is that the statute requires that the trustee be able to vest the corpus or income in himself “solely by himself,” which the beneficiary allegedly cannot do with a distribution decision based upon whether ascertainable standards are satisfied. This seems consistent with the legislative history which states that § 678 treats a person as an owner of the trust “if he has an

unrestricted power to take the trust principal or income.” S. Rep. No. 1622, 83d Cong., 2d Sess. 87 (1954).

2. ***Argument that Trust is a Grantor Trust.*** Case law under a predecessor provision to § 678 is consistent with such trusts being grantor trusts. *See Funk v. Comm’r*, 185 F.2d 127 (3d Cir. 1950) (trustee’s power to distribute income to herself for her “needs” resulted in a grantor trust); *Smith v. United States*, 108 F. Supp 772 (S.D. Tex 1952), *aff’d*, 205 F.2d 518 (5th Cir. 1953) (trustee was not taxed owner where power to distribute income was limited to support, maintenance, comfort and enjoyment). A case applying the ascertainable standard exception to a life estate after the enactment of § 678 was *United States v. DeBonchamps*, 278 F.2d 127, 130 (9th Cir. 1960), which held that the grantor trust rules applied to determine tax effects of the holder of the life estate. In that case, undistributed capital gains were not taxed to life tenant because the life tenant did not have unrestricted power under state law to distribute corpus to self, but only for “needs, maintenance and comfort”. Private rulings, however, have been inconsistent. PLR 8211057 (trustee beneficiary taxable on income under § 678 due to discretionary principal interest for “support, welfare and maintenance”); PLR 9227037 (trustee-beneficiary with discretionary principal interest for “health, support and maintenance” held not taxable under § 678). *See also* PLR 8939012 (trustee–beneficiary not taxable as owner of trust under § 678; however distribution standard not clearly set forth in ruling).

B. *Co-Trustees.*

The issue is not present if there is a co-trustee because § 678 applies to powers that are exercisable alone. Grantor trust status may be unclear if the beneficiary–sole trustee subsequently appoints a co-trustee.

C. *Satisfaction of Trustee’s Support Obligation.*

Section 678(c) provides that distributions that satisfy the person’s legal obligation of support are taxed as income to the person to the extent that such distributions are actually made. § 678(c). *See* PLR 8939012 (sole trustee not taxable under § 678 where beneficiaries were trustee’s adult children and descendants to whom he owed no legal obligation of support). If support distributions are made, the power holder is taxed under § 661–§ 662 — based on an allocation of DNI — rather than being treated as the owner of a portion of the trust. § 678(c).

D. *Disclaimers.*

Section 678 does not apply if the power holder renounces or disclaims the power within a reasonable time after the holder first became aware of its existence. § 678(d).

E. *Crummey Withdrawal Rights.*

The IRS generally treats the holder of a *Crummey* power as the owner of the portion of the trust subject to the withdrawal power under § 678(a)(1) while the power exists and under § 678(a)(2) after the power lapses if the power holder is also a beneficiary of the trust. See PLRs 200011058, 200011054-056, 199942037 and 199935046.

1. ***Lapse Instead of Release.*** The IRS's position under § 678(a)(2) as to lapsed powers may be questioned because that section confers grantor trust status following the "release or modification" of a withdrawal power, and a release arguably is not the same as the lapse of a withdrawal power. A "release" requires an affirmative act whereas a "lapse" results of a passive non-exercise of a power. The gift and estate tax statutes distinguish between lapses and releases. §§ 2041(b)(2) and 2514(e) ("the lapse of a power...shall be considered a release of a power.") Nonetheless, the IRS treats the beneficiary as an owner of the trust with respect to lapsed withdrawal rights.
2. ***Application to Corpus.*** Section 678(b) literally applies only as to "a power over income" and a withdrawal power is typically a power to withdraw corpus. The 1954 Committee Reports relating to §§ 671 through 678, however, make clear that the language of § 678(b) contains a drafting error and that it was intended to apply to a power over income and corpus, similar to § 678(a)(1). It stated:

A person other than the grantor may be treated as a substantial owner of a trust if he has an unrestricted power to take the trust principal or income...unless the grantor himself is deemed taxable because of such a power.

H.R. Rep. No. 1337, 83d Cong., 2d Sess. 63 (1954); S. Rep. No. 1622, 83d Cong., 2d Sess. 87 (1954).

3. ***Taxation of Grantor Instead of Crummey Beneficiary.*** Section 678(b) generally provides that, if grantor trust status is conferred on the grantor under §§ 671–677 and on a beneficiary under § 678, the grantor trust status of the original grantor will prevail. The IRS has confirmed in private letter rulings that a trust will be a grantor trust owned by the original grantor and not the beneficiary even though the beneficiary has *Crummey* withdrawal rights that lapsed. PLRs. 200729005, 200729007, 200729008, 200729009, 200729010, 200729011, 200729013, 200729014, 200729015, 200729016, and 200730011. A trust with a *Crummey* withdrawal power was still a grantor trust as to the grantor although the withdrawal was held by the grantor’s spouse, which would otherwise make her an owner under § 678. PLRs 200603040 and 200606006.

XXIII. CERTAIN FOREIGN TRUSTS.

A foreign trust is taxed as a grantor trust if a United States person transferred property to the trust and there is a United States beneficiary of any portion of the trust. § 679.

A. Foreign Trusts.

A trust is a foreign trust unless both of the following tests are satisfied: (1) courts in the United States must be able to exercise primary supervision over the trust; and (2) one of more U.S. persons must have the authority to control all substantial decisions of the trust. §§ 7701(a)(30)(E) and (31)(B).

1. ***Foreign Persons.*** A foreign person is someone who is not (among other things) a U.S. citizen or resident, or a U.S. domestic corporation. Foreign trust status results even if a foreign person has control over only one “substantial decision”.
2. ***Substantial Decisions.*** “Substantial decisions” are “all decisions other than ministerial decisions.” Reg. § 301.7701-7(d)(1)(ii). Examples include, but not limited to, the power to determine the timing, amount and selection of beneficiaries, and other administrative actions such as making income/principal allocations, investment decisions, and compromising claims. The definition includes the power to appoint a successor trustee, unless it is restricted so that it cannot change the trust’s residency, and the power to remove, add, or replace a trustee. *Id.*

B. *Foreign Grantors.*

The grantor trust rules do not apply if they cause someone other than a U.S. citizen or resident or a domestic corporation to be treated as the owner of the income. § 672(f). Thus, the grantor rules do not apply if a foreign person is the grantor.

C. *Foreign Non-Grantor Trust.*

Notwithstanding § 679, a foreign trust is not a grantor trust if it is created by a testamentary transfer at the death of the U.S. grantor, it is created by a non-U.S. grantor, or it is created during the lifetime of a U.S. grantor and does not have any U.S. beneficiaries. Special income tax rules apply in that event. The problem for foreign non-grantor trusts is that if all of the DNI is not distributed each year, accumulation distributions determined under the rules in § 665(b) are taxed under the throwback rule. § 665(d). The tax under the throwback rule is increased by an interest charge. §§ 667(a)(3) and 668.

D. *Termination of Grantor Trust Status.*

Section 684 imposes a tax on the unrealized appreciation upon termination of grantor trust status — *i.e.*, upon the death of the grantor or if there are no longer any U.S. beneficiaries. If that occurs because of the death of the grantor, § 1014 should avoid any gain to which § 684 would apply due to the step-up in basis.

E. *S Corporations.*

Foreign trusts are not eligible shareholders of S corporations. § 1361(c)(2).

F. *Reporting.*

The reporting requirements for foreign trusts include the following:

1. U.S. beneficiaries and the grantor who receive, directly or indirectly, distributions from foreign trusts must report information to the IRS on Form 3520. Additional required information is described in Notice 97-34.
2. A U.S. person who makes a gift to a foreign trust must file a notice of the gift on Form 3520, with penalties of up to 35% of the amount transferred if the report is not made.

3. The foreign trust must file an annual return, and if it does not, the U.S. person (if any) who is treated as the owner of the trust is liable for a 5% penalty of the value of the trust assets that are treated as owned by that person. § 6677(b).
4. If a U.S. trust becomes a foreign trust during the lifetime of a U.S. grantor, the U.S. grantor must report the transfer. § 679(a)(5).

PART FOUR— RELATED ESTATE TAX ISSUES

XXIV. SECTION 2036(a)(1) RETAINED LIFE ESTATES.

Section 2036(a)(1) provides that the value of a decedent's gross estate includes the value of all property to the extent of any interest therein with respect to which—

- The decedent made a transfer that is not a bona fide sale for an adequate and full consideration in money or money's worth;
- The decedent has retained (i) for his life, (ii) for any period not ascertainable without reference to his death, or (iii) for any period which does not in fact end before the decedent's death;
- The possession or enjoyment of, or the right to the income from, the property.

A. *Must be a Donative Transfer.*

Section 2036 does not apply to transfers that are for full and adequate consideration. Thus, § 2036 does not apply if the decedent sells an asset to a trust and receives full and adequate consideration.

B. *Right to Possess or Enjoy the Property or its Income.*

1. ***Implied Agreements.*** Section 2036 applies even when the right is not retained pursuant to an express agreement, but instead, there is an implied understanding that the decedent can use or receive the income from the property. Reg. § 20.2036-1(a) (last sentence). In *Estate of Skinner v. United States*, 316 F.2d 517 (3d Cir. 1973), § 2036 included property in the gross estate based upon an implied agreement where the trustee distributed all income to the settlor not withstanding discretion to make distributions to the settlor and

others. A similar finding was made where the donor transferred almost all assets to a trust. *Estate of Paxton v. Comm'r*, 86 T.C. 785 (1986). The implied agreement rule has been used to apply § 2036 to family limited partnerships. See *Estate of Strangi v. Comm'r*, 85 T.C.M. (CCH) 1331 (2003), *aff'd*, 417 F.3d 468 (5th Cir. 2005); *Kimbell v. United States*, 244 F. Supp. 2d 700 (N.D. Tex. 2003), *rev'd* 371 F.3d 257 (5th Cir. 2004); *Estate of Thompson v. Comm'r*, 84 T.C.M. (CCH) 374 (2002), *aff'd* 382 F.3d 367 (3rd Cir. 2004); *Estate of Harper v. Comm'r*, 83 T.C.M. (CCH) 1641 (2002).

2. ***Retained Right to Gifted Residence.*** One area of § 2036 implied agreement controversy is a donor's continued occupancy of a residence following a gift of the residence. See *Estate of Tehan*, 89 T.C.M. (CCH) 1374 (2005). Mere continued possession of a residence generally is not enough to establish an implied agreement. For example, the IRS holds that continued co-occupancy of a residence following a gift from one spouse to the other does not by itself support an inference or understanding as to retained possession or enjoyment by the donor. Rev. Rul. 78-409, 1978-2 C.B. 234; PLR 200240020. Non-spousal transfers to family members, however, are not treated so leniently. See, e.g., *Estate of Trotter v. Comm'r*, 82 T.C.M. (CCH) 633 (2001).
3. ***Rental Payments.*** The extent that § 2036 applies when a donor retains use of transferred property under a lease or rental agreement is not clear. The trend is that § 2036 does not apply if adequate rent is paid. See e.g., *Estate of Barlow v. Comm'r*, 55 T.C. 666 (1971) (no inclusion under § 2036 even though decedent stopped paying rent after two years because of medical problems); *Estate of Giselman v. Comm'r*, 55 T.C.M. (CCH) 1654 (1988). Cf. e.g., *Estate of Du Pont v. Comm'r*, 63 T.C. 746 (1975) (adequate rent not paid); *Disbrow v. Comm'r*, 91 T.C.M. (CCH) 794 (2006). The IRS has ruled that the donor of a qualified personal residence trust may retain the right in the initial transfer to lease the property for fair rental value at the end of the QPRT term without causing estate inclusion following the end of the QPRT term under § 2036. See e.g., PLR 199931028. However, the IRS does not concede that renting property for a fair rental value always avoids application of § 2036. See T.A.M. 9146002 (*Barlow* distinguished).
4. ***Fulfillment of Grantor's Obligation of Support.*** Section 2036(a)(1) applies if the trust requires payments that fulfill the grantor's obligation to support the grantor's dependents. Reg. § 2036-1(b)(2).

If the trust provides, however, that the grantor continues to have the obligation to support the beneficiary, § 2036(a)(1) will not apply because a distribution under those circumstances will not benefit the grantor. *See Colonial-American Nat'l Bank v. United States*, 243 F.2d 312 (4th Cir. 1957). The requirement that the trustee consider the beneficiary's other resources avoids § 2036(a)(1) if the other resources include the grantor's obligation to support the dependent. PLR 8504011. *See also Wishard v. United States*, 143 F.2d 704 (7th Cir. 1944). Section 2036 ceases to apply once the grantor is no longer obligated to support the trust beneficiary. *Estate of Pardee v. Comm'r*, 49 T.C. 140 (1967). The scrivener of the trust in *Upjohn v. United States*, 72-2 U.S.T.C. ¶ 12,888 (W.D. Mich. 1972), addressed this problem by providing that the trustee could not make distributions for the purpose of meeting the trustee's legal obligation of support.

5. ***Effect of Grantor as Beneficiary.*** Section 2036(a)(1) includes property in a grantor's gross estate if the grantor "retained" a "right" to income. If the grantor is a beneficiary solely in the trustee's discretion, there is a question as to whether the grantor has a "right" to income, and if so, whether the grantor "retained" that right. Inclusion in the grantor's gross estate will result from the following:
- (a) The trust is included in the grantor's gross estate if there is an actual or implied agreement that the grantor would receive the income.
 - (b) The trust is included in the grantor's gross estate if the grantor is the trustee.
 - (c) The trust is included in the grantor's gross estate if the trustee's discretion to distribution income to the grantor is subject to a standard that the grantor can enforce. *See Blunt v. Kelly*, 131 F.2d 632 (3d. Cir. 1941) ("support, care or benefit"); *Estate of John J. Toeller*, 165 F.2d 665 (7th Cir. 1946) ("misfortune or sickness"); *Estate of Boardman v. Comm'r*, 20 T.C. 871 (1953), *acq.* 1954-1 C.B. 3 (trust provided distributions for grantor "as the trustee deems necessary for her comfort, support and/or happiness").
 - (d) The trust is included in the grantor's gross estate if the grantors creditors can reach the income to pay the grantor's debts. *See Rev. Rul. 76-103*, 1976-1 C.B. 293; *Estate of Uhl*

v. Comm’r, 241 F.2d 867 (7th Cir. 1957); *Outwin v. Comm’r*, 76 T.C. 153 (1981); cf. Rev. Rul. 77-378, 1977-2 C.B. 347

XXV. SECTIONS 2036(a)(2) AND 2038 RETAINED POWERS OF DISPOSITION.

The powers that trigger §§ 2036(a)(2) and 2038 are very similar, and the two sections have a great deal of overlap. Neither section applies to the extent that the grantor makes a transfer that is a “bona fide sale for an adequate and full consideration.” Under § 2036(a)(2), only powers “retained” by the decedent cause inclusion. Under § 2038, it is sufficient that the decedent holds the power at death, regardless of “at what time or from what source the decedent acquired his power.” Reg. § 20.2038-1(a). For example, if a decedent did not retain the power to control distributions, but acquired the power only through appointment as trustee by another person, § 2038 would apply, but § 2036 would not.

A. Section 2036(a)(2) Retained Power of Disposition.

Under § 2036(a)(2), a decedent’s gross estate includes the value of all property to the extent of any interest therein of which—

- The decedent made a transfer that is not a bona fide sale for an adequate and full consideration in money or money’s worth;
- The decedent has retained (i) for his life, (ii) for any period not ascertainable without reference to his death, or (iii) for any period which does not in fact end before the decedent’s death;
- The right either alone or in conjunction with any other person;
- To designate who shall possess or enjoy the property or its income.

B. Section 2038 Revocable Transfers.

Under § 2038, a decedent’s gross estate includes the value of all property to the extent of any interest therein of which—

- The decedent has made a transfer by trust or otherwise other than a bona fide sale for full and adequate consideration.

- Under which the decedent had at his death the power exercisable in any capacity, either by the decedent alone or in conjunction with any person (regardless of when or from what source the decedent acquired a power).
- To alter, amend, revoke, or terminate enjoyment of the property.
- Or where such power is relinquished during the 3-year period ending on the date of his death.

C. *Amounts of Inclusion Powers Over Income.*

The amount of the inclusion is different depending upon the inclusion is under § 2036(a)(2) or § 2038 where there is a power over income.

1. ***Section 2036(a)(2).*** The trust property is included in the gross estate under § 2036(a)(2) if there is a retention of a power over distributing or accumulating income alone.
2. ***Section 2038.*** Only the actual property over which a power is held (only the income interest) is included in the estate under § 2038 where there is power over only over income. Similarly, a power over only the remainder interest would require inclusion of just the remainder interest and not the income interest under § 2038. Rev. Rul. 70-513, 1970-2 C.B. 194.

D. *Types of Powers Resulting in Inclusion.*

1. ***Sprinkle Powers.*** Both § 2036(a)(2) and § 2038 cause inclusion in the decedent's gross estate if the grantor retains the power to shift income or trust property among beneficiaries. *Estate of McManus v. Comm'r*, 172 F.2d 697 (6th Cir. 1949) (predecessor to § 2036(a)(2)); *Estate of Craft v. Comm'r*, 608 F.2d 240 (5th Cir. 1980) (§ 2038 inclusion where decedent had power to change beneficiaries and change their respective shares). The power to add beneficiaries also causes inclusion.
 - (a) ***Testamentary Power.*** Inclusion in the gross estate also results from a power in the decedent's will to change the beneficiaries. *Adriance v. Higgins*, 113 F.2d 1013 (2d Cir. 1940) (predecessor to § 2038); *Marshall v. United States*, 338 F. Supp 1321 (D. Md. 1971).

(b) **Possibility of Additional Children.** The decedent's ability to have more children and add beneficiaries is not a power to change beneficial interests under § 2038. Rev. Rul. 80-255, 1980-2 C.B. 272.

2. **Accumulation Powers.** A power affecting the timing of distributions, as opposed to the beneficiaries who receive distributions, causes estate tax inclusion under § 2038. *Lober v. United States*, 346 U.S. 335 (1953); *Estate of Alexander v. Comm'r*, 81 T.C. 767 (1983); Reg. § 20.2038-1(a) ("Section 2038 is applicable to any power affecting the time or manner of enjoyment of property or its income, even though the identity of the beneficiary is not affected.").

(a) A power to accumulate or distribute income also causes inclusion under § 2036(a)(2) where the income beneficiary is different from the remainder beneficiary, because accumulating income may shift the recipient from the income beneficiary to the remainderman. *United States v. O'Malley*, 383 U.S. 627 (1966), *rev'g* 340 F.2d 930 (7th Cir. 1964).

(b) If the income beneficiary and the remaindermen are the same (if the assets pass to the income beneficiary's estate or if the income beneficiary holds a general power of appointment), neither the statutory language of § 2036(a)(2) nor the regulations address whether § 2036(a)(2) applies. An argument can be made that § 2036(a)(2) should not apply because a power "to designate the persons who shall possess or enjoy" connotes some ability to choose among multiple "persons." The Tax Court has observed that "[w]hile this position is not without a certain superficial appeal, as well as some support from commentators, we conclude that the weight of logic and judicial precedent is to the contrary." *Estate of Alexander*, 81 T.C. 757 (1983), *aff'd* in unpub. Op. (4th Cir. 1985). Cases have held that § 2036(a)(2) applies even in the single vested beneficiary situation. *Struthers v. Kelm*, 218 F.2d 810 (8th Cir. 1955); *Ritter v. United States*, 297 F.Supp. 1259 (S.D. W. Va. 1968); *Estate of Alexander*, 81 T.C. 757 (1983), *aff'd* in unpub. Op. (4th Cir. 1985); *Estate of O'Connor v. Comm'r*, 54 T.C. 969 (1970). *Cf. Joy v. United States*, 404 F.2d 419 (6th Cir. 1968) *aff'g* 272 F. Supp. 544 (E.D. Mich. 1967).

3. ***Power to Distribute Corpus.*** The power to invade corpus is a power to alter enjoyment under § 2038. *Estate of Yawkey v. Comm’r*, 12 T.C. 1164 (1949). The power to terminate a trust by acceleration of the corpus distribution causes inclusion under § 2038. *Lober v. United States*, 346 U.S. 335 (1953); *Estate of O’Connor v. Comm’r*, 54 T.C. 969 (1970). Under § 2036(a)(2), an unlimited power to invade corpus for the income beneficiary or other beneficiary is subject to § 2036(a)(2). *See Comm’r v. Holmes*, 326 U.S. 480 (1946).

4. ***Joint Powers.*** A power can result in inclusion under both § 2036(a)(2) and § 2038 even if the decedent holds the power jointly with another person. Whether the co-holder of the joint power is adverse interest is irrelevant. Reg. § 20.2036-1(b)(3). It does not matter if the co-holder can override the grantor’s decisions (*e.g.*, majority vote controls). *See Biscoe v. United States*, 148 F. Supp. 224, 225 (D. Mass. 1957); *Estate of Carrie Grossman v. Comm’r*, 27 T.C. 707 (1957); *Estate of Yawkey v. Comm’r*, 12 T.C. 1164 (1949) Rev. Rul. 70-513, 1970-2 C.B. 194; Rev. Rul. 55-683, 1955-2 C.B. 603; PLR 8038014.

5. ***Power Held by Disabled Grantor.*** The grantor’s inability to exercise the power due to incompetency or other disability does not defeat inclusion. T.A.M. 8623004.

6. ***Capacity in Which Power is Held.*** Estate inclusion is not affected by whether the power is held in an individual or a fiduciary capacity. *See Rifkind v. United States*, 84-2 U.S.T.C. 13,577, 5 Ct. Cl. 362 (1984).

7. ***Contingent Powers.*** A power can result in inclusion under § 2036(a)(2) “whether the exercise of the power was subject to a contingency beyond the decedent’s control which did not occur before his death (*e.g.*, the death of another person during the decedent’s lifetime).” Reg. § 20.2036-1(b)(3); *See also Estate of Farrel v. United States*, 553 F.2d 637 (Ct. Cl. 1977); Rev. Rul. 73-21, 1973-1 C.B. 405. One case disagrees. *Estate of Kasch v. Comm’r*, 30 T.C. 102 (1958).
 - (a) Section 2038 does not apply, however, unless it is actually possessed at death. Reg. § 20.2038-1(b) (“Section 2038 is not applicable to a power the exercise of which was subject to a contingency beyond the decedent’s control which did not

occur before his death (e.g., the death of another person during the decedent's life).”).

- (b) Section 2036(a)(2)'s contingency rule creates an estate inclusion trap if there is a possibility that the grantor might be appointed as the successor trustee if a vacancy occurs, even if the grantor does not hold the power to fire a trustee and appoint himself. *Estate of Gilchrist v. Comm'r*, 630 F.2d 340 (5th Cir. 1980) (power of grantor to appoint himself as trustee if vacancy occurs).
- (c) ***Powers Held By Third Party Trustee.*** Powers held by a third party trustee do not cause estate inclusion.

E. ***Ascertainable Standard.***

There is no explicit ascertainable standard exception in the statutory provisions or regulations to § 2036 and § 2038.

1. The seminal case establishing the ascertainable standard exception for a donor controlled power over disposition is *Jennings v. Smith*, 161 F.2d 74 (2d Cir. 1947). In that case, the grantor retained the power as trustee to make distributions to enable the beneficiary to keep himself and his family in comfort “in accordance with the station in life to which he belongs.” The court held that power would not cause inclusion under the predecessor to § 2038.
2. Since that time, many courts have ruled on whether particular standards are sufficient to avoid inclusion under §§ 2036 and 2038. Standards relating to “health, education, support and maintenance” are invariably held to avoid estate inclusion, by analogy to the standards exception in § 2041. See e.g., *Estate of Weir v. Comm'r*, 17 T.C. 409 (1951), *acq.* 1952-1 C.B. 4.
3. However, the power to make payments early “in case of need for education purposes or because of illness or for any other good reason” is not an ascertainable standard. Rev. Rul. 73-143, 1973-1 C.B. 407.
4. ***Sole Discretion.*** Providing that a trustee may decide in its sole or uncontrolled discretion whether the stated standards have been satisfied has been held not to change the result. See *Jennings v. Smith*, 161 F.2d 74 (2d Cir. 1947); *State Street Trust Co. v. United*

States, 160 F. Supp 877 (D. Mass 1958), *aff'd*, 263 F.2d (1st Cir. 1959); *Estate of Budd v. Comm'r*, 49 T.C. 468 (1968).

- (a) In *Estate of Budd*, the IRS contended that the modifier “in his uncontrolled discretion” rendered the standard as unascertainable. The Tax Court disagreed, reasoning that even though “a court of equity ordinarily will not substitute its discretion for that of the trustee, nevertheless, even where the power is granted in terms of the ‘sole’ or ‘uncontrolled’ discretion of the trustee, it will review his action to determine whether in light of the standards fixed by the trust instrument, such discretion has been honestly exercised.” *Cf.* Reg. § 25.2511-1(g)(2) (“the fact that the governing instrument is phrased in discretionary terms is not itself an indication that no such standard exists”).

- (b) PLR 9625031 held that trusts were not included under § 2036 or § 2038 where the trustees — including the grantor — had the right to pay the beneficiary “in their discretions” for his health, support, maintenance, and education).

XXVI. IDENTIFYING THE GRANTOR FOR ESTATE TAX PURPOSES.

Under § 2036 (Retained life estates) and § 2038 (Revocable transfers), a decedent’s gross estate only includes property transferred by the decedent. In the case of a trust, the transferor for this purpose is the person who is determined under state law to have made the transfer of the property. *Heasty v. United States*, 239 F. Supp. 345 (D. Kan. 1965), *aff'd*, 370 F.2d 525 (10th Cir. 1966).

A. Reciprocal Trusts.

The taxpayers in *United States v. Grace*, 395 U.S. 316 (1969) created trusts for each other with identical terms and values. The Supreme Court held that the transfers were so interrelated that they should be treated as though each taxpayer created the trust for his own benefit.

1. **Substantially Identical.** The reciprocal trust doctrine does not apply if the trust terms are not substantially identical. *Estate of Levy v. Comm'r*, 46 T.C.M. 910 (1983) (one trust gave broad *inter vivos* special power of appointment and the other trust did not); PLR 200426008 (citation to and apparent acceptance of *Estate of Levy*).

2. ***Application to Powers.*** *Grace* involved reciprocal interests rather than reciprocal powers. Subsequent cases differ as to whether the doctrine also applies to powers that cause estate inclusion under §§ 2036(a)(2) or 2038. *Estate of Bischoff v. Comm’r*, 69 T.C. 32 (1977) (reciprocal trust doctrine applied to §§ 2036(a)(2) and 2038 powers); *Exchange Bank & Trust Co. of Florida v. United States*, 694 F.2d 1261 (Fed. Cir. 1984); T.A.M. 8019041 (applied doctrine to trusts created by two brothers naming each other as trustee with broad distribution powers); *but see Estate of Green v. Comm’r*, 68 F.3d 151 (6th Cir. 1995) (reciprocal trust doctrine did not apply to powers).
3. ***Unequal Values.*** If trusts of unequal value are reciprocal, the values to be included in either grantor’s estate under the reciprocal trust doctrine cannot exceed the value of the smallest trust. *Estate of Cole v. Comm’r*, 140 F.2d 636 (8th Cir. 1944).

B. *Indirect Transfers.*

The transfer of property from one person to another with the understanding that the second person will transfer the property to a trust for the first person’s benefit is treated as a transfer by the first person, not the second person. *Estate of Shafer v. Comm’r*, 749 F.2d 1216 (6th Cir. 1984). A gift from a husband to his wife followed by a gift from the wife to a trust is a transfer by the husband as the “real donor” under the step-transaction doctrine for purpose of including the gift tax paid in the husband’s estate under the three year rule of § 2035. *Brown v. United States*, 329 F.3d 664 (9th Cir. 2003). A husband’s repayment of a loan from his wife into a trust for the wife results in treatment of the wife as the trust grantor. *Estate of Marshall v. Comm’r*, 51 T.C. 696 (1969), *nonacq.* 1969-2 C.B. xxvi. *Cf.* Reg. § 25.2511-1(h)(1), (2), (3) and (9) (examples of indirect transfers for gift purposes). In *Estate of Kanter v. Comm’r*, 337 F.3d 833 (7th Cir. 2003), a son was treated for income tax purposes as the grantor of trusts that purportedly were established by his mother but the son had provided the funding.

XXVII. *POWERS OF ADMINISTRATION OR MANAGEMENT.*

Administrative decisions can effectively shift benefits among beneficiaries. However, courts recognized that “standard” administrative powers did not invoke the predecessors of § 2036 and § 2038. *See, e.g., Reinecke v. Northern Trust Co.*, 278 U.S. 339 (1929). In some early cases, the IRS successfully argued that broad

administrative powers can cause estate tax inclusion under § 2036 and § 2038. *See, e.g., State Street Co. v. United States*, 263 F.2d 635 (1st Cir. 1959) (the power to exchange trust property for other property without regard to the values of the properties, as well as other broad powers, caused the predecessor to § 2036 to apply).

A. *Powers Subject to Court Review.*

Broad management powers held by a grantor should not invoke § 2036 or § 2038 if the grantor's actions are subject to court review (*e.g.*, the exercise of the power is subject to fiduciary standards.). The decision in favor of the IRS in *State Street*, *supra*, was overruled by the same court which adopted the position that that no amount of administrative discretion prevents judicial supervision of the trustee under Massachusetts law. *Old Colony Trust Co. v. United States*, 423 F.2d 601, 603 (1st Cir. 1970). Similarly, *United States v. Powell*, 307 F.2d 821 (10th Cir. 1962) held that trustee-grantor's power to invest assets as he deemed "most advisable for the benefit of the trust estate" did not invoke the predecessor to § 2038 because it was subject to review by a court of equity. The Tax Court has held that a grantor's non-trustee powers were reserved in a fiduciary capacity and § 2036 and § 2038 did not apply because they were subject to court review. *Estate of King v. Comm'r*, 37 T.C. 973 (1962), *nonacq.* 1963-1 C.B. 5. A grantor's control over Illinois land trust resulted in inclusion under § 2036(a)(2) and § 2038 where there was an absence of a fiduciary duty. *Estate of Bowgren v. Comm'r*, 105 F.3d 1156 (7th Cir. 1997).

B. *Power to Allocate Between Income and Principal.*

Broad authority to allocate receipts and disbursements between income and principal generally does not result in estate tax inclusion under § 2036 or § 2038. *See, e.g., Old Colony Trust Co. v. United States*, 423 F.2d 601, 604 (1st Cir. 1970); *Estate of Budd v. Comm'r*, 49 T.C. 468 (1968). The trust instrument in *Estate of Ford v. Comm'r*, 53 T.C. 114, 120 (1969), *nonacq.* 1978-2 C.B. 3, *aff'd per curiam*, 450 F.2d 878 (2d Cir. 1971) authorized the trustee "to apportion between principal and income of the trust estate any loss or expenditure in connection with the trust estate, which in his opinion should be apportioned, and in such manner as he may deem advantageous and equitable." The court observed that this "provision is commonly included in trust instruments 'to give the trustee some discretion so that he would not be required to seek court guidance in making doubtful allocations...'" The trustee herein is directed to exercise this power in an 'advantageous and equitable' manner. Of course, should he abuse his

discretion by classifying an obvious item of principal as income, he would be subject to equity court review.” *Ford*, 53 T.C. at 128.

C. *Broad Investment Authority.*

Various cases recognize that authorizing the trustee to invest in investments that would not otherwise be permissible under state law or to sell or exchange trust assets does not invoke § 2036 or § 2038. *See, e.g., United States v. Powell*, 307 F.2d 821 (10th Cir. 1962); *Estate of Ford v. Comm’r*, 53 T.C. 114 (1969), *nonacq.* 1978-2 C.B. 3, *aff’d per curiam*, 450 F.2d 878 (2d Cir. 1971) (“the power to invest in ‘nonlegals’ (i.e., investments not classified under a particular State law or ruling of the pertinent court as legal investments for trust funds) and the power to sell or exchange the trust property do not amount to a right to designate who shall enjoy the trust property or a right to alter, amend, or revoke the terms of the trust”); *Estate of Budd v. Comm’r*, 49 T.C. 468, 475 (1968) (authority to retain or invest in securities or property that may not be of a character permitted for trustees’ investment under applicable state law).

D. *Broad Grant of Authority Powers.*

Neither § 2036 nor § 2038 applies if the trustee is granted common catch-all powers that the settlor could have exercised over the property if it had not been transferred to the trust. *Old Colony Trust Co. v. United States*, 423 F.2d 601, 603 (1st Cir. 1970). The court reasoned that the language does not prevent accountability to the court for exercise of the power.

E. *Power to Substitute Assets.*

A grantor’s power to substitute assets of equivalent value does not cause § 2036 or § 2038 to apply if it is held in a fiduciary capacity. *Estate of Jordahl v. Comm’r*, 65 T.C. 92 (1975), *acq.*, 1977-2 C.B. 1. The IRS also concedes that there is no estate tax inclusion if the power is held in a non-fiduciary capacity. Rev. Rul. 2008-22, 2008-16 I.R.B. 796. The predecessor to § 2036, however, applied where there was a power to exchange trust property for other property without regard to values. *State Street Co. v. United States*, 263 F.2d 635 (1st Cir. 1959).

F. *Exculpatory Clauses.*

Broad exculpatory clauses should not trigger § 2036(a)(2) or § 2038 because it is not possible to give a trustee complete exculpation from liability for its decisions. RESTATEMENT (SECOND) OF TRUSTS § 222

provides exculpatory clauses are invalid if they would relieve a trustee of liability for a breach of trust committed in bad faith, intentionally or with reckless indifference to the interest of the beneficiary. *See, e.g., Old Colony Trust Co. v. United States*, 423 F.2d 601, 602 (1st Cir. 1970).

G. *Guarantees.*

The IRS suggested in PLR 9113009 that a guaranty by an individual for the benefit of another is a transfer, but the IRS indicated that it was not taking a position as to how the gift should be valued. That ruling came under intense criticism and was withdrawn by PLR 9409018. There have been no further rulings or cases that address whether guarantees constitute gifts.

H. *United States v. Byrum — Fiduciary Standard.*

The Supreme Court held in *United States v. Byrum*, 408 U.S. 125 (1972), that the retained right to vote transferred closely held corporate stock was not a § 2036(a)(2) power over the stock. The Court first reasoned that management powers generally are not powers subject to § 2036(a)(2). The Court further held that Mr. Byrum did not have a retained “right” defined in § 2036(a)(2) because Mr. Byrum owed fiduciary duties to the corporation.

1. ***Congressional Response to Byrum.*** The Tax Reform Act of 1976 amended § 2036 to provide that a grantor’s retention of the power to vote shares in a “controlled corporation” is deemed to be the retention of the enjoyment of the property for purposes of § 2036(a)(1). § 2036(b). Section 2036(b) does not disturb the holding in *Byrum* as to § 2036(a)(2). Section 2036(b) requires that there be a controlled corporation, and the decedent must have retained voting rights.
2. ***Controlled Corporations.*** A corporation is a “controlled corporation” if at any time after the transfer of stock and during the three year period ending on the date of the decedent’s death, the decedent owned or had the right (alone or in conjunction with any person) to vote stock possessing at least 20% of the total combined voting power of all classes of stock taking into account the attribution rules of § 318. § 2036(b)(2).
3. ***Non-Voting Stock.*** The right to vote non-transferred stock does not count, and the grantor may give non-voting stock and retain voting stock of the corporation. Prop. Reg. § 20.2036-2(a).

4. ***Powers Held as a Trustee.*** A grantor retains the right to vote even if the power is exercisable in a fiduciary capacity as trustee or co-trustee, or where the grantor may appoint himself as trustee. Prop. Reg. § 20.2036-2(c).
5. ***Three-Year Rule.*** Section 2036(b) has its own three-year rule instead of relying upon the § 2035 three-year rule. The difference is that § 2036(b) applies if the grantor holds the power to vote at any time within three years prior to death, whereas § 2035 does not apply if relinquishment of the problematic power occurs automatically under the agreement without any volition on the part of the grantor. For example, if the grantor of a GRAT is the trustee during the initial term of the GRAT, the grantor must survive at least three years after relinquishing any voting power over controlled corporation stock to avoid inclusion under § 2035.

XXVIII. TRUSTEE REMOVAL AND APPOINTMENT POWERS.

Life insurance proceeds are included in the insured's estate if (i) the proceeds are payable to or for the benefit of the insured's estate, or (ii) if the insured possessed any incidents of ownership in the policy at the insured's death, whether exercisable either alone or in conjunction with any other person. § 2042.

A. *Incidents of Ownership.*

Incidents of ownership" includes most any power regarding the policy, including the following powers: to change the beneficiary; to surrender or cancel the policy; to assign the policy; or to pledge the policy for a loan or obtain a loan on the policy from the insurer. Reg. § 20.2042-1(c)(2). Powers to elect settlement options, to veto the owner's right to assign the policy or to designate policy beneficiaries are incidents of ownership. *In Re Estate of Lumpkin*, 474 F.2d 1092 (5th Cir. 1973); Rev. Rul. 75-70, 1975-1 C.B. 301. Merely making a loan from the insured to a trust to enable the trust to pay premiums is not an incident of ownership in the policy provided the policy is not used as collateral for the loan. PLR 9809032.

B. *Powers in Fiduciary Capacities.*

Powers held by the insured in a fiduciary capacity have been treated as if the insured held the incidents of ownership for purposes of § 2042. Reg. § 20.2042-1(c)(4); *Terriberry v. United States*, 517 F.2d 286 (5th Cir.

1975), cert denied, 427 U.S. 977 (1976); *Freuhauf v. Comm'r*, 427 F.2d 80 (6th Cir. 1970); *but see Bloch v. Comm'r*, 78 T.C. 850 (1982).

1. ***Exception for Certain Powers Held in Fiduciary Capacity.*** Rev. Rul. 84-179, 1984-2 C.B. 195, however, holds that an insured who holds powers over a policy in a fiduciary capacity avoids § 2042 if all of the following are satisfied: (i) the powers are held only in a fiduciary capacity, (ii) the powers are not exercisable for the insured's personal benefit, (iii) the insured did not transfer the policy to the trust or transfer any of the consideration for purchasing or maintaining the policy by the trust from the insured's personal assets, and (iv) the insured did not obtain the insured's trustee powers through a prearranged plan in which the insured participated.
2. ***Power to Substitute Assets of Equivalent Value.*** *Estate of Jordahl v. Comm'r*, 65 T.C. 92 (1975), *acq.* 1977-1 C.B. 1, held that policies of life insurance were not included in the decedent's gross estate although the decedent retained the power to substitute securities, property, and policies "of equal value" for those transferred to the trust. Rev. Rul. 82-5, 1982-1 C.B. 131, held to the same effect stating:

While the Service takes no position on whether the survivor's loss benefits are classifiable as life insurance proceeds, nonetheless, the proceeds would not be includible in the decedent's gross estate because the decedent did not possess any incidents of ownership. Neither the power to cancel the policy and relinquish the motor vehicle registration nor the power to substitute a policy with identical survivor's benefits constitutes an incident of ownership within the meaning of section 2042.

Rev. Rul. 2008-22, 2008-16 I.R.B. 796, extended the *Jordahl* exclusion for purposes of § 2036 and § 2038 to powers of substitution held in a non-fiduciary capacity. However, Rev. Rul. 2008-22 does not mention § 2042, which raises the question whether a power of substitution in a trust that owns life insurance conveys an incident of ownership.

C. *Non-Fiduciary Option to Purchase Policy.*

The Tax Court has held that a decedent did not have incidents of ownership where the decedent's employment agreement provided that if the employer-company, owner of two life insurance policies on decedent's life, elected not to pay the premiums on or to surrender and terminate the policies, the employer-company would first give decedent the right to take an assignment of the policies in exchange for their cash value. *Smith v. Comm'r*, 73 T.C. 307 (1979), *acq.* in result, 1981-1 C.B. 2. At the decedent's death, his rights were too contingent, and the proceeds of the policies are not includable in his gross estate.

XXIX. *TRUSTEE REMOVAL AND APPOINTMENT POWERS.*

A grantor is deemed to hold a trustee's dispositive or management powers if the grantor can appoint the grantor as trustee at any time. Reg. § 20.2036-1(b)(3) (power to remove trustee and appoint himself); *Estate of McTighe v. Comm'r*, 36 T.C.M. 1655 (1977).

A. *Contingent Power to Appoint Self as Successor Trustee.*

Although § 2038 does not apply to a grantor's contingent power to appoint himself as trustee upon the occurrence of an event that is outside the grantor's control (*e.g.*, a prior trustee ceasing to serve due to death or resignation), § 2036(a) will apply. *Estate of Farrel v. United States*, 553 F.2d 637 (Ct. Cl. 1977); *Estate of Alexander v. Comm'r*, 81 T.C. 757 (1983); Rev. Rul. 73-21, 1973-1 C.B. 405; *see* Reg. § 20.2036-1(b)(3).

B. *Power to Replace Trustee.*

The IRS ruled in Rev. Rul. 79-353, 1979-2 C.B. 325, that a grantor's unqualified power to remove a trustee and appoint a new trustee was the same as a reservation by the grantor of the trustee's discretionary powers of distribution. The IRS' theory was the grantor could appoint trustees who would do the grantor's bidding. The theory was rejected in *Estate of Vak v. Comm'r*, 973 F.2d 1409 (8th Cir. 1992) and *Estate of Wall v. Comm'r*, 101 T.C. 300, 312 (1993). The IRS' changed its position in Rev. Rul. 95-58, 1995-2 C.B. 1, "holding that even if the decedent had possessed the power to remove the trustee and appoint an individual or corporate successor trustee that was not related or subordinate to the decedent (within the meaning of § 672(c)), the decedent would not have retained a trustee's discretionary control over trust income." This position is consistent with

the removal provisions in the income tax regulations for grantor trusts. Reg. § 1.674(d)-2. The IRS has not addressed the effect of a removal power without cause for purposes of § 2042, but it ought to be the same as under § 2036 and § 2038 as provided in Rev. Rul. 95-58. *See* PLR 200314009 (if trustee ceased to serve or was removed, insured could appoint successor trustee who was not related or subordinate to insured; held that section 2042 did not apply. The ruling did not clarify whether the insured held a removal power, but the reasoning of the ruling seems to apply Rev. Rul. 95-58 for § 2042 purposes).

C. *Power to Add Co-Trustees.*

Sections 2036 and 2038 apply to powers held jointly with someone else. The mere power allowing a grantor to add co-trustees other than the grantor should not be treated as though the grantor held the powers of the trustees. *Durst v. United States*, 559 F.2d 910 (3d Cir. 1977). However, the ability to add one's self as a co-trustee is as damaging as being able to become sole trustee.

XXX. SECTION 2041 SAVINGS CLAUSE.

Savings clauses to avoid adverse tax results for grantors and beneficiaries can be effective. For example, PLR 7935015 concluded that the beneficiary-trustee did not have a general power of appointment because of this clause in the instrument:

Restriction on exercise of power for fiduciary's benefit. (a) Except as provided in subsection (b), a power conferred upon a person in his capacity as a fiduciary to make discretionary distributions of principal or income to himself or to make discretionary allocations in his own favor or receipts or expenses as between income and principal cannot be exercised by him. If the power is conferred on two or more fiduciaries, it may be exercised by the fiduciaries who are not so disqualified. If there is no fiduciary qualified to exercise the power, it may be exercised by a special fiduciary appointed by the court.

PART FIVE— INCOME TAX REPORTING FOR GRANTOR TRUSTS

XXXI. RETURN REQUIREMENTS.

There are several methods for reporting income earned by a grantor trust.

A. *Simplified Filing — Method 1.*

In general, no return is required for a grantor trust using Method 1 if the trust is taxed solely to one person. Reg. § 1.671-4(b)(2).

1. Under Method 1, the trustee furnishes the owner's social security number and the trust's address to payors of income. TINs are not needed, and it is not wise to obtain them.
2. The owner must provide a Form W-9 to the trustee.
3. Unless the owner is also a trustee, the trustee must give the owner a statement that shows all items of income, deduction and credit of the trust, identifies the payor of each item of income, explains how the owner takes those items into account when figuring the owner's taxable income or tax, and informs the owner that those items must be included when figuring taxable income and credits on the owner's income tax return.
4. A trust is treated as taxed to one person if it is taxed to a husband and wife as the owners and they file a joint income tax return.
5. Simplified filing is not available if the trust is a qualified subchapter S trust, if any of its assets are located outside the U.S., if the owner's tax year is not the calendar year, if the trust is a foreign trust, or if the owner is not a U.S. person.

B. *Simplified Filing — Method 2.*

In general, no return is required for a grantor trust using Method 2 if the trust is taxed solely to one person.

1. Under Method 2, the trustee furnishes the trust's TIN and address to the payors of income.
2. The trustee reports the income paid to the trust by filing Form 1099s showing the trust as payor and the owner as the payee.
3. Unless the owner is a trustee, the trustee must give the owner a statement that shows all items of income, deduction and credit of the trust, explains how the owner takes those items into account when figuring the owner's taxable income or tax, and informs the owner

that those items must be included when figuring taxable income and credits on the owner's income tax return.

C. *Simplified Filing — Method 3.*

If the trust has two or more owners, no return is required if the trust elects Method 3.

1. Under Method 3 reporting, the trustee furnishes the trust's TIN and address to the payors of income.
2. The trustee then files Form 1099s showing the trust as the payor and each owner as the payees.
3. Whether or not the owners are trustees, the trustee must give each owner a statement that shows all items of income, deduction and credit of the trust attributable to the owner, explains how the owner takes those items into account when figuring the owner's taxable income or tax, and informs the owner that those items must be included when figuring taxable income and credits on the owner's income tax return.

D. *Form 1041 Reporting.*

If simplified filing is not available or is not used, the only income, deductions and credits reported on Form 1041 are the portions taxable to the trust, *i.e.*, the non-grantor portion. If all of the trust is a grantor trust, only the entity portion of the return (*e.g.*, name of trust, address, TIN) is completed. The grantor portion of the trust is reported on a separate attachment to the return. Form K-1 is NOT used for the grantor portion. Corporate trustees typically use Form 1041 reporting even when simplified reporting is available.