

# **GRANTOR TRUST ROUNDUP – THOUGHTS AND ISSUES ON USING GRANTOR TRUSTS**

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## DEVELOPMENTS INVOLVING GRANTOR TRUSTS

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## DEVELOPMENTS INVOLVING GRANTOR TRUSTS

### **A. What is a Grantor Trust?**

A grantor trust is a trust where the grantor or another person is treated as the owner of the trust income and/or principal for Federal income tax purposes. This means that the grantor or such other person must include in the computation of his or her taxable income all items of “income, deductions, and credits against tax of the trust” attributable to the portion of the trust over which the grantor or such other person is deemed to be the owner. In other words, the grantor or such other person treated as the owner of the trust is taxed to the same extent as if he or she had received the item directly.<sup>1</sup>

One question that often arises is who is considered the grantor for grantor trust purposes. A grantor includes the person who created a trust as well as any person who directly or indirectly makes a gratuitous transfer of cash or other property to a trust.<sup>2</sup> A “gratuitous transfer” is any transfer other than a transfer for fair market value, however, such transfer does not necessarily have to be considered a gift for Federal gift tax purposes.<sup>3</sup> A transfer will be considered to be made for fair market value to the extent of the property received from the trust, the services rendered by the trust or the right to use the property of the trust.<sup>4</sup> The Treasury Regulations under Section 671 provide an example that “rents, royalties, interest, and compensation paid to a trust are transfers for fair market value only to the extent that the payments reflect an arm's length price for the use of the property of, or for the services rendered by, the trust.” An interest in a trust, however, is not property received from a trust. Furthermore, just because the transferor recognizes gain on the transfer does not mean that the transfer was made for fair market value.<sup>5</sup> Finally, distributions from property in which the trust has an interest, such as dividends distributed by a corporation in which the trust owns stock, are not gratuitous transfers.<sup>6</sup>

If a person creates or funds a trust on behalf of another person, both persons are treated as grantors of the trust.<sup>7</sup> The person who creates the trust, however, must make a gratuitous transfer to the trust in order to be treated as an owner of any portion of the trust under Sections 671 through 677 or Section 679.<sup>8</sup> A person who acquires an interest in a trust from a grantor of such trust will also be considered a grantor of such trust if the interest acquired is an interest in certain investment trusts described in Section 301.7701-4(c) of the Treasury Regulations, which includes liquidating trusts and environmental remediation trusts.<sup>9</sup>

If a trust makes a gratuitous transfer of property to another trust, the grantor of the transferor trust generally will be treated as the grantor of the transferee trust.<sup>10</sup> If, however, the

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<sup>1</sup> Section 671; Treas. Reg. Section 1.671-2(d).

<sup>2</sup> Treas. Reg. Section 1.671-2(e)(1).

<sup>3</sup> Treas. Reg. Section 1.671-2(e)(2).

<sup>4</sup> Treas. Reg. Section 1.671-2(e)(2)(i).

<sup>5</sup> Id.

<sup>6</sup> Treas. Reg. Section 1.671-2(e)(2)(ii).

<sup>7</sup> Treas. Reg. Section 1.671-2(e)(1).

<sup>8</sup> Id.

<sup>9</sup> Treas. Reg. Section 1.671-2(e)(3).

<sup>10</sup> Treas. Reg. Section 1.671-2(e)(5).

transfer is made through the exercise of a general power of appointment over the transferor trust, the person exercising the power of appointment will be treated as the grantor of the transferee trust, even if the grantor of the transferor trust is treated as the owner of the transferor trust under the grantor trust rules.<sup>11</sup> This is an important consideration when decanting a grantor trust into a new trust to ensure that the act of decanting cannot be construed as a general power of appointment if the intention is to keep the same person as the sole grantor of the transferee trust for grantor trust purposes.

Section 1.671-2(e)(6) of the Treasury Regulations provides the following examples of who is treated as a grantor and an owner for purposes of the grantor trust rules:

EXAMPLE 1. A creates and funds a trust, T, for the benefit of her children. B subsequently makes a gratuitous transfer to T. Under Section 1.671-2(e)(1), both A and B are grantors of T.

EXAMPLE 2. A makes an investment in a fixed investment trust, T, that is classified as a trust under Section 301.7701-4(c)(1). A is a grantor of T. B subsequently acquires A's entire interest in T. Under Section 1.671-2(e)(3), B is a grantor of T with respect to such interest.

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

EXAMPLE 4. A creates and funds a trust, T. A does not retain any power or interest in T that would cause A to be treated as an owner of any portion of the trust under Sections 671 through 677. B holds an unrestricted power, exercisable solely by B, to withdraw certain amounts contributed to the trust before the end of the calendar year and to vest those amounts in B. B is treated as an owner of the portion of T that is subject to the withdrawal power under section 678(a)(1). However, B is not a grantor of T under Section 1.671-2(e)(1) because B neither created T nor made a gratuitous transfer to T.

EXAMPLE 5. A transfers cash to a trust, T, through a broker, in exchange for units in T. The units in T are not property for purposes of determining whether A has received fair market value under Section 1.671-2(e)(2)(ii). Therefore, A has

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<sup>11</sup> Id.

made a gratuitous transfer to T, and, under Section 1.671-2(e)(1), A is a grantor of T.

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

EXAMPLE 7. A, B's brother, creates a trust, T, for B's benefit and transfers \$50,000 to T. The trustee invests the \$50,000 in stock of Company X. C, B's uncle, purportedly sells property with a fair market value of \$1,000,000 to T in exchange for the stock when it has appreciated to a fair market value of \$100,000. Under Section 1.671-2(e)(2)(ii), the \$900,000 excess value is a gratuitous transfer by C. Therefore, under Section 1.671-2(e)(1), A is a grantor with respect to the portion of the trust valued at \$100,000, and C is a grantor of T with respect to the portion of the trust valued at \$900,000. In addition, A or C or both will be treated as the owners of the respective portions of the trust of which each person is a grantor if A or C or both retain powers over or interests in such portions under Sections 673 through 677.

EXAMPLE 8. G creates and funds a trust, T1, for the benefit of G's children and grandchildren. After G's death, under authority granted to the trustees in the trust instrument, the trustees of T1 transfer a portion of the assets of T1 to another trust, T2, and retain a power to revoke T2 and revest the assets of T2 in T1. Under Sections 1.671-2(e)(1) and (e)(5), G is the grantor of T1 and T2. In addition, because the trustees of T1 have retained a power to revest the assets of T2 in T1, T1 is treated as the owner of T2 under section 678(a).

EXAMPLE 9. G creates and funds a trust, T1, for the benefit of B. G retains a power to revest the assets of T1 in G within the meaning of section 676. Under the trust agreement, B is given a general power of appointment over the assets of T1. B exercises the general power of appointment with respect to one-half of the corpus of T1 in favor of a trust, T2, that is for the benefit of C, B's child. Under Section 1.671-2(e)(1), G is the grantor of T1, and under Sections 1.671-2(e)(1) and (e)(5), B is the grantor of T2.

It generally is desirable, when creating a grantor trust, to ensure that the grantor is treated as the owner as to the entire trust as it is possible that the grantor is treated as the owner only of a portion of the trust. If the grantor is treated as the owner of the entire trust, the grantor takes into account all items of income, deduction and credit (including capital gains and losses) relating to the trust in computing the grantor's income tax liability.<sup>12</sup> If the grantor is deemed to be the owner of only a portion of the trust, then the grantor includes only those items of income, deductions and credits allocable to that portion.<sup>13</sup> When dealing with only a portion of the trust, items must be apportioned in a reasonable manner in light of all the circumstances, including the

<sup>12</sup> Treas. Reg. Section 1.671-3(a)(1).

<sup>13</sup> Treas. Reg. Section 1.671-3(a)(2).

terms of the governing instrument, local law and the reasonable and consistent practice of the trustee.<sup>14</sup>

There are three ways a grantor can own a portion of a trust:

- (1) Income or Principal Only - The grantor owns either the ordinary income portion of the trust or the principal portion of the trust. This occurs when the power or interest creating the grantor trust status extends only to income or only to principal. A grantor may only include items of ordinary income of a trust if the grantor has a power over ordinary income.<sup>15</sup> Thus, if a grantor is treated under Section 673 as an owner by reason of a reversionary interest in ordinary income only, items of income allocable to corpus will not be included in the portion the grantor is deemed as owning. Similarly, if a grantor or another person is treated under Sections 674-678 as an owner of a portion by reason of a power over ordinary income only, items of income allocable to corpus are not included in that portion.<sup>16</sup> If the trust is a grantor trust only as to principal, then only the income allocable to principal is included in computing the grantor's tax liability.<sup>17</sup>
- (2) Fractional or Pecuniary Share – The grantor can be deemed the owner of both income and principal but only as to a fractional or pecuniary share of such income and principal. This occurs when the trust can be treated as a grantor trust to one or more individuals. It also can occur when the power or interest does not extend fully. In such a case, a pro rata share of each item of income, deduction and credit will be allocated to such portion.<sup>18</sup> For example, if the grantor retains the right to borrow up to one-half (1/2) of the trust assets, the grantor owns a fifty percent (50%) share of the trust and is allocated fifty percent (50%) of the income, deductions and credits of the trust. If the portion deemed owned by the grantor includes an interest in or right to an amount of principal only, a fraction of each item, including items allocated to principal, such as capital gains, is attributed to the portion, the numerator of such fraction will be the amount that is subject to the control of the grantor and the denominator will be the fair market value of the trust principal at the beginning of the applicable taxable year.<sup>19</sup>
- (3) Specific Assets – Finally, the grantor can be deemed the owner of both income and principal but only as to specific assets of the trust. For example, the grantor retains the right to substitute assets under Section 675(4) excluding life insurance policies. The grantor would not be deemed the owner of the life insurance policies for Federal income tax purposes.

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<sup>14</sup> Id.

<sup>15</sup> Treas. Reg. Section 1.671-3(b)(1).

<sup>16</sup> Id.

<sup>17</sup> Treas. Reg. Section 1.671-3(c).

<sup>18</sup> Treas. Reg. Section 1.671-3(a)(3).

<sup>19</sup> Id.

In addition to understanding what is meant by “grantor”, “owner” and “portion”, it is important to understand the meaning of the following terms for purposes of the grantor trust provisions:

- Adverse party: An “adverse party” is a person with a substantial beneficial interest in the trust that will be adversely affected by the exercise or nonexercise of a power possessed by such party.<sup>20</sup> An interest in the trust is substantial if “its value in relation to the total value of the property subject to the power is not insignificant”.<sup>21</sup> Generally, an interest of a remainderman is only adverse as to the exercise of a power over principal.<sup>22</sup> The interest of an ordinary income beneficiary, however, may be adverse to just a power over income but could also be adverse to a power over principal.<sup>23</sup>
- Nonadverse party: A “nonadverse party” is anyone who is not an adverse party.<sup>24</sup>
- Related or subordinate party: A “related or subordinate party” is the grantor’s spouse, parent, issue, sibling, employee, or any employee of a corporation in which the stock holdings of the grantor and the trust are significant from the viewpoint of voting control; or a subordinate employee of a corporation of which the grantor is an executive.<sup>25</sup>
- Spouse: In general, the grantor is treated as owning any power or interest in a trust that is held by the grantor’s spouse. For purposes of this spousal attribution rule, “spouse” means an individual who is the spouse of the grantor at the time of the creation of such power or interest, or an individual who became the grantor’s spouse after the creation of such power or interest, but only with respect to such periods after such individual became the grantor’s spouse.<sup>26</sup>

Sections 673 through 679 define the situations in which the grantor or another person is deemed to be the owner of the trust, thereby creating a grantor trust.<sup>27</sup> Each of these Sections is briefly described below. For an in depth discussion of each Section, please refer to the following outlines from presentations previously made at the ABA Tax Section meetings:

- (1) “What’s Yours is Mine and What’s Mine is Mine: Grantor Trust Sections 673 and 676”, Lisa Whitcomb and Scott A. Bowman, January 22, 2011
- (2) “Creating Intentional Grantor Trusts Using Section 674”, Stephen R. Akers, Rachel Burke and Marya P. Robben, September 25, 2010;

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<sup>20</sup> Section 672(a).

<sup>21</sup> Treas. Reg. Section 1.672(a)-1(a).

<sup>22</sup> Treas. Reg. Section 1.672(a)-1(d).

<sup>23</sup> Treas. Reg. Section 1.672(a)-1(c).

<sup>24</sup> Section 672(b).

<sup>25</sup> Section 672(c).

<sup>26</sup> Section 672(e). For further discussion of who qualifies as a spouse for purposes of the grantor trust rules, see “Section 675(2) and 675(3) Grantor Trust Status Based on Borrowing Power”, Anne W. Coventry (May 8, 2010).

<sup>27</sup> Treas. Reg. Section 1.671-1(a).

- (3) “Planning with Grantor Trusts – Structuring a Grantor Trust to Maximize the Benefits and Minimize the Risks”, Stephen R. Akers, Rachel Burke and Marya P. Robben, September 25, 2010;
- (4) “Focus on Grantor Trusts – Section 675: Grantor Trust Status under Section 675(1): Power to Deal with Property for Inadequate Consideration and Grantor Trust Status under Section 675(4)(A) and (B): Administrative Powers over Closely-Held Stock”, Howard Zaritsky, Anne W. Coventry and Matie B. Little, May 8, 2010;
- (5) “Section 675(2) and 675(3) Grantor Trust Status Based on Borrowing Power”, Anne W. Coventry, May 8, 2010;
- (6) “Grantor Trusts Status under Section 677: Trust Income for the Benefit of the Grantor”, H. Carter Hood and Matie B. Little, May 7, 2010;
- (7) “Navigating Grantor Trust Issues under Section 678 Before and After the Settlor’s Death”, Laura Peebles, September 26, 2009; and
- (8) “Inbound, Outbound and Rebound: Section 679 and the Taxation of Foreign Trusts with US Beneficiaries”, A. Christopher Segal and Jessica B. Baggenstos, January 23, 2010.

Sections 671 through 677 do not apply if the income of a trust is taxable to a grantor's spouse under Section 71 relating to alimony or separate maintenance payments, or under Section 682 relating to income of an estate or trust in the case of divorce.<sup>28</sup> Furthermore, the grantor trust rules do not apply to a pooled income fund under Section 642(c)(5), a charitable remainder annuity trust under Section 664(d)(1) or a charitable remainder unitrust under Section 664(d)(2).<sup>29</sup>

A brief overview of the grantor trust provisions follows:

1. *Section 673 – Reversionary Interests*

Section 673(a) applies where the grantor has retained a reversionary interest in either the trust principal or trust income, the value of which, at the time of the creation of the trust or the portion over which the grantor has such reversionary interest, exceeds five percent (5%) of the value of the trust or such portion. The following example illustrates the concept of a reversion:

*Example.* A creates a trust for the benefit of B, under which B may receive distributions of income or principal or both in the discretion of the Trustee, T. Upon B’s death, any property remaining in the trust reverts to A, if A is living, or, if not, to A’s estate. A has retained a reversionary interest in the trust.

A reversion alone will not cause the trust to be treated as a grantor trust. Only if the value of the reversion at the time the trust is created exceeds five percent (5%) of the value of the entire trust will the trust be considered a grantor trust. The five percent test in Section 673 corresponds to the five percent test in Section 2037, which states that a decedent’s estate includes assets that the decedent had transferred during the decedent’s lifetime in which the decedent

<sup>28</sup> Treas. Reg. Section 1-671-1(b).

<sup>29</sup> Treas. Reg. Section 1-671-1(d).

retained a reversionary interest worth more than five percent (5%) of the total value of the assets on the date of the decedent's death.<sup>30</sup> It is accepted practice that the Section 7520 tables must be used to value a reversionary interest for purposes of Section 673.<sup>31</sup> These tables combine the current interest rate and the age of the life beneficiary or years until the interest will revert.

Because the retention of the reversionary interest risks inclusion of the trust in the grantor's estate under Section 2037, Section 673 is not often utilized to create an intentional grantor trust. The times at which the five percent (5%) test is measured under the two provisions are different. Under Section 673, the measurement for grantor trust status occurs on the creation of the trust. Under Section 2037, the measurement for estate tax inclusion occurs at the time of the grantor's death. Thus, it is possible that the reversion will not cause inclusion, but given the uncertainty of what the interest rates (and the corresponding valuation under Section 7520) will be when the grantor passes away, Section 673 is not an often used provision to create a grantor trust.

There is an exception to Section 673 for certain trusts created for a minor descendant. Section 673 does not apply to a reversionary interest in the grantor if the grantor creates a trust (i) for a beneficiary who is a minor lineal descendent, (ii) the grantor has a reversionary interest only in the event the beneficiary dies before age 21, and (iii) the beneficiary holds all present interests in the trust. That is, Section 673 does not apply to a trust that satisfies the requirements of Section 2503(c).

## 2. *Section 674 – Power to Control Beneficial Enjoyment*

Section 674(a) provides that the grantor will be treated as the owner of any portion of a trust over which the grantor has retained a power of disposition. A power of disposition includes any power that can affect the beneficial enjoyment of the trust property.<sup>32</sup> For example, a power to allocate income among the beneficiaries of the trust is a power of disposition. Similarly, a power to add more beneficiaries is a power of disposition, unless the power is limited so that only after-born or after-adopted children can be added.<sup>33</sup>

To qualify as a grantor trust, such power of disposition must be exercisable by the grantor or a nonadverse party, or both, without the consent of an adverse party.<sup>34</sup>

Section 674(a) on its own would turn many trusts into grantor trusts. Thus, the limitations to Section 674(a) are as significant as the rule itself. The first exceptions, found in Section 674(b), are certain powers that, even though they are technically powers of disposition, do not cause grantor trust status, even if held by the grantor or a nonadverse party. The second exception, found in Section 674(c), provides an exception for the exercise of powers of disposition by an "independent trustee". The third exception, found in Section 674(d), is an

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<sup>30</sup> However, it is important to consider the grantor may be treated as the owner of any reversionary interest (regardless of its value) under Section 677(a)(2), discussed below.

<sup>31</sup> See Rev. Rul. 76-178, 1976-1 C.B. 273.

<sup>32</sup> Treas. Reg. Section 1.674(a)-1(a).

<sup>33</sup> See Section 674(b)(5).

<sup>34</sup> Section 674(a).

exception for certain powers of disposition exercisable by a trustee who is not the grantor or the grantor's spouse.

First, there are eight exceptions that, even though technically a power of disposition, will not cause the trust to be treated as a grantor trust.

- (1) Power to Apply Income to Support of Dependent – If the Trustee or the grantor or any other person has the authority to pay or apply the trust income to discharge the grantor's legal obligation to support a dependent, the trust will not be treated as a grantor trust.<sup>35</sup> If, however, income is actually distributed in a manner that discharges the grantor's legal obligation to support a dependent, then the trust will be treated as a grantor trust.<sup>36</sup> Note: If the trust income (or principal) can be used to discharge the grantor's legal obligation to support a beneficiary of the trust and the grantor passes away, the trust property will be included in the grantor's estate for Federal estate tax purposes.<sup>37</sup>
- (2) Power Affecting Beneficial Enjoyment Only After Occurrence of Event – A power to affect the beneficial enjoyment of the trust property that only arises after the occurrence of an event will not cause the trust to be treated as a grantor trust.<sup>38</sup> If, however, the power is postponed for a period that, if such power were a reversionary interest, would cause the trust to meet the five percent test under Section 673, then the trust will be treated as a grantor trust.<sup>39</sup> In other words, the power must be postponed for a long enough period of time that the value of such power is less than five percent (5%) of the value of the trust. Once the event occurs, the trust could become a grantor trust, unless the power has been relinquished.<sup>40</sup>
- (3) Power Exercisable Only by Will – If the grantor only may exercise the power of disposition by Will, then the trust will not be treated as a grantor trust, unless the power is to appoint income that has been “accumulated for such disposition by the grantor or may be so accumulated in the discretion of the grantor or a nonadverse party, or both, without the approval or consent of any adverse party”.<sup>41</sup> Thus, the grantor may retain a testamentary power of appointment over the trust principal without causing grantor trust status. However, such power of appointment could also cause the trust property to be included in the grantor's estate for Federal estate tax purposes.<sup>42</sup> In addition, if the grantor is able to appoint the trust principal to the grantor's creditors or to the grantor's estate, the power could be

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<sup>35</sup> Section 674(b)(1).

<sup>36</sup> Sections 674(b)(1) and 677(b).

<sup>37</sup> Treas. Reg. Section 20.2036-1(b)(2).

<sup>38</sup> Section 674(b)(2).

<sup>39</sup> Id.

<sup>40</sup> Id.

<sup>41</sup> Section 674(b)(3).

<sup>42</sup> Section 2041.

deemed to be a reversionary interest, in which case Section 677(a) may apply causing the trust to be treated as a grantor trust.<sup>43</sup>

- (4) Power to Allocate Among Charitable Beneficiaries – A trust will not be treated as a grantor trust when the grantor or a nonadverse party or both have the power to make distributions to charitable beneficiaries.<sup>44</sup> For example, the grantor can retain the right to designate the remainder beneficiaries of a charitable remainder trust and the trust will not be treated as a grantor trust.
- (5) Power to Distribute Corpus Subject to Reasonably Definite Standard or to Advance Principal – The grantor or a nonadverse party or both may hold a power to distribute principal if the power is limited by a reasonably definite standard set forth in the trust agreement without causing the trust to be treated as a grantor trust.<sup>45</sup> Examples of a reasonably definite standard include:
- education, support, maintenance, or health of the beneficiary;
  - reasonable support and comfort;
  - to enable the beneficiary to maintain his accustomed standard of living; and
  - to meet an emergency.<sup>46</sup>

Alternatively, a power to distribute principal for the “pleasure, desire, or happiness of a beneficiary” is not a reasonably definite standard. Furthermore, if the trust agreement provides that the trustee’s determination is conclusive with respect to the exercise or nonexercise of the power, the power will not be limited by a reasonably definite standard.<sup>47</sup> It is important to note that, if the power is limited to a reasonably definite standard, the trust property should not be included in the grantor’s estate for Federal estate tax purposes.

Additionally, the power to make distributions to current income beneficiaries where such distributions are charged against those beneficiaries’ proportionate shares of the trust principal will not cause the trust to be treated as a grantor trust.<sup>48</sup> With respect to such advances, the Trustee must treat the beneficiary’s share of the trust principal as a separate trust.<sup>49</sup>

If, however, the grantor or a nonadverse party or both retains one of the two powers above and anyone has the power to add beneficiaries to the trust, other than after-born or after-adopted children, then the trust will be treated as a grantor trust.<sup>50</sup> The exception to this rule is that a beneficiary can be granted a power of

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<sup>43</sup> Treas. Reg. Section 1.674(b)-1(b)(3).

<sup>44</sup> Section 674(b)(4).

<sup>45</sup> Section 674(b)(5)(A).

<sup>46</sup> Section 1.674(b)-1(b)(5)(i).

<sup>47</sup> Id.

<sup>48</sup> Section 674(b)(5)(B).

<sup>49</sup> Treas. Reg. Section 1.674(b)-1(b)(5)(ii).

<sup>50</sup> Section 674(b)(5).

appointment over his or her portion of the trust without causing the trust to be treated as a grantor trust.<sup>51</sup>

- (6) Power to Withhold Income Temporarily – A trust will not be a grantor trust if income of the trust can be withheld from the income beneficiary, so long as such income must ultimately be distributed in any of the following ways:
- to the beneficiary;
  - to the beneficiary’s estate;
  - to the beneficiary’s appointees subject to a broad limited or special power of appointment; or
  - on the termination of the trust, or with current principal distributions, to the current income beneficiaries in shares irrevocably specified in the trust agreement.<sup>52</sup>

Even though the grantor could be one of the possible appointees under a broad limited or special power of appointment, such inclusion will not cause the trust to be treated as a grantor trust under Section 677.<sup>53</sup> Note: The exceptions under Section 674(b)(6) do not apply if the power to accumulate income is combined with a power in any person to add beneficiaries to the trust, other than after-born or after adopted children. That is, even if the 674(b)(6) exceptions are satisfied, the trust will be treated as a grantor trust if anyone has the power to add beneficiaries to the trust, other than after-born or after-adopted children.<sup>54</sup>

- (7) Power to Withhold Income During Disability of Beneficiary – If the grantor or a nonadverse party or both, without the consent of an adverse party, reserves the power to withhold income from a beneficiary during any legal disability or until the beneficiary reaches the age of 21, the trust will not be treated as a grantor trust.<sup>55</sup> This power is different from the power in Section 674(b)(6) in that such accumulated income may be distributed to other beneficiaries.<sup>56</sup> Like Section 674(b)(6), however, the exception does not apply if the power to withhold income is combined with a power in any person to add beneficiaries to the trust, other than after-born or after adopted children.<sup>57</sup>
- (8) Power to Allocate Between Principal and Income – The power to allocate receipts and disbursements between principal and income, no matter how broadly stated, does not cause the trust to be treated as a grantor trust.<sup>58</sup>

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<sup>51</sup> Treas. Reg. Section 1.674(d)-2(b).  
<sup>52</sup> Section 674(b)(6).  
<sup>53</sup> Treas. Reg. Section 1.674(b)-1(b)(6)(i).  
<sup>54</sup> Section 674(b)(6).  
<sup>55</sup> Section 674(b)(7)(A) and (B).  
<sup>56</sup> Treas. Reg. Section 1.674(b)-1(b)(7).  
<sup>57</sup> Section 674(b)(7).  
<sup>58</sup> Section 674(b)(8).

Second, there is the exception to the application of Section 674(a) for powers exercisable by an “independent Trustee”. If a trustee or trustees, “none of whom is the grantor, and no more than half of whom are related or subordinate parties who are subservient to the wishes of the grantor” may “distribute, apportion, or accumulate income” or distribute principal “to or for a beneficiary or beneficiaries, or to, for, or within a class of beneficiaries”, the trust will not be treated as a grantor trust.<sup>59</sup> For this exception to apply, that is, to avoid having a discretionary trust be treated as a grantor trust, the independent Trustee must be able to act without the consent of any other person.<sup>60</sup> When relying on this provision, care should be taken to ensure that a Trustee is in fact nonadverse.<sup>61</sup> The 674(c) exception does not apply if the power to withhold income is combined with a power in any person to add beneficiaries to the trust, other than after-born or after adopted children.<sup>62</sup>

Third, if a nonadverse Trustee has the power to distribute or accumulate income subject to a reasonably definite standard, the income portion of the trust will not be treated as a grantor trust pursuant to the exception in Section 674(d).<sup>63</sup> Such nonadverse Trustee may not be the grantor or a spouse living with the grantor. Again, the exception does not apply if the power to withhold income is combined with a power in any person to add beneficiaries to the trust, other than after-born or after-adopted children.<sup>64</sup>

Often times, the grantor will retain the right to remove and replace Trustees of the trust. If the power to remove and replace Trustees is unrestricted, the grantor will be deemed to hold all of the Trustees’ powers.<sup>65</sup> Thus, the exception in Section 674(d) noted above could not apply and a trust would be treated as a grantor trust. If, however, the power to appoint a replacement Trustee is limited so that the appointment of a replacement trustee would not convert the trust to a grantor trust, then the trust will not be a grantor trust because of this power.<sup>66</sup>

### 3. *Section 675 – Administrative Powers*

Under Section 675, a trust is treated as a grantor trust if certain administrative powers are present. Each power must be exercisable by the grantor or a nonadverse party without the consent of an adverse party.

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<sup>59</sup> Section 674(c)(1) and (2).

<sup>60</sup> Section 674(c). However, requiring the consent of an adverse party would negate the application of Section 674(a).

<sup>61</sup> For example, if the trustee has an obligation to support any trust beneficiary, even if the Trustee does not have a beneficial interest in the trust, the Trustee could be deemed to have a general power of appointment under Section 2041 or 2514 and therefore be an adverse party. See “Creating Intentional Grantor Trusts Using Section 674”, Stephen R. Akers, Rachel Burke and Marya P. Robben (September 25, 2010).

<sup>62</sup> Section 674(c).

<sup>63</sup> If a dispositive provision is subject to a reasonably definite standard, Section 674(b)(5) will likely prevent application of grantor trust status as to the principal portion of the trust.

<sup>64</sup> Section 674(d).

<sup>65</sup> Treas. Reg. Section 1.674(d)-2.

<sup>66</sup> Treas. Reg. Section 1.674(d)-2(a).

a. *Power to Deal for Less than Adequate and Full Consideration*

When the grantor or a nonadverse party can deal with the trust principal for less than full and adequate consideration, without the consent of an adverse party, the trust will be treated as a grantor trust.<sup>67</sup> This power could allow the grantor to remove assets from the trust for such a small amount of consideration that, effectively, the grantor could terminate the trust. The retention of a power to revoke the trust causes the trust assets to be included in the grantor's gross estate for Federal estate tax purposes.<sup>68</sup> Therefore, this power generally should not be included in a trust that is not intended to be included in the grantor's estate for Federal estate tax purposes. In addition, if the grantor has the power to deal with trust principal for less than full and adequate consideration, any gifts the grantor makes to the trust may be deemed to be incomplete because the grantor arguably has the power to revert title in the grantor or to change the beneficial interests in the trust by exercise of such a power.<sup>69</sup>

A trust may be treated as a grantor trust if the power to deal with the trust principal for less than full and adequate consideration is held by any nonadverse party. However, the concern with giving such a power to a party other than the grantor is that the nonadverse third party would be deemed to have a general power of appointment under Section 2041.

b. *Power to Borrow Trust Property without Adequate Interest or Adequate Security*

A power in the trust agreement that allows the grantor to borrow the trust principal or trust income without adequate interest or without adequate security will cause the trust (or some portion thereof) to be treated as a grantor trust for Federal income tax purposes.<sup>70</sup> The trust agreement must be specific as to the grantor's authority to borrow rather than just a general lending power to make loans to any person without adequate interest or without adequate security.<sup>71</sup>

When using this power to create an intentional grantor trust, most practitioners will draft to require adequate interest. This relates to the issues on intra-family loans. When the interest on an intra-family loan is below the acceptable interest rate, which is generally the applicable Federal rate determined under Section 1274(d), the lender is treated as having made a gift of the difference between the interest the lender should have received at the higher interest rate and the interest the lender is actually receiving. Therefore, it is best to avoid making a loan for no interest or at an interest rate that is below the applicable Federal rate.

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<sup>67</sup> Section 675(1).

<sup>68</sup> Section 2038(a)(1).

<sup>69</sup> Treas. Reg. Section 25.2511-2(c).

<sup>70</sup> Section 675(2).

<sup>71</sup> Treas. Reg. Section 1.675-1(b)(2).

c. *Grantor Actually Borrows Trust Property without Adequate Interest or Adequate Security*

Even if the trust agreement does not provide that the grantor has the power to borrow trust principal or trust income without adequate interest or without adequate security, if the grantor actually borrows trust principal or income without adequate interest or without adequate security and does not repay the loan and interest thereon before the beginning of the next taxable year, the trust will be treated as a grantor trust.<sup>72</sup>

The trust also will be treated as a grantor trust if there is indirect borrowing by the grantor or the grantor's spouse. For example, in *Holdeen Estate v. Comm'r*, the trustees of a trust bought mortgage notes secured by property owned by the grantor. The grantor did not repay the mortgage notes on a timely basis. Accordingly, the Tax Court held that the grantor indirectly borrowed the trust assets and was treated as the grantor over such portion of the trust.<sup>73</sup> The Tax Court also held that a trust was a grantor trust where the trust made a loan to a partnership in which the grantor was a general partner.<sup>74</sup>

It is important to note that the grantor may not deduct the interest that the grantor pays on a loan from a grantor trust. The Internal Revenue Service ("Service") has stated that such payment of interest is really just a gift to the beneficiaries of the trust and does not qualify for an interest deduction.<sup>75</sup> The payment of the interest, however, is not a gift for Federal gift tax purposes. Furthermore, the Service has made it clear that transactions between the grantor and the grantor trust are disregarded for Federal income tax purposes.<sup>76</sup>

d. *Powers to Vote Stock, Control Investments or Substitute Property*

The final group of administrative powers that cause a trust to be treated as a grantor trust must be exercisable in a nonfiduciary capacity by the grantor or a nonadverse party without the approval or consent of a person in a fiduciary capacity.<sup>77</sup> A power is deemed to be exercisable in a fiduciary capacity if it is exercisable primarily in the interest of the beneficiaries of the trust.<sup>78</sup> When a trustee holds any power, such power is presumed to be held in a fiduciary capacity, unless it can be shown by clear and convincing evidence that the power is not exercisable primarily in the interest of the trust beneficiaries.<sup>79</sup> It is a facts and circumstances test.<sup>80</sup>

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<sup>72</sup> Section 675(3).

<sup>73</sup> *Holdeen Estate v. Comm'r*, 34 T.C.M. 129 (1975), app. Dism'd sub nom., *Adams v. Comm'r* (2d Cir. 1976).

<sup>74</sup> *Bennett v. Comm'r.*, 79 T.C. 470 (1982).

<sup>75</sup> Rev. Rul. 86-106, 1986-2 C.B. 28.

<sup>76</sup> Treas. Reg. Section 1.1001-2(c), Ex. 5; Rev. Rul. 85-13, 1985-1 C.B. 184.

<sup>77</sup> Section 675(4); Treas. Reg. Section 1.675-1(b)(4).

<sup>78</sup> Treas. Reg. Section 1.675-1(b)(4).

<sup>79</sup> Id.

<sup>80</sup> Id.

This group includes the following powers:

- (1) The power to “vote or direct the voting of stock or other securities of a corporation in which the holdings of the grantor and the trust are significant from the viewpoint of voting control”;<sup>81</sup>
- (2) The power to “control the investment of the trust funds either by direct investments or reinvestments, or by vetoing proposed investments or reinvestments, to the extent that the trust funds consist of stocks or securities of corporations in which the holdings of the grantor and the trust are significant from the viewpoint of voting control”;<sup>82</sup> and
- (3) The power to “reacquire the trust corpus by substituting other property of an equivalent value”.<sup>83</sup>

With respect to the powers over stock and securities described in Section 675(4)(A) and 675(4)(B), neither the Code nor the Regulations define the phrase “significant from the viewpoint of voting control”. Therefore, if the grantor and the trust own stock in the same corporation, the trust provisions should be considered carefully so that a grantor trust is not inadvertently created if the trust agreement is going to give the grantor or a nonadverse party some ability to either vote the stock or determine how the stock and other trust assets should be invested.

The powers with respect to certain stock and securities described in Sections 675(4)(A) and 675(4)(B) are not often used to intentionally trigger grantor trust status. This is because inclusion of such powers risks inclusion of such stock in the grantor’s estate for estate tax purposes. If the grantor has the power to vote stock in a “controlled corporation”, there is a risk that such stock will be included in the grantor’s estate under Section 2036. A power to determine the trust’s investments without fiduciary consent could be deemed to be a power to alter or amend beneficial enjoyment, risking inclusion in the grantor’s estate for purposes of Section 2036(a)(2) or Section 2038.

Giving the grantor the power to reacquire trust assets in order to create an intentional grantor trust has been a significant topic of conversation among practitioners. In 1975, in *Estate of Jordahl v. Comm’r*, the Tax Court held that the power of substitution did not cause the trust assets to be includible in the grantor’s estate under Section 2038 because the grantor was bound by fiduciary standards and thus could not alter, amend or revoke the trust.<sup>84</sup> In that case, the grantor was a fiduciary. Thus, the question arose whether the substitution power in Section 675(4), which must be exercised in a nonfiduciary capacity, would cause inclusion of the trust assets in the grantor’s estate.

In 2008, the Service issued Revenue Ruling 2008-16, in which it held that, when the grantor has a power to substitute property held in trust and such power is held in a nonfiduciary capacity, the trust property will not be includible in the grantor’s gross estate under Sections

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<sup>81</sup> Section 675(4)(A).

<sup>82</sup> Section 675(4)(B).

<sup>83</sup> Section 675(4)(C).

<sup>84</sup> *Estate of Jordahl v. Comm’r*, 65 T.C. 92 (1975).

2036 or 2038, so long as the Trustee has a fiduciary obligation to ensure that the grantor complies with the trust terms.<sup>85</sup> Such fiduciary obligation can be provided either in the trust agreement or under local law. To ensure the grantor's compliance, the Trustee must determine that the properties acquired and substituted by the grantor are in fact of equivalent value. Finally, the Trustee must determine that the power cannot be exercised in a manner that would shift benefits among the beneficiaries of the trust. The Revenue Ruling states that:

“A substitution power cannot be exercised in a manner that can shift benefits if: (a) the trustee has both the power (under local law or the trust instrument) to reinvest the trust corpus and a duty of impartiality with respect to the trust beneficiaries; or (b) the nature of the trust's investments or the level of income produced by any or all of the trust's investments does not impact the respective interests of the beneficiaries, such as when the trust is administered as a unitrust (under local law or the trust instrument) or when distributions from the trust are limited to discretionary distributions of principal and income.”

Revenue Ruling 2008-16 has given practioners more comfort in utilizing the power of substitution to create a grantor trust. However, there are still concerns which may limit its use. The substitution power is discussed further at Section B below.

#### 4. *Section 676 – Power to Revoke*

If the grantor or a nonadverse party or both has the power revest title to property held in trust in the grantor, the trust will be treated as a grantor trust.<sup>86</sup> The power to revest title of the trust assets in the grantor includes a power to revoke, terminate, alter, amend or appoint.<sup>87</sup> If, however, such power is deferred and cannot be exercised until after the exercise of a certain event, then the trust may not be treated as a grantor trust.<sup>88</sup> This will be the case if the trust would not be treated as a grantor trust under Section 673 if the grantor had retained a reversionary interest.<sup>89</sup>

Of course, if the grantor retains the right to revoke the trust, the trust property will be included in the grantor's gross estate for Federal estate tax purposes.<sup>90</sup> The revocability of a trust is a question of state law. The modern trend is for state law to deem a trust revocable if there is not an express statement in the trust agreement that the trust is irrevocable.<sup>91</sup> Accordingly, it is important to review state law to ensure that the trust is drafted consistent with the grantor's intent with respect to revocability, being mindful of the potential results for both grantor trust status and estate inclusion.

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<sup>85</sup> Rev. Rul. 2008-16, 2008-16 I.R.B. 796.

<sup>86</sup> Section 676(a).

<sup>87</sup> Treas. Reg. Section 1.676(a)-1.

<sup>88</sup> Section 676(b).

<sup>89</sup> Id.

<sup>90</sup> Section 2038(a)(1).

<sup>91</sup> See, e.g., Section 602 of the Uniform Trust Code.

5. *Section 677 – Income for Benefit of Grantor*

There are several powers that will cause the grantor to be treated as the owner of the income of the trust for Federal income tax purposes. These powers arise where the income either can be used or actually is used, directly or indirectly, for the benefit of the grantor or the grantor's spouse. As with most of the other grantor trust powers, for the trust to be treated as a grantor trust, such powers must be exercisable by the grantor or a nonadverse party or both without the consent or approval of any adverse party.<sup>92</sup> These powers include the following:

- (1) the discretion to distribute or the actual distribution of the trust income to the grantor or the grantor's spouse;<sup>93</sup>
- (2) the discretion to hold or accumulate or the actual holding and accumulation of trust income for future distribution to the grantor or the grantor's spouse;<sup>94</sup> or
- (3) the discretion to apply or the application of the trust income to pay premiums on insurance on the life of the grantor or the grantor's spouse.<sup>95</sup>

When the grantor is deemed for Federal income tax purposes to own only the income portion of the trust, the grantor will only be taxed on the ordinary income items and the trust will be taxed on capital gains.<sup>96</sup> If the capital gain items can be held or accumulated for future distribution to the grantor or the grantor's spouse, however, then the capital gains also would be taxable to the grantor.<sup>97</sup>

If the Trustee has the discretion to distribute or accumulate the trust income to discharge a legal obligation of the grantor, then the trust will be treated as a grantor trust, even though neither the grantor nor the grantor's spouse is a beneficiary of the trust.<sup>98</sup> There is an exception for such discretion held by a Trustee with respect to the grantor's legal obligation to support a minor child. If distributions may be made to discharge the grantor's legal obligation to support a minor child, grantor trust status will not be triggered except to the extent that trust income is actually used to discharge such obligation.<sup>99</sup>

The power to use trust income to purchase insurance on the life of the grantor or the grantor's spouse is a power that is frequently used to intentionally trigger grantor trust status, and it is discussed further below. With respect to the payment of insurance premiums, if the trust is not intended to be treated as a grantor trust, it is important that trust income never be used to pay insurance premiums. In Private Letter Ruling 8839008, the trust agreement specifically prohibited the use of trust income to pay insurance premiums. However, five years after the trust was created, the Trustees purchased a second-to-die policies on the grantors' lives with a single premium payment. The Service ruled that the premium payment caused the trust to be treated as

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<sup>92</sup> Section 677(a).

<sup>93</sup> Section 677(a)(1).

<sup>94</sup> Section 677(a)(2).

<sup>95</sup> Section 677(a)(3).

<sup>96</sup> Treas. Reg. Section 1.677(a)-1(e) and (g).

<sup>97</sup> Id.

<sup>98</sup> Section 677(a); Treas. Reg. Section 1.677(a)-1(d).

<sup>99</sup> Section 677(b).

a grantor trust in the year of the payment to the extent that trust income was used to pay the premium.

6. *Section 678 – Grantor Trust to Someone Other Than Grantor*

A trust can be deemed to be a grantor trust as to an individual other than the grantor where an individual has a power to appoint trust principal or income to himself or herself or had such a power that has been released but, after the release, such individual has control that, if the grantor, would cause the trust to be treated as a grantor trust.<sup>100</sup> This situation can arise with Crummey powers granted to beneficiaries to qualify contributions to the trust for the Federal gift tax annual exclusion because the beneficiaries are given the right to withdraw some portion or all of the amount contributed to the trust.

Another situation is where the Trustees may use the trust property to discharge a beneficiary's legal obligation.<sup>101</sup> As with Section 677(b), however, with respect to the discharge of a support obligation, the beneficiary will only be treated as the grantor when funds are actually used to discharge such obligation.<sup>102</sup>

If the grantor is treated as the owner of the trust income for Federal income tax purposes, no other person will be treated as the grantor under Section 678(a).<sup>103</sup> Notice that this only applies where the trust is a grantor trust to the grantor as to income. If the trust is a grantor trust to the grantor only as to principal, then the beneficiary will be the owner for Federal income tax purposes as to income.

7. *Section 679 – Foreign Trusts with U.S. Beneficiaries*

Generally, if a U.S. person transfers property to a foreign trust with one or more U.S. beneficiaries, the trust will be treated as a grantor trust.<sup>104</sup> The trust will be a grantor trust in this situation regardless of the terms of the trust or whether the grantor or any other person has retained any of the grantor trust powers previously discussed.

A foreign trust is any trust that is not a U.S. trust.<sup>105</sup> A U.S. trust is trust over which (i) a U.S. court has primary jurisdiction over its administration, and (ii) one or more U.S. persons have the authority to control all of the substantial decisions of the trust.<sup>106</sup>

For purposes of Section 679, a “transfer” refers to any direct, indirect or constructive transfer.<sup>107</sup> However, if property is sold by a U.S. person to a foreign trust with U.S. beneficiaries for consideration at least equal to its fair market value, the trust will not be treated

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<sup>100</sup> Section 678(a)(1) and (2).

<sup>101</sup> Treas. Reg. Section 1.678(a)-1(b).

<sup>102</sup> Section 678(c).

<sup>103</sup> Section 678(b).

<sup>104</sup> Section 679(a)(1).

<sup>105</sup> Section 7701(a)(31)(B).

<sup>106</sup> Section 7701(a)(31)(E).

<sup>107</sup> Treas. Reg. Section 1.679-3(a).

as a grantor trust as to such person.<sup>108</sup> For purposes of this fair market value exception, consideration does not include any obligation issued or guaranteed by the trust, the grantor, any beneficiary, any deemed owner of the trust or any person “related” to any grantor, owner or beneficiary of the trust.<sup>109</sup> A person is considered “related” if the relationship would result in a disallowance of losses under Section 267 or 707(b).<sup>110</sup>

For purposes of this section, a U.S. trust is presumed to have a U.S. beneficiary unless: (i) under the terms of the trust, no part of income or corpus may be paid or accumulated for the benefit of a U.S. person, and (ii) if the trust were terminated at any time during the year, no part of the trust income or corpus would be paid to a U.S. person. A U.S. person’s contingent interest in a U.S. trust is deemed to be an interest for purposes of this section.<sup>111</sup>

Section 679 does include an exception for testamentary trusts.<sup>112</sup> Thus, if a U.S. person leaves assets under his or her Will to a foreign trust with U.S. beneficiaries, the trust will not be treated as a grantor trust as to the decedent’s estate.

As recent legislation has shown, Section 679 is used to target taxpayers who attempt to shield assets from U.S. income taxes by placing such assets in a foreign trust.<sup>113</sup> A foreign trust with U.S. beneficiaries is subject to onerous reporting requirements<sup>114</sup> and additional income tax consequences.<sup>115</sup> As a result, foreign trusts are not frequently used or recommended for U.S. taxpayers seeking to obtain the benefits of a grantor trust for estate planning purposes.

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<sup>108</sup> Section 679(a)(2)(B).

<sup>109</sup> Section 679(a)(3).

<sup>110</sup> Section 643(i)(2)(B)(i). Under Section 267, a loss is disallowed if the transaction creating the loss was between “members of a family [that is, brothers and sisters, spouse, ancestors and lineal descendants of the party at issue], an individual and a corporation more than 50 percent of which in value of the outstanding stock of which is owned, directly or indirectly, by or for such individual, two corporations which are members of the same controlled group, a grantor and a fiduciary of a trust, a fiduciary of a trust and a fiduciary of another trust, if the same person is a grantor of both trusts, a fiduciary of a trust and a beneficiary of such trust, a fiduciary of a trust and a beneficiary of another trust, if the same person is a grantor of both trusts, a fiduciary of a trust and a corporation more than 50 percent in value of the outstanding stock of which is owned, directly or indirectly, by or for the trust or by or for a person who is a grantor of the trust, a person and an organization to which Section 501...applies and which is controlled directly or indirectly by such person or (if such person is an individual) by members of the family of such individual, a corporation and a partnership if the same persons own more than 50 percent in value of the outstanding stock of the corporation, and more than 50 percent of the capital interest, or the profits interest, in the partnership, an S corporation and another S corporation if the same persons own more than 50 percent in value of the outstanding stock of each corporation, or except in the case of a sale or exchange in satisfaction of a pecuniary bequest, an executor of an estate and a beneficiary of such estate.” Section 267(b) and (c).

<sup>111</sup> Section 679(c)(1).

<sup>112</sup> Section 679(a)(2)(A).

<sup>113</sup> Hiring Incentives to Restore Employment Act (P.L. 111-147, §§ 531-533) (amending Section 679) (2010).

<sup>114</sup> Section 6048; Notice 97-34, 1997-1 CB 422 (June 2, 1997),

<sup>115</sup> If a U.S. beneficiary receives a distribution from a foreign trust that includes income accumulated in prior taxable years, the distribution is subject to additional tax imposed by the “throwback rule” and interest. Section 667.

## **B. Most Often Used Powers to Create Grantor Trust**

There are four powers that are most often used to create a grantor trust:

1. Power to add charitable beneficiaries under Section 674;
2. Power to make loans to the grantor without adequate security under Section 675(2);
3. Power of substitution under Section 675(4); and
4. Power to use income to pay premiums on insurance on the life of the grantor or the grantor's spouse under Section 677(a)(3).

Generally, these powers are considered the "safe" powers, as they should not cause the trust property to be included in the grantor's estate for Federal estate tax purposes. However, there are still arguments that certain of these powers could cause estate inclusion. Of course, there are other reasons why grantors may not be as comfortable with even these powers.

Many grantors do not want to give another person the authority to make distributions of trust assets to charity. While it would seem that grantors should be charitable, not all of them actually are. Thus, allowing a third party to potentially divert assets intended for the grantor's family to charity, may not sit well with all grantors. Of course, there is always the threat of removal when the proper Trustee is given this power and the grantor retains the authority to remove and replace the Trustee, but the threat may not be enough and it may be exercised too late.

There are some practitioners who believe that the ability of the grantor to borrow the trust assets without adequate interest or without adequate security is, in effect, a retained interest under Sections 2036 and 2038. There is no authority on this point at this time. It seems that more practitioners are concerned with not having adequate interest and only permit the loan to be made to the grantor without adequate security.

The power of substitution has been blessed by the Service in Revenue Ruling 2008-16 more or less. As explained above, a power to substitute trust property that is held in a nonfiduciary capacity will not cause the trust property to be includible in the grantor's gross estate under Sections 2036 or 2038, so long as the Trustee has a fiduciary obligation to ensure that the grantor complies with the trust terms.<sup>116</sup> Of course, the Revenue Ruling is not black and white and it leaves open possibilities for situations where such power of substitution, if not properly drafted, would cause inclusion in the grantor's estate. Furthermore, the question of whether a power is exercised or exercisable in a nonfiduciary capacity is determined based on the facts and circumstances.<sup>117</sup>

In addition, there is a question of whether the grantor should have the ability to remove an insurance policy from the trust. Some practitioners raise concerns that this could be deemed an incident of ownership over the policy causing inclusion under Section 2042(2). One solution would be to give the power to a nonadverse party who would not have the inclusion issue. But

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<sup>116</sup> Rev. Rul. 2008-16, 2008-16 I.R.B. 796.

<sup>117</sup> Treas. Reg. Section 1.675-1(b)(4).

again, that raises trust questions with the grantor and who could be given such a power. There should, however, be less concern for abuse, as the nonadverse party would be required to substitute assets with an equivalent value. If it is an insurance policy, though, and the insured is still alive, what is its value for this purpose? It is not likely the death benefit.

There are no estate tax concerns with the power under Section 677(a)(3) to pay insurance premiums from income. However, the issue has been raised as to whether it is enough just to include the power in the trust when the trust does not own any insurance on either the grantor or the grantor's spouse.<sup>118</sup> Section 677(a)(3), however, does seem clear as it states that the discretion to use income to pay insurance premiums is sufficient to create a grantor trust.<sup>119</sup>

Probably the most significant issue, however, is the choice of Trustee. Each of the powers above must be exercised by the grantor or a nonadverse party without the consent of an adverse party. As discussed above, an "adverse party" is a person with a substantial beneficial interest in the trust that will be adversely affected by the exercise or nonexercise of a power possessed by such party.<sup>120</sup> A "nonadverse party" is anyone who is not an adverse party.<sup>121</sup> It can be difficult for the grantor to find someone to serve as Trustee or hold the power who does not have a substantial beneficial interest in the trust.

### **C. Tax Reimbursement Clauses**

While not a new development, tax reimbursement clauses are an important consideration when working with irrevocable grantor trusts. Prior to the Service's ruling in 2004, there was a question of whether including the ability to reimburse the grantor for the grantor's payment of the grantor trust's income tax liability causes the trust property to be included in the grantor's estate for Federal estate tax purposes. Revenue Ruling 2004-64<sup>122</sup> clarified the circumstances in which such a clause would cause inclusion in the grantor's estate.

In Revenue Ruling 2004-64, the grantor established an irrevocable trust for the benefit of his descendants. Only persons who were not related or subordinate to the grantor within the meaning of Section 672(c) could serve as Trustees of the trust. The grantor did not retain any interest in the trust that would cause any transfer to be an incomplete gift to the trust or would cause the trust property to be included in the grantor's estate. The grantor, however, did retain powers sufficient to cause the trust to be treated as a grantor trust under Sections 671 through 678.

The Ruling analyzes the gift and estate tax consequences of the grantor's payment of the Federal income taxes on the income generated by the trust assets in three situations:

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<sup>118</sup> The uncertainty is attributable at least in part to the inconsistent guidance on the topic. For further discussion, see "Grantor Trusts Status under Section 677: Trust Income for the Benefit of the Grantor", H. Carter Hood and Matie B. Little (May 7, 2010).

<sup>119</sup> See also IRS Field Att'y Advice Mem. 20062701F (July 7, 2006).

<sup>120</sup> Section 672(a).

<sup>121</sup> Section 672(b).

<sup>122</sup> Rev. Rul. 2004-64, 2004-2 C.B. 7.

*Situation 1:* Neither the trust instrument nor the applicable state law requires or permits the Trustee to reimburse the grantor for the income taxes the grantor pays on the income generated by the trust.

In Situation 1, the Service ruled that the payment of the income tax liability by the grantor is not a gift to the trust. Furthermore, no portion of the trust property will be included in the grantor's estate as a result of the payment because the grantor did not retain the right to have the trust property distributed to discharge a legal obligation of the grantor.

*Situation 2:* The trust instrument requires the Trustee to reimburse the grantor from trust assets for the income taxes the grantor pays on the income generated by the trust.

In Situation 2, because the Trustee was required to reimburse the grantor for payment of the income tax liability, the Service ruled that the full value of the trust assets were includible in the grantor's estate upon death. The result will be the same whether such requirement is set forth in the trust instrument or under applicable state law. The Service stated that the grantor, however, will not be making a gift to the trust when paying the income tax liability.

*Situation 3:* The trust instrument gives the Trustee discretion to reimburse the taxpayer for the income taxes the taxpayer pays on the income generated by the trust.

In Situation 3, the Service stated that the payment of the income tax by the grantor will not be treated as a gift and, because the right of reimbursement is discretionary, the trust property will not be included in the grantor's estate. The Service, however, stated that the discretion to reimburse the grantor combined with other facts, such as an understanding or pre-existing arrangement between the grantor and the Trustee regarding the Trustee's exercise of this discretion, a power retained by the taxpayer to remove the Trustee and name the grantor as a Trustee, or a provision under applicable state law subjecting the trust assets to the grantor's creditors, may cause the trust assets to be included in the grantor's estate.

Based on this ruling, should everyone be including discretionary tax reimbursement clauses in irrevocable grantor trusts? Of course, it depends. Generally, one of the primary benefits of having the grantor pay the income taxes of the grantor trust is that it allows the trust assets to grow without the reduction for income taxes at no transfer tax cost to the grantor. However, no one can predict the future and there could come a time when the grantor does not have sufficient assets to pay the income tax generated by the grantor trust. The inclusion of the reimbursement clause will allow the Trustees to address this situation should it arise.

The most important consideration in using the clause is to know your client. The mere inclusion of a discretionary reimbursement clause will not automatically cause inclusion of the trust assets in the grantor's estate, however, if the grantor and the Trustee have some understanding as to when that discretion will be exercised, there is going to be a problem. The burden of proof is on the taxpayer to show there was no understanding.

#### D. Toggling Grantor Trust Status

Another question that arises with a grantor trust is whether once it is a grantor trust will it always be a grantor trust? Many grantors are comfortable with the idea of paying the income tax liability of the trust, as it is a way to make a “free gift” to the trust beneficiaries and allow the trust assets to continue to grow unburdened by the income tax obligations. More often than not, some years after the creation of the trust, the grantor no longer wishes to be burdened with the income tax liability of the trust and wants the grantor trust status to end. But what are the tax consequences when grantor’s trust status ends during the grantor’s lifetime? How is the power exercised to turn off grantor trust status? What if the grantor wants to turn grantor trust status back on? Could toggling be viewed as an abuse?

##### 1. *Income Tax Consequences of Turning Off Grantor Trust Status*

When grantor trust status terminates during the grantor’s lifetime, the grantor is deemed to have transferred to the trust all of the assets in the trust and all of the liabilities of the trust.<sup>123</sup> If the liabilities deemed transferred to the trust exceed the basis of the assets deemed transferred to the trust, the grantor will recognize gain on the difference.<sup>124</sup> If, however, the liability was incurred by reason of the acquisition of the property, the liability will not be included in the amount realized.<sup>125</sup> Furthermore, because transactions between the grantor and the grantor trust are disregarded for Federal income tax purposes, any liabilities between the grantor and the grantor trust should be disregarded.<sup>126</sup>

The Regulations illustrate the tax consequences of turning off grantor trust status in Treasury Regulation Section 1.1001-2(c), Example (5):

“In 1975, C, an individual, creates T, an irrevocable trust. Due to certain powers expressly retained by C, T is a “grantor trust” for [Federal income tax purposes] and therefore C is treated as the owner of the entire trust. T purchases an interest in P, a partnership. C, as the owner of T, deducts the distributive share of partnership losses attributable to the partnership interest held by T. In 1978, when the adjusted basis of the partnership interest held by T is \$1,200, C renounces the powers previously and expressly retained that initially resulted in T being classified as a grantor trust. Consequently, T ceases to be a grantor trust and C is no longer considered to be the owner of the trust. At the time of the renunciation all of [P’s] liabilities are liabilities on which none of the partners have assumed any personal liability and the proportionate share of which of the interest held by T is \$11,000. Since prior to the renunciation C was the

<sup>123</sup> Treas. Reg. Section 1.1001-2(c), Example (5); *Madorin v. Comm’r*, 84 T.C. 667 (1985); Rev. Rul. 77-402, 1977-2 C.B. 222.

<sup>124</sup> Treas. Reg. Section 1.1001-2(a)(1). This section provides that the “amount realized from the sale or other disposition of property includes the amount of liabilities from which the transferor is discharged as a result of the sale or disposition.”

<sup>125</sup> Treas. Reg. Section 1.1001-2(a)(3).

<sup>126</sup> See Rev. Rul. 85-13, 1985-1 C.B. 184

owner of all the entire trust, C was considered the owner of all the trust property for Federal income tax purposes, including the partnership interest. Since C was considered to be the owner of the partnership interest, C not T, was considered to be the partner in P during the time T was a “grantor trust.” However, at the time C renounced the powers that gave rise to T’s classification as a grantor trust, T no longer qualified as a grantor trust with the result that C was no longer considered to be the owner of the trust and trust property for Federal income tax purposes. Consequently, at that time, C is considered to have transferred ownership of the interest in P to T, now a separate taxable entity, independent of its grantor C. On the transfer, C’s share of partnership liabilities (\$11,000) is treated as money received. Accordingly, C’s amount realized is \$11,000 and C’s gain realized is \$9,800 (\$11,000-\$1,200).”

## 2. *Exercising the Power to Turn Off Grantor Trust Status and Turn It Back On*

The trust agreement generally should be drafted in a manner that will give the grantor the flexibility to turn off the grantor trust status. Certain grantor trust powers are personal to the grantor and likely require that the grantor be the one to relinquish them. However, it is important to be careful not to draft the trust in a manner that gives the grantor the right to relinquish a power but then subsequently reacquire it. Such ability likely will be construed as a power to amend the trust, which will cause the trust to be treated as a grantor trust anyway.<sup>127</sup> Thus, it is important to give the power to reinstate a power to a third party.

There is no requirement that the person who holds the power to relinquish or reinstate grantor trust powers must be a nonadverse party. Therefore, even the grantor’s spouse may be given the authority to relinquish such powers in most circumstances.

## 3. *Is Toggling an Abuse?*

In 2007, the Service issued Notice 2007-73 identifying a toggling grantor trust transaction as a reportable transaction of interest.<sup>128</sup> The Service has identified certain transactions as “transactions of interest”. These generally are transactions that have the potential for tax avoidance or evasion, but for which the Service lacks sufficient information to classify as tax avoidance transactions. When a person enters into a transaction of interest, such person must disclose the transaction to the Service in accordance with Treasury Regulation Section 1.6011-4. This Notice applies to such transactions and those that are substantially similar entered into on or after November 2, 2006.

In the Notice, the Service identified two variations on a particular transaction relating to the toggle power in the grantor trust that it believes constitutes a transaction of interest. Both transactions typically occur within a short period of time during the taxable year, usually within 30 days, and, in each case, the grantor claims that the termination and subsequent reestablishment of grantor trust status result in a tax consequence that could not be achieved

<sup>127</sup> Treas. Reg. Section 1.675-1(a).

<sup>128</sup> Notice 2007-73, 2007-36 I.R.B. 545.

without the toggling on and off of grantor trust status. The Service noted that the transactions do not include a situation where just the grantor trust status is terminated and there is not also a subsequent reinstatement of grantor trust status.

Variation One - In the first variation, the grantor purchases four options, the values of which are expected to move inversely in relation to at least one of the other options so that there will be two options with a gain and two options with a loss that substantially offsets the gain. The grantor then transfers the four options and a small amount of cash to a trust. The grantor retains a noncontingent reversionary interest in the trust, giving another beneficiary a short-term unitrust interest. The remainder interest is structured to have a value, as determined under Section 7520, that equals the fair market value of the options. The grantor also retains a power of substitution in accordance with Section 675(4) that will become effective on a specified date in the future. The reversionary interest and the power of substitution cause the trust to be treated as a grantor trust for Federal income tax purposes.

After the trust is funded, the grantor sells the remainder interest to an unrelated person for the fair market value of the remainder interest, which is equal to the fair market value of the options. The grantor claims that the basis in the remainder interest is determined by allocating a portion of all of the trust assets to the remainder interest, which results in no gain recognized in the sale of the remainder interest. The buyer gives the grantor a note, cash or other consideration for the remainder interest. The grantor claims that the grantor trust status has terminated as a result of the sale of the remainder interest.

Once the substitution power becomes effective, grantor claims that the trust becomes a grantor trust again. At that time, the loss options are closed out and grantor recognizes the loss. The grantor calculates the loss based on the difference between the amount realized and the original basis in the loss options, even though the grantor already used a portion of the basis to eliminate the grantor's gain on the sale of the remainder interest.

The buyer then purchases the unitrust interest from the beneficiary for the actuarial value of that interest, which equals or approximates the amount of cash the grantor contributed to the trust. The buyer now owns the unitrust interest and the remainder interest in the trust, resulting in the effective termination of the trust by operation of law. The buyer's basis in the gain options and the cash is claimed to be equal to the amount the buyer paid for the two separate interests. The grantor does not treat the termination of the trust as a taxable disposition by the grantor of the assets in the trust.

The buyer then sells the gain options and recognizes gain only to the extent that the amount realized exceeds the basis the buyer allocated to the gain options. Such gain ends up to be minimal as a result of the structure of the transaction. If the buyer purchased the remainder interest with a note, the buyer uses the proceeds from the gain options to repay the note.

Variation Two – The facts in the second variation are the same, except that the grantor contributes cash or marketable securities to the trust with a basis equal to fair market value. Before the date on which the substitution power becomes effective, the grantor sells the remainder interest in the trust to the buyer for an amount equal to its fair market value. The

grantor does not recognize any gain (or very little gain or a loss). Again, the grantor claims the sale terminates the grantor trust status of the trust. After the substitution power becomes effective, the grantor substitutes appreciated property for the liquid assets owned by the trust. The fair market value of the appreciated property equals the fair market value of the liquid assets. Then, the grantor claims that, once the substitution power becomes effective, the grantor trust status is restarted. Thus, the grantor does not recognize gain on the substitution.

Then the buyer purchases the unitrust interest from the beneficiary and the trust terminates by operation of law. The grantor does not treat the termination as a disposition. The buyer's takes a basis in the trust assets equal to the amount the buyer paid for the interests in the trust.

#### **E. What Happens When the Grantor Dies?**

One looming question is what happens to a grantor trust when the grantor dies? There are several theories and substantial debate on the income tax consequences on the termination of grantor trust status as a result of the grantor's death. There seems to be agreement that the termination of the trust is a transfer of the assets and liabilities by the grantor to the trust.<sup>129</sup> But the debate lies in the type and timing of the transfer. The Code does not address this.

**Note: In Chief Counsel Advice 200923024 (June 5, 2009), discussed at item F.1. below, the Office of the Chief Counsel addressed a transaction where a nongrantor trust was converted to a grantor trust. The Chief Counsel discussed the authorities addressed in this outline regarding the termination of a grantor trust during the grantor's lifetime, including Madorin, Rev. Rul. 77-402 and Treasury Regulation Section 1.1001-2, Ex. 5. In that ruling, the Office of Chief Counsel stated the following: "We would also note that the rule set forth in these authorities is narrow, insofar as it only affects inter vivos lapse of grantor trust status, not that causes by the death of the owner *which is generally not treated as an income tax event.*" [Emphasis added.] While there is no authority for this, it certainly sets forth a possible position of the Service on the issue of what happens when grantor trust terminates on the death of the grantor.**

##### *1. No Gain and Possible Step-Up*

Some commentators view the termination of grantor trust status upon the death of the grantor as a testamentary transfer.<sup>130</sup> This theory recognizes the deemed transfer of all of the assets and all of the liabilities of the trust by the grantor to the trust on the grantor's death, but states that Section 1001 does not apply.

Section 1001(a) defines gain on the sale or other disposition of property as the excess of the amount realized over the adjusted basis of the property. Amount realized is the sum of the

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<sup>129</sup> Treas. Reg. Section 1.1001-2(c) Example (5); *Madorin v. Comm'r*, 84 T.C. 667 (1985); Rev. Rul. 77-402, 1977-2 C.B. 222.

<sup>130</sup> See "Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor's Death", Jonathan G. Blattmachr, Mitchell M. Gans and Hugh H. Jacobson, 97 J. Tax'n 149 (2002)

cash received plus the fair market value of any other property received.<sup>131</sup> When a donor gives property to the donee, the donor does not receive any property in return for the gift, resulting in a zero amount realized. The same is true on a bequest - the decedent does not receive any consideration for the bequest, thus, no gain is realized. The commentators find support in this theory in the *Crane* case.<sup>132</sup>

In *Crane*, the taxpayer inherited a building and lot subject to a mortgage with a principal value of \$255,000 and overdue interest of \$7,042. The property was appraised as of the decedent's date of death at \$262,042. Seven years later, Crane sold the property for \$3,000, subject to the mortgage, and paid \$500 in sales expenses. Crane reported a taxable gain of \$1,250 stating that the basis of the property was zero and half of the net proceeds were reportable as income because the property was a capital asset. The Service determined that Crane realized a gain of \$23,767. The Supreme Court held that Crane realized \$275,000 on the sale of the property. The Court further stated that Crane's basis in the property was equal to its appraised value at the time of inheritance. In the disposition of the property, the amount realized is not just the cash or other property Crane received, but also the benefit of having been relieved of the debt associated with the property. Therefore, the amount realized was equal to the \$2,500 of cash Crane received plus the \$255,000 mortgage.

The Service has acquiesced in this logic in issuing Revenue Ruling 73-183.<sup>133</sup> In that ruling, the issue was whether the decedent's final income tax return should reflect a loss on the transfer of securities from the decedent to the executor of the decedent's estate at the time of the decedent's death. During the decedent's lifetime, the decedent purchased stock for \$30 per share. On the decedent's date of death, the stock was valued at \$20 per share. The Service stated that "[t]he mere passing of property to an executor or administrator on the death of the decedent does not constitute a taxable realization of income even though the property may have appreciated in value since the decedent acquired it." It continued that the "transfer of the stock of the deceased taxpayer to the executor of his estate did not result in a sale or other disposition of such stock within the meaning of Section 1001(a)". Accordingly, the decedent could not recognize the loss on the decedent's final income tax return. Even if the stock was worth more at the decedent's date of death, there also would not be a gain recognized.

This theory also relies on the Service's position set forth in the Treasury Regulations under Section 684. This section provides that when a US person transfers property to a foreign estate or trust, the transfer is treated as a sale or exchange.<sup>134</sup> The transferor is required to recognize gain on such transfer the excess of the fair market value of the property transferred over the transferor's adjusted basis of such property.<sup>135</sup> This rule, however, does not apply if the trust is treated as a grantor trust for Federal income tax purposes.<sup>136</sup>

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<sup>131</sup> Section 1001(b).

<sup>132</sup> *Crane v. Comm'r*, 331 U.S. 1 (1947).

<sup>133</sup> Rev. Rul. 73-183, 1973-1 C.B. 364.

<sup>134</sup> Section 684(a).

<sup>135</sup> Id.

<sup>136</sup> Section 684(b).

The Code seems to track Section 1001. The Regulations, however, deviate and set up a timing fiction. The Regulations state that, when a foreign trust ceases to be treated as a grantor trust, the grantor will be deemed to have transferred the trust assets immediately before, but on the same date that, the trust is no longer treated as a grantor trust.<sup>137</sup> The Regulations provide the following example on the death of the grantor:

“On January 1, 2001, A transfers property, which has a fair market value of 1000X and an adjusted basis of 400X, to [a foreign trust (“FT”)]. At the time of the transfer, FT has a U.S. beneficiary within the meaning of section 1.679-2, and A is treated as owning FT under section 679. Under section 1.684-3(a), section 1.684-1 does not cause A to recognize gain at the time of the transfer.

“On July 1, 2003, A dies, and as of that date no other person is treated as the owner of FT. On that date, the fair market value of the property is 1200X, and its adjusted basis equals 350X. Under paragraph (e)(1) of this section, A is treated as having transferred the property to FT immediately before his death, and generally is required to recognize 850X of gain at that time under section 1.684-1. However, an exception may apply under section 1.684-3(c).”<sup>138</sup>

The commentators suggest that this portion of the Regulations shows that the Service is abandoning the “no-gain-at death” rule. There is an exception, however, where no gain will be recognized if the basis of the assets in the hands of the Trustee will be determined under Section 1014.<sup>139</sup>

The final question addressed under this theory is what is the basis of the assets in the trust following the death of the grantor? There are three alternatives: (1) if the transfer is viewed as a bequest or devise, then Section 1014 applies to cause the basis to equal the date of death value; (2) if the transfer is viewed as a sale by the grantor to the trust, the trust’s basis will equal the purchase price under Section 1012; or (3) if the transfer is viewed as a gift by the decedent, then the basis will be the same as the grantor’s basis under Section 1015. The commentators under this theory believe there is a compelling argument that Section 1014 applies and the assets in the grantor trust should be equal to the date of death value of the assets.

## 2. *No Gain but No Step-Up*

Another theory takes the position that there is no gain recognized at the grantor’s death, but no step up in basis.<sup>140</sup> The commentators take the position that, because the cessation of grantor trust status and the resulting deemed transfer occurs because of the death of the grantor, the principals that apply to a transfer to the estate should apply. The Service has ruled that the

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<sup>137</sup> Treas. Reg. Section 1.684-2(e).

<sup>138</sup> Treas. Reg. Section 1.684-2(e)(2).

<sup>139</sup> Treas. Reg. Section 1.684-3(c).

<sup>140</sup> See “Deferred Payment Sales to Grantor Trusts, GRATs and Net Gifts: Income and Transfer Tax Elements”, Elliott Manning and Jerome M. Hesch, 24 Tax Management, Estates, Gifts and Trusts Journal 3 (1999).

transfer of property from a decedent to his estate is not a recognition event.<sup>141</sup> Further, items of income in respect of a decedent (IRD) are not realized at death. Rather, they are not entitled to a step-up in basis under Section 1014(a).

The commentators also disagree that a mortgage on the property deemed transferred at the decedent's death should be treated as an amount realized, thus, potentially causing the recognition of gain when the amount realized equals the basis of the assets. They state that there is no other recognition of unrealized changes in the value of an asset, so a liability should not have any consequence either. For example, an estate that owns a tax shelter investment does not have an income tax consequence because of the death of a decedent.

The fact that the entity is a grantor trust and not an estate does not change the commentators' analysis. They state that the grantor trust status before the grantor's death is ambiguous. A grantor trust is not a fully disregarded entity, as Section 671 and Treasury Regulations Sections 1.671-2 and 1.671-3(a) provide that the grantor is taxed as the owner of certain items as if the trust does not exist, thereby implying that the trust does have some status, even if the grantor is treated as the owner of the entire trust. Furthermore, Treasury Regulations Section 1.671-4 sets forth reporting obligations for a grantor trust, providing that some items are not reportable on the trust's Form 1041, but on an attached statement. Moreover, until the Subchapter S provisions were amended to permit grantor trusts to be owners of S corporation stock, the transfer of S corporation stock to a revocable trust terminated the S election.<sup>142</sup> But then rulings, like Revenue Ruling 85-13, does demonstrate a more inclination that a grantor trust is a disregarded entity.

On the timing issue of when grantor trust status terminates, the commentators believe it does not matter. They believe that it is a question of realization at death and nothing more and, as noted above, believe that there is no realization at death. They reason that the trust continues to hold the property with a transferred basis, increased by any obligation in accordance with the *Crane* case.

### 3. *Gain to Extent Liabilities Exceed Basis and No Step-Up*

Many commentators follow the same rules for termination of grantor trust status at death that apply during lifetime.<sup>143</sup> That is, the grantor will recognize gain to the extent that the liabilities of the trust exceed the grantor's basis in the trust assets.

The idea is that, upon the death of the grantor, the assets of the trust are no longer treated as being owned by the grantor and the liabilities of the trust are no longer treated as being owed by the grantor. Now, the trust is treated as a separate taxpaying entity and treated as the owner of the trust assets and the obligor of the trust's liabilities. As with termination of grantor trust status during the life of the grantor, the grantor is deemed to have transferred the assets in the

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<sup>141</sup> Rev. Rul. 75-183, 1973-1 C.B. 364.

<sup>142</sup> *American Nurseryman Publishing Co. v. Comm'r*, 75 T.C. 274 (1980); *W & W Fertilizer Corp. v. Comm'r*, 527 F. 2d 621 (Ct. Cls. 1975).

<sup>143</sup> See "Tax Consequences of Outstanding Trust Liabilities When Grantor Trust Status Terminates", Deborah V. Dunn and David A. Handler, 95 J. Tax'n 49 (2001).

trust and the liabilities of the trust to the trust.<sup>144</sup> If there are any outstanding liabilities, the grantor must recognize gain to the extent that the liabilities exceeds the grantor's basis in the trust assets. Any liability that was incurred to acquire the property and not taken into account in determining the trust's basis in the property is not included in the determination of the recognized gain.<sup>145</sup>

The real debate though regarding the treatment upon the death of the grantor comes with respect to the timing of the transfer and whether there is a step-up in the basis of the assets. The two issues are intertwined. So, which is it?

If the transfer is deemed to take place immediately *before* the grantor's death, the commentators state that the assets should not received a step up in basis under Section 1014(a) because they were not owned by the grantor at the time of the grantor's death. As noted above, if there are liabilities in excess of basis, the grantor will recognize gain on the deemed transfer to the extent of the excess. Finally, if the liability is owed to the grantor and the sale is reported on the installment method, the beneficiaries of the grantor's estate who inherit the note will report the gain as income in respect of a decedent as payments are made under Section 691, reduced by the estate tax attributable to the inclusion of the note in the grantor's estate.<sup>146</sup>

If the transfer is deemed to take place immediately *after* the grantor's death, the grantor's estate will recognize gain on the transfer to the extent that the liabilities exceed the estate's basis in the assets. The extent of the liabilities depends upon whether the assets in the trust receive a step up in basis upon the grantor's death. If there is a step up in basis allowed under Section 1014, then the trust's basis in the assets will be stepped up to their fair market value as of the date of the grantor's death. Following such adjustment, if the liabilities exceed the trust's new basis in the assets, then there will be gain recognition to the grantor's estate. If, however, Section 1014 does not apply, then the same rules apply as if the transfer is deemed to take place before the grantor's death.

Accordingly, the timing of the deemed transfer only makes a difference if there is authority for a step up in basis upon the grantor's death. The commentators under this theory do not believe that a step up is possible. Section 1014(a) provides that the "basis of property in the hands of a person acquiring the property from a decedent or to whom the property pass from a decedent shall, if not sold, exchanged, or otherwise disposed of before the decedent's death by such person, be the fair market value of the property at the date of the decedent's death...." The following situations demonstrate how property is considered to have been acquired from a decedent or to have passed from a decedent:

- (a) Property acquired by bequest, devise or inheritance or by the decedent's estate from the decedent;<sup>147</sup>

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<sup>144</sup> Treas. Reg. Section 1.1001-2(c), Example 5; *Madorin v. Comm'r*, 84 TC 667 (1985); Rev. Rul. 77-402, 1977-2 CB 222.

<sup>145</sup> Treas. Reg. Section 1.1001-2(c).

<sup>146</sup> Section 691(c).

<sup>147</sup> Section 1014(b)(1).

- (b) Property transferred to a trust by the decedent during his or her lifetime in which the decedent retained an income interest and the right to revoke the trust;<sup>148</sup>
- (c) Property transferred to a trust by the decedent in which the decedent retained the right to “pay the income for life to or on the order or direction of the decedent” and the right to alter, amend or terminate the trust;<sup>149</sup> and
- (d) Property passing without full and adequate consideration under a general power of appointment exercised by the decedent’s Will.<sup>150</sup>

In order for property to pass by bequest, devise or inheritance would require the property to pass pursuant to the decedent’s Will or by intestacy. This does not occur, as the grantor trust was created during the grantor’s lifetime and, in most cases, the grantor does not retain any powers over the trust that would cause the property to pass under the decedent’s Will or by intestacy or otherwise be included in the grantor’s estate for Federal estate tax purposes. This also eliminates the application of the other three examples noted above.

Furthermore, the Regulations expand on the first example to state that property is deemed to have been acquired from a decedent or passed from a decedent if the property is “acquired by bequest, devise, or inheritance, or by the decedent’s estate from the decedent, whether the property was acquired under the decedent’s will or under the law governing the descent and distribution of the property of decedents.”<sup>151</sup> The commentators view this additional language as meaning that the step-up occurs when property is acquired from the decedent’s estate, not merely a deemed acquisition for income tax purposes. It follows that, if such language were not interpreted in this manner, then all property held in any grantor trust should receive a step-up in basis upon the grantor’s death. In addition, the other three examples noted above from Section 1014(b) would not be necessary to distinguish certain types of trusts from the typical grantor trust where the grantor does not retain rights that cause estate tax inclusion.

The timing of the transfer has another important consequence – the deductibility of the income taxes paid on the recognized gain. If the transfer is deemed to have occurred immediately before the grantor’s death, the income taxes should be deductible under Section 2053 as an expense of the grantor’s estate, as such income tax will be paid by the estate when it files the grantor’s final income tax return.<sup>152</sup> This, however, will not be the case if the liability is from the trust to the grantor and it is reported on the installment method, as the gain is income in respect of a decedent to the beneficiary of the note.<sup>153</sup>

If the transfer is deemed to have occurred immediately after the grantor’s death, the income tax will not be deductible under Section 2053. The income tax will be a liability of the estate, not of the decedent, and reported on the estate’s income tax return.

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<sup>148</sup> Section 1014(b)(2).

<sup>149</sup> Section 1014(b)(3).

<sup>150</sup> Section 1014(b)(4).

<sup>151</sup> Treas. Reg. Section 1.1014-2(a)(1).

<sup>152</sup> Treas. Reg. Section 20.2053-6(f).

<sup>153</sup> Section 691(a).

## **F. Rulings Regarding Grantor Trusts**

The following represent a selection of recent rulings in the grantor trust area.

### 1. Private Letter Ruling 201116065 (April 22, 2011) – Transfer of IRD Asset to Grantor Trust

G is disabled and eligible to receive public benefits. G's father designated G and G's siblings as the beneficiaries of two IRAs. G intended to establish a trust that qualifies as a special needs trust. G is the sole beneficiary of the trust during G's lifetime. Under the trust agreement, the Trustees have the discretion to distribute the net income of the trust to G after taking into consideration G's best interest and welfare. If the Trustees believe that the income from the trust and from any of G's other resources, including all public benefits, is not sufficient to provide for G, the Trustee may distribute principal to G. However, in no event may the Trustee distribute the principal of the trust if it will cause any reduction or discontinuation of G's government benefits. Upon G's death, any property remaining in the trust will be distributed to the State as reimbursement for the public assistance G received during his lifetime. If there is any property remaining in the trust after such reimbursement, such remaining property will be distributed to G's issue, or, if none, to G's siblings, with the share of a deceased sibling passing to his or her issue, per stirpes.

G wanted to transfer his share of the IRAs to the trust. The question was whether the transfer of the IRAs to the trust would result in any income tax consequences to G.

The Service first reviewed the rules relating to income in respect of a decedent (IRD) under Section 691. Section 691(a)(1) provides that the amount of all items of gross income in respect of a decedent which are not properly includible in respect of the taxable period in which falls the date of the decedent's death or a prior period (including the amount of all items of gross income in respect of a prior decedent, if the right to receive such amount was acquired by reason of the death of the prior decedent or by bequest, devise, or inheritance from the prior decedent) shall be included in the gross income, for the taxable year when received, of: (A) the estate of the decedent, if the right to receive the amount is acquired by the decedent's estate from the decedent; (B) the person who, by reason of the death of the decedent, acquires the right to receive the amount, if the right to receive the amount is not acquired by the decedent's estate from the decedent; or (C) the person who acquires from the decedent the right to receive the amount by bequest, devise, or inheritance, if the amount is received after a distribution by the decedent's estate of such right. If such right is transferred by a person who received such right, such person must recognize in his or her gross income the fair market value of such right plus an amount equal to the excess of the consideration received for such transfer over such fair market value. Section 691(a)(2). Section 1.691(a)-4(a) provides that if an item of IRD is disposed of by gift, the fair market value of the IRD item at the time of the gift must be included in the gross income of the donor.

In Rev. Rul. 92-47, 1992-1 C.B. 198, the Service ruled that a distribution to the beneficiary of a decedent's IRA that equals the amount of the balance in the IRA at the

decedent's death, less any nondeductible contributions, is IRD under Section 691(a)(1) that is includable in the gross income of the beneficiary for the taxable year the distribution is received.

Under Section 677(a), the grantor of a trust is treated for Federal income tax purposes as the owner of any portion of a trust whose income, without the approval or consent of any adverse party is, or, in the discretion of the grantor or a nonadverse party, or both, may be (1) distributed to the grantor or the grantor's spouse; (2) held or accumulated for future distribution to the grantor or the grantor's spouse; or (3) applied to the payment of premiums on policies of insurance on the life of the grantor or the grantor's spouse.

In this case, G is the grantor of the trust and entitled to receive the income of the trust in the discretion of the Trustee, who appears to be a nonadverse party. The trust does not appear to require the consent of an adverse party in making such distributions. Thus, the IRS concluded that the trust will be treated as owned by G under Section 677(a). Therefore, assuming the transfer of G's share of the IRAs to the trust is not a gift by G, such transfer will not be a sale or disposition for Federal income tax purposes or a transfer for purposes of Section 691(a)(2) and G will not recognize income on the transfer.

2. Private Letter Rulings 201128012 through 201128015 (July 15, 2011) and 201129013 through 201129015 (July 22, 2011) – Nonjudicial Modification of Trust Agreement Does Not Trigger Grantor Trust Status Under Section 678

PLRs 201128012 through 201128015 and 201129013 through 201129015 appear to involve a number of trusts created by and for the benefit of the same family. The rulings address questions regarding the income, estate, gift and generation-skipping transfer tax consequences of a nonjudicial modification agreement executed by the trustees and the beneficiaries of a number of trusts that were made irrevocable prior to September 26, 1985 (referred to generally as the "Trusts").

The Trusts were created for the benefit of the grantors' son ("Son"), the grantors' daughter ("Daughter"), Son's or Daughter's respective spouse, and the grantors' grandchildren. Each of the Trusts created for the benefit of Son provide that during Son's lifetime, all income is to be distributed to Son, and each of the Trusts created for the benefit of Daughter provide that during Daughter's lifetime all income is to be distributed to Daughter.

The terms of the Trusts further provide that Son and an institutional trustee ("Bank") are co-trustees of the Trusts. Son had sole investment authority over the assets of the Trusts so long as Son is serving as a trustee. "Income" was defined for purposes of the Trusts as all of the income of the trust estate, less costs of administration, and the characterization of incoming funds as income was left to the discretion of the trustees. The trustees had the discretion to credit or to charge premiums or discounts to investments, to credit scrip, stock dividends, extraordinary dividends, or other receipts, and to charge taxes or other charges, either to or against principal or income, as the trustees determined proper under the circumstances.

Applicable state law permits a trustee to adjust between principal and income to the extent the Trustee considers necessary if the trustee invests and manages the trust assets as a prudent investor, and the terms of the trust describe the amount to be distributed to a beneficiary by referring to the trust's income. State law further provides that no such adjustment may be made if possessing the power to make an adjustment causes an individual to be treated as an owner of the trust for income tax purposes, or all or part of the trust to be included in the estate of an individual who has the power to remove or appoint a trustee, or if the trustee is a beneficiary of the trust, or if the trustee is not a beneficiary but the adjustment would benefit him.

Consistent with applicable state law, the Trustees and the beneficiaries of the Trusts entered into a nonjudicial modification agreement. This terms of this agreement amended the terms of the Trusts to provide that, among other things, Son is to have sole management and investment authority over the Trust assets without approval from Bank, and that Bank may exercise its discretion to allocate receipts (as defined in such agreement) between principal and income.

The Service ruled that the execution of the nonjudicial settlement agreement which, consistent with applicable state law, permits Bank to make adjustments between income and principal to fulfill Bank's duty of impartiality, does not cause any portion of the Trusts to be treated as owned by the Bank or any of the beneficiaries of the Trusts under Section 678. First, the ability of the Bank to make such adjustments does not cause the Bank to have a power to exercisable solely by itself to vest the corpus or the income therefrom in itself under Section 678(a)(1). Second, with respect to the beneficiaries of the Trusts, execution of the agreement constitutes a switch between methods of determining trust income as authorized by applicable state law, and does not cause any beneficiary to hold a power to vest the corpus or income therefrom in himself under Section 678(a)(1). Finally, this switch between methods, as authorized by applicable state law, does not constitute a release or modification of a power described in 678(a)(2) by either the Bank or the beneficiaries of the Trust.

The Service also ruled that, under Regulation Section 1.643(b)-1, the agreement as to a switch in methods in the allocation of income and principal did not constitute a recognition event under for purposes of Section 1001 because the switch was authorized by applicable state statute.<sup>154</sup>

3. Private Letter Ruling 200949012 (December 4, 2009) and 201039010 (October 1, 2010) – Withdrawal Rights Cause Trust to Be Grantor Trust as to Beneficiary

In PLR 200949012 G created a trust for the benefit of B. B was designated the Investment Trustee, A was designated the Distribution Trustee and a Trust Company was designated as the Administrative Trustee. A does not have any beneficial interest in the trust. The Distribution Trustee has the discretion to distribute the income and/or principal of the trust to B. B has a lifetime power to appoint the net income and/or principal of the trust to B or for

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<sup>154</sup> These PLRs also include rulings regarding the estate, gift and generation-skipping transfer tax consequences of the nonjudicial modification agreements that are beyond the scope of this discussion.

B's benefit for B's health, education, maintenance and support. B also has the power to withdraw amounts contributed to the trust each year to qualify such contributions for the gift tax annual exclusion. Such withdrawal right is limited to the greater of \$5,000 or 5% of the value of the principal of the trust. Upon B's death, the property remaining in the trust will be distributed among those individuals (other than B, B's estate, G, G's estate, B's creditors, the creditors of B's estate, G's creditors or the creditors of G's estate) and/or charitable organizations as B appoints in B's Will. Any property not so appointed will be distributed among those charitable organizations as selected by the Distribution Trustee.

G is not a beneficiary of the trust and has no interest in the trust. No income or principal may be paid or applied for the benefit of G or G's spouse or to pay premiums on insurance policy on the life of G and/or G's spouse. Neither G nor G's spouse may serve as a Trustee of the trust and no more than 1/2 of the Trustees of the trust may be related or subordinate parties to G, within the meaning of Section 672(c). The trust agreement specifically provides that G intends that G does not intend to be treated as the grantor of the trust for income tax purposes so that the trust is treated as a grantor trust. Furthermore, neither G nor any other nonadverse party (as defined in Section 672(b)) has any power to purchase, exchange or otherwise deal with or dispose of the trust property for less than adequate consideration or borrow any trust property without adequate interest or security.

Finally, the trust agreement provides that no person, other than a United States person, shall have the authority to control any substantial decision (within the meaning of Section 7701(a)(30)(E)) of the trust or any trust created thereunder. Only United States courts will exercise primary supervision over the administration of the trust.

The Service reviewed specifically Sections 675 and 677(a) with respect to whether the trust would be treated as a grantor trust with respect to G and held that neither Section applied. However, the Service did rule that the withdrawal rights granted to B caused the trust to be treated as a grantor trust as to B under Section 678(a).

In PLR 201039010, a trust was created by G (and others) for the benefit of B and B's children. The trust was an irrevocable trust. G expressly renounced and relinquished all rights, interests and powers in the trust property. Pursuant to the terms of the trust agreement, an independent trustee had the power to make discretionary distributions of income to any one or more of the trust beneficiaries. In addition, during G's lifetime, whenever a gift was made to the trust, B had the power to withdraw out of the assets of the trust an amount not to exceed the amount of the gift, provided, however, that the amount B could withdraw was limited to the greater of \$5,000 or 5% of the value of the principal of the trust.

The only transfers to the trust were cash gifts from G. The total amount of such cash gifts did not exceed \$5,000 or 5% of the value of the principal of the trust. B did not exercise B's withdrawal right.

A ruling was sought because the trust was contemplating purchasing stock in X, Inc., an S corporation of which B was the sole shareholder. The Service ruled that under Section 678(a), B was the owner of the entire trust. Therefore, because the owner of a grantor trust is treated as

the shareholder for purposes of the S corporation rules, the trust could purchase stock in X, Inc. without risking X, Inc.'s status as an S corporation.

4. Private Letter Ruling 200944002 (October 30, 2009) – Power of Substitution Does Not Cause Estate Tax Inclusion

G created an irrevocable trust for the benefit of G, G's spouse and G's descendants. A Trust Company was appointed to serve as the initial Trustee. The Trust Company is not a related or subordinate party within the meaning of Section 672(c). The Trustee has the discretion to distribute the income and/or principal of the trust to any of G, G's spouse and G's descendants. The Trustee, however, may not pay G or G's executors any income or principal in discharge of G's income tax liability. Upon the death of the latter of G and G's spouse to survive, the remaining trust property will be distributed among G's then-living descendants. If none of G's descendants is then living, such property will be distributed to charity. No portion of the trust property may be distributed to G, G's estate, G's creditors or the creditors of G's estate upon the termination of the trust.

The trust also provides for restrictions on who may serve as the Trustee of the trust. The following persons may not serve as the Trustee: G, G's spouse or former spouse, an individual who is a beneficiary of the trust or any trust created thereunder, the spouse or former spouse of any such beneficiary, or anyone who is related or subordinate to G within the meaning of Section 672(c). G also may not remove any Trustee.

G has the power, exercisable in a nonfiduciary capacity, without the approval or consent of any person in a fiduciary capacity, to acquire property held in the trust by substituting other property of an equivalent value. Such power must be exercised by certifying in writing that the substituted property and the trust property for which it is substituted are of equivalent value. The Trustee has a fiduciary obligation to ensure this as well. The power may not be exercised in a manner that can shift benefits among the beneficiaries of the trust.

The law of the state in which the trust is created allows for creditor protection for self-settled trusts such as this, with certain exceptions.

It should be noted that the Service specifically did not rule on whether the trust qualifies as a grantor trust for Federal income tax purposes. However, the power of substitution is generally utilized to create a grantor trust.

The issues raised in the Ruling are as follows:

- a. *Will contributions to the trust be completed gifts?*

The first issue is whether G's status as a discretionary beneficiary of the trust causes gifts to the trust to be incomplete for Federal gift tax purposes. A gift is complete when the "donor has so parted with the dominion and control as to leave him no power to change its disposition,

whether for the donor's benefit or for the benefit of another".<sup>155</sup> If the donor reserves the power to revest the beneficial title to the property in himself, to name new beneficiaries or to change the interests of the beneficiaries as between themselves, the gift is incomplete for Federal gift tax purposes.<sup>156</sup>

In this case, G is a discretionary beneficiary of the trust. G did not retain any power to revest beneficial title in himself or any right to name new beneficiaries or change the interests of the designated beneficiaries. Therefore, the Service ruled that G's contributions to the trust will be completed gifts for Federal gift tax purposes.

b. *Will any portion of the trust's assets be included in G's estate?*

The second issue addressed by the Ruling is whether any portion of the trust property will be includible in G's estate for Federal estate tax purposes. Property transferred in trust is includible in the grantor's estate where the grantor retained for his lifetime the possession or enjoyment of, or the right to the income from, the transferred property.<sup>157</sup> If the property can be used to discharge a legal obligation of the grantor, the grantor is deemed to have retained the possession and enjoyment of the property and, thus, the property is includible in the grantor's estate.<sup>158</sup>

The Service first addressed the power of substitution retained by G. Citing Revenue Ruling 2008-16, the Service ruled that the substitution power, by itself, will not cause the trust property to be included in G's estate.

The Service then reviewed Revenue Ruling 2004-64 relating to the power to reimburse the grantor for taxes the grantor pays on the income generated by a grantor trust. In this case, the Trustee is prohibited from reimbursing G for any income taxes G pays. Therefore, G has not retained a right to be reimbursed for income taxes and there should be no inclusion.

The Service, however, would not rule on whether the Trustee's discretion to distribute income and principal to G would cause inclusion in G's estate under Section 2036. The Service recognized that the discretion in the Trustee alone should not cause estate tax inclusion. However, if there were other facts, such as an understanding or pre-existing arrangement between G and the Trustee regarding the exercise of the Trustee's discretion, then the trust assets may be included in G's estate.

5. Chief Counsel Advice 200923024 (June 5, 2009) – Conversion of Nongrantor Trust to Grantor Trust

The taxpayer, A, A's three children, B, C and D, and A's spouse formed a limited liability company, contributing a nominal amount of cash. A, B, C and D also transferred shares

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<sup>155</sup> Treas. Reg. Section 25.2511-2(b).

<sup>156</sup> Treas. Reg. Section 25.2511-2(c).

<sup>157</sup> Section 2036(a)(1).

<sup>158</sup> Treas. Reg. Section 25.2036-1(b)(2).

in a Subchapter S corporation to the LLC. A, B, C and D each then established an irrevocable trust funded with \$100,000 for the benefit of each grantor's then-living issue. The trusts were nongrantor trusts for Federal income tax purposes. The Trustees of each trust were A's spouse, an independent individual Trustee and an independent corporate Trustee. Each trust terminated on the death of its grantor, at which time the remaining trust property was to be distributed, subject to further trust provisions, to the grantor's then-living issue, or, if none, the living issue of the grantor's mother.

Each of A, B, C and D sold his or her respective interest in the LLC to the trust he or she created in exchange for an unsecured private annuity. The amount of the annuity varied depending upon the age of the transferor. The LLC then made an election under Section 754 to adjust the basis of the LLC property as a result of the sale, allowing the basis of the stock in the S corporation to be stepped up to its fair market value as of the date of the sale. The LLC then sold all of its shares in the S corporation pursuant to its initial public offering for an amount almost equal to its new basis in the shares. The LLC then distributed an amount equal to the annuity payments to A, B, C and D and A, B, C and D reported such amount as income on their income tax returns. They did not, however, report the gain from the sale of the LLC interests to the trusts. In Year 2, A, B, C and D again reported the annuity amounts as income on their income tax returns.

The independent corporate Trustee was removed by a trust adviser who was not related or subordinate to the grantor of each trust within the meaning of Section 672(c). The trust adviser appointed in place of the independent corporate Trustee an individual who was an employee of a corporation in which the stock holdings of A, B, C and D are significant from the viewpoint of voting control and/or a subordinate employee of a corporation in which A, B, C and D are executives. The exercise of certain powers by the new Trustee would cause the trusts to be treated as grantor trusts under Section 674(a) and (c). From that point forward, each grantor stopped reporting the annuity amounts received as income on his or her income tax return.

The first issue that arose was whether the conversion of the trust from a nongrantor trust to a grantor trust caused recognition of gain on the transfer. The examining agent argued that the same rules that apply to the conversion from a grantor trust to a nongrantor trust apply in this case by asserting that ownership of a trust's assets changes hands when its separate existence for tax purposes disappears on becoming a grantor trust. The agent cited the authorities that discuss the tax consequences of the conversion of a grantor trust to a nongrantor trust.

- Revenue Ruling 77-402, holding that, when a grantor trust owns a partnership interest subject to liabilities and the grantor renounces all grantor trust powers, the grantor is treated as having transferred the interest to the trust and will recognize gain or loss on the transfer.<sup>159</sup>
- Treasury Regulation Section 1.1001-2(c), Ex. 5, providing an example of termination of grantor trust status where the trust owns a partnership interest and its share of partnership liabilities is treated as money received on the termination.

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<sup>159</sup> Rev. Rul. 77-402, 1977-2 C.B. 222.

- *Madorin v. Comm'r*, which upholds Example 5 in Treasury Regulation Section 1.1001-2(c).<sup>160</sup>

The Chief Counsel stated that such authority deals with the opposite situation to that at hand. Furthermore, even if the authorities were to apply to the conversion of a nongrantor trust to a grantor trust, they do not support the position that the new deemed owner of the trust assets will have taxable income on receipt of the assets. While this particular transaction may be abusive, the result would have an adverse effect on non-abusive situations. The Chief Counsel listed examples as the appointment of a related or subordinate Trustee that causes a trust to be treated as a grantor trust under Section 674, borrowing of trust corpus by the grantor under Section 675(3) or the payment of the grantor's legal support obligations under Section 677(b). There is no authority stating that any of these events results in taxable income to the deemed transferee. Revenue Ruling 85-13 held that the grantor became the owner of a trust when the grantor indirectly borrowed assets from the trust.<sup>161</sup> The grantor could not then engage in a transaction with the trust that would be respected for income tax purposes. It did not, however, conclude that the grantor realized the amount of the indirect borrowing as income under Section 61. Accordingly, the Office of Chief Counsel stated that the Service should not take the position that the conversion of a nongrantor trust to a grantor trust results in taxable income to the grantor.

The second issue addressed by the Advice was whether the grantors of the trusts are considered to have indirectly borrowed the trust property by selling partnership interests to the trusts in exchange for unsecured annuities. A trust is treated as a grantor trust when the grantor has directly or indirectly borrowed trust income or principal and has not completely repaid the loan before the beginning of the taxable year, unless such loan is made with adequate interest and adequate security by a trustee other than the grantor or a party who is related or subordinate to the grantor within the meaning of Section 672(c).<sup>162</sup> In Revenue Ruling 85-13, the grantor created a nongrantor trust funded with stock for the benefit of his child. The grantor trust transferred appreciated stock to the grantor in exchange for an unsecured promissory note for the full value of the stock. The grantor then sold the stock to an unrelated party. The Ruling holds that the sale is the equivalent of a borrowing from the trust, in that the result is the same as the grantor having contributed cash to the trust and then borrowing back the cash in exchange for an unsecured note. Thus, the grantor is treated as the owner of the trust assets under Section 675(3) and the sale between the grantor and the grantor trust is disregarded for Federal income tax purposes.

The Chief Counsel stated that it does not agree that the facts in this case are substantially similar to the facts in Revenue Ruling 85-13. In that ruling, the economic benefit is to the grantor. In this case, the grantors are giving up property in return for an unsecured promise by the trust to pay. Furthermore, the Chief Counsel cited Revenue Ruling 69-74, which treats the exchange of appreciated property for a private annuity as a sale rather than a borrowing.<sup>163</sup> Accordingly, the Chief Counsel concluded that the grantors are not considered to have indirectly

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<sup>160</sup> *Madorin v. Comm'r*, 84 TC 667 (1985).

<sup>161</sup> Rev. Rul. 85-13, 1985 C.B. 184.

<sup>162</sup> Section 675(3).

<sup>163</sup> Rev. Rul. 69-74, 1969-1 C.B. 43.

borrowed the trust property and the trusts did not become grantor trusts when the grantors sold the LLC interests to the trusts.

6. Private Letter Ruling 200920031 (May 15, 2009) – Distribution of Appreciated Securities by Grantor CLAT

G created a charitable lead annuity trust that was treated as a grantor trust for Federal income tax purposes. G transferred an interest in a family owned limited liability company to the CLAT. The CLAT was required to make a fixed annuity payment to a private foundation equal to a percentage of the initial value of the assets transferred to the CLAT each year for a period of 20 years. The Trustees wanted to distributed appreciated securities to the foundation rather than from the CLAT's income and the question was whether such payment will trigger a gain or loss to the grantor or to the CLAT.

In *Kenan v. Comm'r*,<sup>164</sup> the Trustees of a testamentary trust were directed to pay the beneficiary \$5,000,000 when the beneficiary reached the age of 40. The Trustees could make the distribution all in cash or all in securities, and decided to make the distribution in part cash and part securities. The Second Circuit held that the transfer of the securities in satisfaction of the distribution was treated as a sale of the securities by the trust and a distribution of the sales proceeds to the beneficiary. Thus, the trust recognized gain on the transfer of the securities.

The Service then cited Revenue Ruling 83-75<sup>165</sup> stating that it adopted the reasoning in *Kenan* where a distribution by a nongrantor trust of appreciated securities to satisfy its obligation to pay a fixed annuity to charity resulted in a taxable gain to the trust. Although the trustee had the authority to pay the annuity to qualified charities of the trustee's choice, the Service stated that the distribution was a taxable exchange, as it was made in satisfaction of a right to receive a specified dollar amount.

Revenue Procedure 2007-45<sup>166</sup> sets forth sample provisions and other information regarding inter vivos grantor charitable lead annuity trusts. One such provision provides that the donor may claim a Federal income tax charitable contribution deduction in the year the assets are transferred to the trust, but will then be taxed on all income earned by the trust without reduction for the annuity payment made to the charity each year.<sup>167</sup> If the trustee distributes appreciated property to satisfy the annuity payment, the donor will realize capital gain on the assets distributed.<sup>168</sup>

G cited to Revenue Ruling 55-410.<sup>169</sup> In that ruling, the Service ruled that the satisfaction of a pledge to charity with appreciated (or depreciated) property does not result in realization of gain or loss. The Service stated that this ruling does not apply to the distribution to

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<sup>164</sup> *Kenan v. Comm'r*, 114 F.2d 217 (2d Cir. 1940).

<sup>165</sup> Rev. Rul. 83-75, 1983-1 C.B. 114.

<sup>166</sup> Rev. Proc. 2007-45, 2007-2 C.B. 89.

<sup>167</sup> Rev. Proc. 2007-45, 2007-2 C.B. 89, Section 8.01(2).

<sup>168</sup> Rev. Proc. 2007-45, 2007-2 C.B. 89, Section 8.02(2).

<sup>169</sup> Rev. Rul. 55-410, 1955-1 C.B. 297.

satisfy an annuity payment by a CLAT. With the CLAT, the charity has a claim against the trust assets that is satisfied by the transfer of the appreciated property. In Revenue Ruling 55-410, the Service found that the pledge was not a debt because the individual making the pledge is not entitled to the income tax deduction until the pledge is satisfied. Accordingly, the Service ruled that G will recognize gain on the transfer of appreciated securities in satisfaction of the annuity payments.

7. Private Letter Rulings 200848006, 200848015, 200848016 and 200848017 (November 28, 2008) – Service Cannot Determine Whether Substitution Power Exercisable in Fiduciary or Nonfiduciary Capacity Until Examination of Federal Income Tax Returns of Parties

In each ruling, A created and funded an irrevocable trust for the benefit of A's children. A and all of the beneficiaries of the trust intended to modify the trust, in accordance with state law, to provide that A will have the power, solely in a nonfiduciary capacity and without the approval of any person in a fiduciary capacity, to reacquire any property owned by the trust by substituting property of equivalent value. The issue is whether, the addition of such power will cause the trust to be treated as a grantor trust as to A for Federal income tax purposes.

The grantor is treated as the owner of a trust for Federal income tax purposes where the grantor has the power to reacquire the trust principal by substituting other property of an equivalent value so long as such power is exercisable in a nonfiduciary capacity without the approval or consent of any person in a fiduciary capacity.<sup>170</sup> If the terms of the trust agreement or the circumstances surrounding its administration demonstrate that “administrative control is exercisable primarily for the benefit of the grantor rather than the beneficiaries of the trust”.<sup>171</sup> A power of substitution can be deemed to be exercisable primarily for the benefit of the grantor.<sup>172</sup> With respect to the power of substitution, whether the power is exercisable in a fiduciary or a nonfiduciary capacity depends on the terms of the trust and the circumstances surrounding its creation and administration.<sup>173</sup>

The Service concluded that the circumstances surrounding the administration of the trust will determine whether the power of substitution in this case is exercisable in a fiduciary or nonfiduciary capacity. As this is a question of fact, the Service stated that it cannot make a determination until the Federal income tax returns of the parties involved have been examined. If they do determine that the power is exercisable in a nonfiduciary capacity, then A will be treated as the owner of the trust for Federal income tax purposes.

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<sup>170</sup> Section 675(4)(C).

<sup>171</sup> Treas. Reg. Section 1.675-1(a).

<sup>172</sup> Treas. Reg. Section 1.675-1(b)(4)(iii).

<sup>173</sup> Id.

8. Private Letter Ruling 200842007 (October 17, 2008) – Exercise of Substitution Power is Not Gift

G created a trust for the benefit of G's spouse and G's issue. During G's lifetime, the Trustees may distribute as much as the trust property to G's spouse as the Trustees determine for any reason not prohibited by the trust agreement. Following G's death, the Trustees may distribute as much as the trust property to G's spouse as the Trustees determine for the health, maintenance and support of G's spouse. G's spouse also has an inter vivos limited power of appointment to have trust property distributed to G's issue, so long as such distribution does not discharge G's obligation to support the recipient. G's spouse also has a testamentary limited power appointment over the trust property. Any property not so appointed by G's spouse's Will upon her death will be distributed to G's issue, per stirpes.

G's spouse has a *Crummey* withdrawal right, limited to by the "five or five" power of Sections 2514(e) and 2041(b)(2). G has retained a power of substitution that may be exercised only in a fiduciary capacity. The trust agreement defines "fiduciary capacity" as an "action that is undertaken in good faith and in the best interests of the Trust and its beneficiaries subject to fiduciary standards imposed under applicable state law".

G would like to exercise his power of substitution by transferring shares of Company 1 stock that G owns in exchange for shares of Company 2 stock that the trust owns. G will transfer to or withdraw from the trust any amount of cash necessary to make the substitution of equivalent value. Neither of the Trustees is a descendant of G nor are otherwise related or subordinate to G within the meaning of Section 672(c). If there is a vacancy in the office of Trustee, it must be filled by a person who is not related or subordinate to G within the meaning of Section 672(c). The stock of both Company 1 and Company 2 is publicly traded.

Five issues were addressed by the ruling:

(a) The first issue was whether the retention of the power of substitution will cause the trust property to be included in G's estate for Federal estate tax purposes under Sections 2033, 2036(a), 2038 or 2039. In *Estate of Jordahl*,<sup>174</sup> the Tax Court held that the decedent's reserved power to substitute property was not a power to alter, amend or revoke the trust within the meaning of Section 2038(a)(2) because the power was exercisable only in good faith and subject to fiduciary standards and the substituted property must have been equal in value to the assets replaced. This, the Tax Court believed, provided that the decedent could not exercise the power to deplete the trust to shift the benefits among the beneficiaries. This idea was furthered by the Service in Revenue Ruling 2008-22,<sup>175</sup> in which the Service stated that a power of substitution exercisable in a nonfiduciary capacity will not cause inclusion of the trust assets in the grantor's estate.

In this case, G's power to substitute assets may be exercised only in a fiduciary capacity and G must substitute assets of equivalent value. Accordingly, the Service ruled that the power

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<sup>174</sup> *Estate of Jordahl v. Comm'r*, 65 T.C. 92 (1975), acq. 1977-1 C.B. 1.

<sup>175</sup> Rev. Rul. 2008-22, 2008-16 I.R.B. 796.

will not cause the trust assets to be included in G's estate under Sections 2033, 2036(a), 2038 or 2039.

(b) The second and third issues were combined. The second issue is whether G's exercise of the power of substitution will constitute a gift if the total value of the assets transferred to the trust equals the total value of the assets transferred from the trust. The third issue is whether the gift tax value of the stock being exchanged will be determined by valuing each stock at the mean between its highest and lowest quoted selling price on the date of the substitution in accordance with Treasury Regulation Section 25.2512-2(b)(1).

The Service reviewed the provisions of Section 2512. Section 2512(a) provides that, when a gift is made in property, the value of the property as of the date of the gift is considered the amount of the gift. If property is transferred for less than "adequate and full consideration in money or money's worth, then the amount by which the value of the property exceeded the value of the consideration shall be deemed a gift...."<sup>176</sup> If, however, the transfer is bona fide, at arm's length and free from any donative intent, then such transfer will be deemed to have been for full and adequate consideration.<sup>177</sup> The value of property for gift tax purposes is the "price at which such property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell, and both having reasonable knowledge of relevant facts."<sup>178</sup> When dealing with publicly traded stock, the value of the stock is equal to the mean between the highest and lowest quoted selling prices on the date of the gift.<sup>179</sup>

In this case, the stock being exchanged will be valued in accordance with the rules of Treasury Regulation Section 25.2512-2(b)(1). G has represented that, if the value of the stocks is not equal, then G will transfer to the trust or the trust will transfer to G cash to make up the difference. Accordingly, the Service concluded that G's exercise of the power of substitution will not constitute a gift as long as the total fair market value of the assets transferred to the trust equals the total fair market value of the assets transferred from the trust.

(c) The last issues are whether the trust is a grantor trust and whether G or the trust will recognize any income or loss by reason of the exercise of the power of substitution. Section 677(a)(1) provides that a trust will be treated as a grantor trust if the income of the trust may be distributed to the grantor spouse by the grantor or a nonadverse party without the consent of an adverse party. In Revenue Ruling 85-13,<sup>180</sup> the Service ruled that, if the trust is a grantor trust, transactions between the grantor and the grantor trust will be disregarded for Federal income tax purposes. In this case, the Trustees are nonadverse parties within the meaning of Section 672(a). The Trustees may distribute the income of the trust to G's spouse for any purpose while G is living. Thus, the trust is a grantor trust under Section 677(a)(1). As a result, the Service ruled that the exercise of the power of substitution will not result in the recognition of gain or loss by either G or the trust.

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<sup>176</sup> Section 2512(b).

<sup>177</sup> Treas. Reg. Section 25.2512-8.

<sup>178</sup> Treas. Reg. Section 25.2512-1.

<sup>179</sup> Treas. Reg. Section 25.2512-2(b)(1).

<sup>180</sup> Rev. Rul. 85-13, 1985-1 C.B. 184.

Note: The Service did not comment on whether the power of substitution caused the trust to be treated as a grantor trust. This likely is because of the fact that it must be exercised in a fiduciary capacity. But in any event, it is interesting that this power was not even raised as a possible power to cause grantor trust status.

9. Private Letter Ruling 200822008 (May 30, 2008) – Addition of Reimbursement Clause Should Not Cause Estate Tax Inclusion

G created an irrevocable trust naming G's spouse as the initial Trustee of the trust. Until the earlier of G's death or G's spouse's death, the Trustee must distribute all of the income and/or principal of the trust to G's spouse as the Trustee determines, in the Trustee's sole discretion, but with the consent of an adverse party, as defined in Section 672(a). The Trustee is prohibited from reimbursing G for his payment on the income tax attributable to the trust while it is a grantor trust and G expressly waived any right of reimbursement. The Trustee wanted to modify the trust to provide that the Trustee would be authorized, but not directed, to distribute to G funds sufficient to cover the income tax liability incurred by G attributable to the grantor trust status of the trust. Any exercise of such power would be required to be approved by a "reimbursement committee", which must consist of members who are not related or subordinate to G within the meaning of Section 672(c), and at least of child beneficiary who qualifies as an adverse party under Section 672(a).

The Service concluded that the addition of the reimbursement provision will not cause the trust assets to be included in G's estate for Federal estate tax purposes. In accordance with Revenue Ruling 2004-64, the power to reimburse is not mandatory and must be approved by the reimbursement committee. Assuming there is no express or implied understanding between G and the members of the reimbursement committee and the Trustee, the Trustee's discretion to exercise the right to reimburse G alone will not cause the trust property to be includible in G's estate. Furthermore, the Service noted that the inclusion of the reimbursement provision should not jeopardize grantor trust status.

10. Notice 2008-63 – Proposed Guidance for Treatment of Private Trust Companies Used as Trustees by Family Members

In July 2008, the Service issued Notice 2008-63<sup>181</sup> in which it set forth a proposed Revenue Ruling on the income, gift, estate and generation-skipping transfer tax consequences of the use of a private trust company by families to serve as the Trustee of a trust of which the family members are the grantors and beneficiaries. The facts of the proposed Revenue Ruling are as follows:

A and B, husband and wife, have three children, C, D and E. Each child is married and has children. A and B established irrevocable trusts with each of their children and grandchildren as the primary beneficiary of the relevant trust. C, D and E also established irrevocable trusts for their own

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<sup>181</sup> Notice 2008-63, 2008-31 I.R.B. 261.

descendants. Contributions are made to each trust only by the individual who created such trust. Each trust agreement provides that the Trustee has the discretion to distribute income and/or principal to the primary beneficiary. The primary beneficiary has a testamentary limited power of appointment over the trust property that can be exercised in favor of any of A and B's descendants (other than the primary beneficiary) and any charitable organization. The grantor has the power to appoint a successor Trustee, other than such grantor, if the current Trustee ceases to serve.

The Notice then sets forth two situations:

Situation 1: In Situation 1, each trust is governed by the laws of a state that has enacted a private trust company statute. Under such statute, each private trust company must create a "Discretionary Distribution Committee (DDC) and delegate to the DDC the exclusive authority to make all decisions regarding discretionary distributions from each trust for which it serves as a Trustee. Any person may serve on the DDC, but no member of the DDC may participate in decisions relating to any trust of which such member or his or her spouse is a grantor or a beneficiary or with respect to a beneficiary to whom such member or such member's spouse owes a legal obligation of support. Only officers and managers of the private trust company may participate in decisions regarding the hiring, discharge, promotion and compensation of personnel of the private trust company. Nothing in the statute or the governing documents of the private trust company may override a more restrictive provision in the trust agreement. No family member may enter into any reciprocal agreement regarding discretionary distributions from any trust for which the private trust company is serving as a Trustee.

In 2008, A and B's family formed a private trust company in accordance with applicable state law. A DDC will make all decisions regarding discretionary distributions in accordance with the statute. There are no restrictions on who may serve on the DDC. A, C and D are officers and serve on the board of directors, as well as members of the DDC. B and E owns shares of the company, but have no other role. E is a manager and an employee of the private trust company.

A financial institution has served as the Trustee of all of the trusts. The only relationship that any grantor has with the Trustee is that of a customer or client. Following the formation of the private trust company, the financial institution resigned as Trustee and the private trust company was appointed as successor Trustee. A also created new trusts for each of A's children and their descendants, naming the private trust company as the initial Trustee.

Situation 2: In Situation 2, the state law governing each trust does not have a statute that governs private trust companies. The facts are the same as above. The private trust company's documents set forth the provisions regarding the DDC. Specifically, the DDC has the exclusive authority to make all decisions regarding discretionary distributions, which are defined as permissible distributions not mandated in the trust agreement or by applicable law. There are no restrictions on who may serve on the DDC, but no member of the DDC may participate in decisions relating to any trust of which such member or his or her spouse is a grantor or a beneficiary or with respect to a beneficiary to whom such member or such member's spouse owes a legal obligation of support. The company's governing documents provide that only officers and managers of the private trust company may participate in decisions regarding the hiring, discharge, promotion and compensation of personnel of the private trust company. Nothing in the private trust company's governing documents may override a more restrictive provision in the trust agreement. No family member may enter into any reciprocal agreement regarding discretionary distributions from any trust for which the private trust company is serving as a Trustee.

The private trust company's governing documents also provide of the creation of an "Amendment Committee". The Amendment Committee has the authority to amend the company's governing documents relating to the creation, function or members of the DDC or Amendment Committee, the provisions delegating exclusive authority regarding personnel decisions to the officers and managers and the prohibition of reciprocal agreements between family members. The Amendment Committee must be made of individuals, a majority of whom must not be members of the family or persons related or subordinate to any shareholder of the private trust company, within the meaning of Section 672(c). A is one of the initial members of the Amendment Committee, with F and G, neither of whom are members of the family, employed by the private trust company or related or subordinate to any members of the family within the meaning of Section 672(c).

A, C and D are officers of the private trust company and serve on the DDC. A, C, D, F and G serve on the Board of Directors. B and E own shares of the private trust company but are not on the DDC or officers or directors of the private trust company. E is a manager and employee of the company.

A financial institution has served as the Trustee of all of the trusts. The only relationship that any grantor has with the Trustee is that of a customer or client. Following the formation of the private trust company, the financial institution resigned as Trustee and the private trust company was appointed as successor Trustee. A also created new trusts for each of

A's children and their descendants, naming the private trust company as the initial Trustee.

Five issues were raised in the Notice. Each issue and its resolution are described below.

(a) *If the private trust company serves as the Trustee, will any portion of the trust assets be included in the grantor's gross estate under Sections 2036(a) or 2038(a)?*

When a decedent made a transfer during lifetime under which he retained for his life the possession or enjoyment of, or the right to the income from, the property transferred or the right to designate the persons who are to possess or enjoy the property or the income therefrom, such property will be includible in the decedent's estate for Federal estate tax purposes.<sup>182</sup> Also, if the decedent transfers property to a trust but retains the right to alter, amend, revoke or terminate such trust, the property will be includible in the decedent's estate for Federal estate tax purposes.<sup>183</sup> Such right includes the discretionary authority to distribute or withhold income.<sup>184</sup>

In Situation 1, the private trust company is the Trustee. Discretionary distributions are made solely by the DDC. No family member may participate in making such distributions where such family member or his or her spouse is the grantor, a beneficiary or has a legal obligation to support a beneficiary. Furthermore, the applicable state statute prohibits any shareholders of the private trust company from changing any provisions regarding the DDC. Accordingly, the Service ruled that no portion of the trust assets be included in the grantor's gross estate under Sections 2036(a) or 2038(a) under Situation 1.

The Service held the same in Situation 2, but noted that Situation 2 is different from Situation 1 because there is no state law restricting the ability of the shareholders of the private trust company from changing the applicable provisions of the DDC. However, this issue was resolved by the appointment of the Amendment Committee.

(b) *If the private trust company is serving as the Trustee, will the trust assets be included in a beneficiary's gross estate under Section 2041?*

When a beneficiary has a general power of appointment over trust property, such property is includible in the beneficiary's estate for Federal estate tax purposes.<sup>185</sup> A general power of appointment is a power to appoint property in favor of the decedent, the decedent's estate, the decedent's creditors or the creditors of the decedent's estate, unless limited by an ascertainable standard.<sup>186</sup> A donee may have a general power of appointment if he has the power to remove or discharge a Trustee and appoint himself as a Trustee.<sup>187</sup>

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<sup>182</sup> Section 2036(a).

<sup>183</sup> Section 2038(a).

<sup>184</sup> See Rev. Rul. 70-348-1970-2 C.B. 193.

<sup>185</sup> Section 2041(a)(2).

<sup>186</sup> Section 2041(b)(1).

<sup>187</sup> Treas. Reg. Section 20.2041-1(b)(1).

In Situation 1, the Trustee has the discretion to distribute the income and/or principal to a beneficiary of the trust. With the private trust company serving as the Trustee, state law provides that such discretionary authority is delegated exclusively to the DDC. No member of the DDC may participate in making such distributions where such member or his or her spouse is the grantor, a beneficiary or has a legal obligation to support a beneficiary. Furthermore, family members cannot enter into reciprocal arrangements that affect distribution decisions. Accordingly, the Service ruled that, C and D as beneficiaries of the trusts and officers, directors and members of the DDC do not have a general power of appointment under Section 2041. Additionally, neither E nor any other beneficiary will be deemed to have a general power of appointment solely for participating in the daily activities of the private trust company relating to investments and the retention of professional advisors. The result under Situation 2 is the same but because of the powers of the Amendment Committee.

(c) *If the private trust company is the Trustee and has the discretionary power to distribute income and/or principal to the grantor's child or descendants, will the grantor's transfer to the trust be a completed gift?*

When the donor has completely parted with all dominion and control over property transferred, the gift is complete.<sup>188</sup> If, however, the donor reserves any power over the disposition of such property, such gift will be incomplete.<sup>189</sup> This is true, even if such power must be exercised in conjunction with another person, if such person does not have a substantial adverse interest in the disposition of the property or its income.<sup>190</sup>

In both Situation 1 and Situation 2, the grantor may serve on the DDC. However, both the statute and the governing documents provide that no member of the DDC may participate in making any discretionary distributions where such member or his or her spouse is the grantor, a beneficiary or has a legal obligation to support a beneficiary. Furthermore, in both situations, family members are prohibited from making reciprocal agreements to make discretionary distributions. Therefore, A's transfer will be considered a completed gift.

(d) *Does the private trust company's appointment as Trustee affect the GST exempt status of the trust or change its inclusion ratio?*

Generally, the modification of a trust agreement by judicial reformation or under applicable state law will not cause a GST exempt trust to become subject to the GST tax if the modification does not shift a beneficial interest in the trust to any beneficiary who occupies a lower generation than the person or persons who held the beneficial interest prior to the modification and if the modification does not extend the time for vesting beyond the period provided in the original trust.<sup>191</sup> In both situations, the only change is a change in Trustee and there is no affect on the beneficial interests in the trust. Furthermore, each trust provides that it must terminate no later than 21 years after the death of the last to die of certain individuals living at the time of the creation of the trust. Therefore, no trust should lose its GST exempt status.

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<sup>188</sup> Treas. Reg. Section 25.2511-2(b).

<sup>189</sup> Id.

<sup>190</sup> Treas. Reg. Section 25.2511-2(e).

<sup>191</sup> Treas. Reg. Section 26.2601-1(b)(4)(i)(D)(1).

Moreover, so long as the private trust company is operated in accordance with the applicable statute and its governing documents, no portion of the trust property should be includible in the estates of the grantors or the beneficiaries and no beneficiary is deemed to have a general power of appointment. Therefore, the inclusion ratio of the trusts should not be affected.

(e) *If the private trust company serves as the Trustee, will the grantor or any beneficiary be treated as the owner of the trust for Federal income tax purposes?*

In Situation 1, none of the terms of the trusts, the statute or the private trust company's governing documents result in any administrative controls under Section 675. However, this is a question of fact that cannot be determined until the Federal income tax returns are examined. Furthermore, the grantor will be deemed to be the owner of the trust for Federal income tax purposes when the income is used to discharge the grantor's obligation to support a beneficiary.<sup>192</sup> This is the result regardless of who is serving as the Trustee, so the appointment of the private trust company will not change the result.

The identity of the Trustee is relevant under Section 674. Section 674 applies when a power is exercisable by the grantor or a nonadverse party without the consent or approval of an adverse party.<sup>193</sup> In both situations, however, a member of the DDC is prohibited from making any decisions with respect to any trust in which such member has an interest. Therefore, there will not be an adverse party to provide consent or approval.

There are some powers under Sections 674(b) and (d) that can be held by any Trustee without causing the trust to be treated as a grantor trust. Thus, the appointment of the private trust company in those circumstances will not have any adverse impact. But if the Trustee is granted the authority to distribute trust property among a group of beneficiaries, the trust will not be treated as a grantor trust if such power is exercisable, without the approval and consent of any other person, by a Trustee or Trustees, none of whom is the grantor and no more than half of whom are related or subordinate to the grantor.<sup>194</sup>

The term "related or subordinate" is defined in Section 672(c). When dealing with a private trust company, such company will be considered related or subordinate when the stock holdings of the grantor and the trust in the company are significant from the viewpoint of voting control.<sup>195</sup> Voting control is relevant when it gives the grantor or the trust a power over distributions. The Service ruled that, in both situations, there are adequate safeguards against the exercise of such powers.

A subordinate employee of a corporation in which the grantor is an executive also is considered a related or subordinate party.<sup>196</sup> Neither situation requires that the Trustee be a

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<sup>192</sup> Section 677(b).

<sup>193</sup> Section 674(a).

<sup>194</sup> Section 674(c).

<sup>195</sup> Section 672(c)(2).

<sup>196</sup> Id.

person who is not related or subordinate to the grantor. Furthermore, there is no requirement that more than half of the members of the DDC be nonadverse parties who are not related or subordinate to the grantor. Thus, it is important to make sure that no member of the DDC falls into this category. However, currently, in both situations, there are no individuals who fall into this category. Therefore, the trusts will not be treated as grantor trusts to any grantor or beneficiary.

The Service requested comments to the Notice that were due on November 4, 2008. Comments were submitted by the American College of Trusts and Estates Council (ACTEC), Arnold & Porter LLP, Caplin & Drysdale Chartered, Florida Bar Tax and Real Property, Probate and Trust Law Sections, Levin, Schreder & Carey Ltd., McGuire Woods LLP, New York City Bar Committee on Estate and Gift Taxation, Sullivan & Cromwell LLP, Thomson & Knight LLP, Warner, Norcross & Judd LLP and the New York State Bar Association. The primary concerns with the Notice are that the restrictions in the rules relating to the DDCs are too tight. Some of the commentators also suggested that the Service should not be addressing the grantor trust rules because of the inconsistencies between the transfer tax rules and the grantor trust rules.

The commentators also asked the Service to clarify that the safe harbor rule regarding removal and replacement of Trustees set forth in Revenue Rule 95-58 does not apply to the removal and replacement of officers, directors and members of the DDC. They also stated that the stock in the private trust company should not be includible in the transferor's estate if the transferor cannot vote the stock or cause the governing documents to be modified to allow voting.

The final Revenue Ruling has not been issued.

## **Speaker Biographies**

**Jeanne L. Newlon** is a Partner with the law firm of Venable LLP, in Washington, DC. Her practice involves advising individuals of significant means on estate and gift planning issues, including business succession, charitable planning, and planning with life insurance. Jeanne received her J.D. from The George Washington University with High Honors, her L.L.M. in Taxation from Georgetown University and her B.S.B.A. with a degree in Finance from the University of Florida. Jeanne is a member of the District of Columbia Estate Planning Council, former Co-Editor of the Council's newsletter, former Co-Chair of the Communications Committee, former member of the Council's Board of Directors and current Secretary of the Council. She also was named as a 2005-2006 John S. Nolan Fellow by the America Bar Association Section of Taxation and is the former Chair of the Fiduciary Income Tax Committee of the ABA Section of Taxation. Jeanne is a fellow with the American College of Trusts and Estates Council (ACTEC). Jeanne is licensed to practice in the District of Columbia, Maryland, Florida and Virginia.

**Jessica Baumgarten Baggenstos** recently relocated to Portland, Oregon, from Washington, DC, where she was an associate in the Tax and Wealth Planning group at Venable LLP. Jessica received her LL.M. in Taxation, with a Certificate in Estate Planning, from Georgetown University Law Center, her J.D. from Boston College Law School and her B.A. in Government and International Relations from the University of Notre Dame. Jessica was the law clerk to The Honorable A. Franklin Burgess, Jr., while he was the Deputy Presiding Judge of the District of Columbia Superior Court, Tax and Probate Division. Jessica has worked at the U.S. Department of the Treasury and was an intern with the Joint Committee on Taxation. Jessica is licensed to practice in Oregon, California and Washington, DC (inactive).