THE LIFE-CHANGING MAGIC OF GRANTOR TRUSTS

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These materials present an overview of so-called "grantor trusts," a popular vehicle in contemporary estate planning. These materials explain when grantor trusts are used, how they work, and the resulting federal income, estate, and gift tax consequences. Although the statutes governing the taxation of grantor trusts have been in place for over 65 years, there are still a number of questions about grantor trusts for which there are no firm answers. Where appropriate, these materials attempt to answer some of those questions.

Some preliminary observations are in order. First, because these materials try to answer questions as to which there is no consensus, it is important to note at the outset that these materials are not intended to impart legal advice, and no one should rely on their contents. Specifically, any federal tax advice contained in these materials is not intended or written to be used, and cannot be used, for the purpose of avoiding penalties under the Internal Revenue Code or for the purpose of promoting, marketing or recommending to another party any transaction or matter addressed herein.

Second, please note that any federal tax advice contained in these materials is not intended or written to be used, and cannot be used, to support any position taken on any tax or information return, to support a determination that any such position satisfies any return preparation standard, or to avoid any penalties arising from any such position.

Third, any citations to sections (using "§" or "§§") are citations to the Internal Revenue Code of 1986, as amended, unless otherwise indicated.

Finally, these materials elaborate considerably on published remarks given at the 40th Heckerling Institute on Estate Planning. See Samuel A. Donaldson, *Understanding Grantor Trusts*, *in* 40 HECKERLING INSTITUTE ON ESTATE PLANNING 2-1 (Tina Portuando ed., 2006). Having established that nothing herein is either reliable or innovative, we may proceed.

I. BACKGROUND AND CONTEXT

By default, trusts are separate entities for federal income tax purposes, which makes them separate taxpayers. Trusts are subject to federal income tax at progressive rates that resemble those applicable to individuals. Tables 1 and 2 show the applicable 2023 federal income tax rates for individuals and trusts taxed as separate entities, respectively.

TABLE 1: 2023 FEDERAL INCOME TAX RATES FOR INDIVIDUALS
(Adapted from Rev. Proc. 2022-38)

<table>
<tr><th colspan="2">Taxable Income Exceeding</th><th rowspan="2">Ordinary Income</th><th rowspan="2">Adjusted Net Cap Gain* & Qualified Dividends</th><th rowspan="2">Medicare Surtax on Earned Income**</th><th rowspan="2">Medicare Surtax on Net Investment Income</th></tr>
<tr><th>Single</th><th>Married Filing Jointly</th></tr>
<tr><td>$0</td><td>$0</td><td>10%</td><td rowspan="2">0%</td><td rowspan="5">2.9%</td><td rowspan="5">0%</td></tr>
<tr><td>$11,000</td><td>$22,000</td><td rowspan="2">12%</td></tr>
<tr><td>$44,625</td><td>$89,250</td><td rowspan="6">15%</td></tr>
<tr><td>$44,725</td><td>$89,450</td><td>22%</td></tr>
<tr><td>$95,375</td><td>$190,750</td><td>24%</td></tr>
<tr><td>$182,100</td><td>AGI over $250,000</td><td rowspan="2">32%</td><td></td><td></td></tr>
<tr><td>AGI over $200,000</td><td>$364,200</td><td rowspan="4">3.8%</td><td rowspan="4">3.8%</td></tr>
<tr><td>$231,250</td><td>$462,500</td><td rowspan="2">35%</td></tr>
<tr><td>$492,300</td><td>$553,850</td><td rowspan="2">20%</td></tr>
<tr><td>$578,125</td><td>$693,750</td><td>37%</td></tr>
</table>

* Other long-term capital gains could be taxed as high as 25% (building recapture) or 28% (collectibles and §1202 stock).
** Includes employer contribution of 1.45% (§3111(b)(6)), individual contribution of 1.45% (§3101(b)(1)), and additional tax of 0.9% for adjusted gross income over $200,000 for an unmarried individual and $250,000 on a joint return (§3101(b)(2), for years after 2012).

FEDERAL INCOME TAX RATES FOR TRUSTS AND ESTATES FOR 2023

(Adapted from Rev. Proc. 2022-38)

<table>
<tr><th>Taxable Income Exceeding</th><th>Ordinary Income</th><th>Adjusted Net Cap Gain* & Qualified Dividends</th><th>Medicare Surtax on Net Investment Income</th></tr>
<tr><td>$0</td><td>10%</td><td rowspan="2">0%</td><td rowspan="5">0%</td></tr>
<tr><td>$2,900</td><td rowspan="2">24%</td></tr>
<tr><td>$3,000</td><td rowspan="3">15%</td></tr>
<tr><td>$10,550</td><td>35%</td></tr>
<tr><td>$14,450</td><td rowspan="2">37%</td></tr>
<tr><td>$14,650</td><td>20%</td><td>3.8%</td></tr>
</table>

* Other long-term capital gains could be taxed as high as 25% (building recapture) or 28% (collectibles and §1202 stock).

Notice that while tax rates applicable to trusts often match the rates applicable to individuals, the thresholds for the application of higher rates for trusts are significantly lower than is the case for individuals. An unmarried individual with taxable income of $15,000 in 2023 is in the 12-percent bracket for ordinary income and pays no tax at all on dividends and adjusted net capital gain, but a trust with $15,000 of taxable income in 2023 is in the 37-percent bracket for ordinary income and the last dollar of dividend income and adjusted net capital gain faces a 23.8-percent rate.

A **grantor trust**, by contrast, is not treated as a separate taxpayer. Instead, the income from a grantor trust is taxed to the grantor (or, sometimes, to another person) because the grantor or someone close to the grantor holds some prescribed interest in or control over the trust's assets. Formally, §671 provides that if the grantor or another person is the deemed owner of any portion of a trust, then the income, deductions, and credits attributable to that portion of the trust will be imputed to that deemed owner. Thus, a single trust will be treated as a part-grantor, part-nongrantor trust if the grantor or some other person owns only a portion of the trust.

For More Information

Perhaps the most complete reference on all aspects of grantor trusts is Danforth & Zaritsky, 819-2d T.M., *Grantor Trusts (Sections 671-679)* (Bloomberg Tax Portfolio). Other helpful sources include Steven G. Siegel, Grantor Trust Answer Book (Wolters Kluwer: 2018); Steven T. Dyer, *Planning with Grantor Trusts* (2018); Halperin & Heller, *Grantor Trusts: Take Nothing for Granted*, 46 Heckerling Institute on Estate Planning 3-1 (Tina Portuando ed., 2012).

As explained further below, having the grantor pay tax on the income from a grantor trust generally results in less federal income tax paid. Such was not always the case. When §671 and the other provisions of Subpart E (§§671 – 679) were introduced (a process that began in 1924 and continued through 1969), the tax brackets for trusts were fatter than the brackets applicable to individuals. As a result, individuals had an incentive to move assets into trusts and have the trusts pay the federal income tax liability on the incomes attributable to the transferred assets. The trusts were usually revocable so grantors could easily reclaim title to the trust's assets if tax brackets or tax rates changed. Because the trusts were revocable, grantors still effectively controlled the assets formally held by the trustee. The common law assignment of income doctrine was ill-equipped to thwart this technique, for formal title to the trust assets technically belonged to a separate taxpayer. Only legislation could solve the problem. Congress therefore enacted Subpart E to detect those situations where grantors were looking to exploit the fatter brackets for trusts while still retaining effective ownership over the trust's assets.

For More Information

A nice summary of the development of Subpart E can be found in Huffaker & Kessel, *How the Disconnect Between the Income and Estate Tax Rules Created Planning for Grantor Trusts*, 100 J. TAX'N 206 (April 2004).

Subpart E generally provides that where grantors (or others) retain certain prescribed powers, the trust will be ignored and the income from trust assets will be taxed directly to the grantor.

EXAMPLE: A trust is a grantor trust if any of the following rights or powers are contained in the trust instrument (this list is not complete; a comprehensive explanation of the powers invoking grantor trust status appears later in these materials):

- The grantor has a **reversionary interest** in either principal or income and the value of the reversion is worth at least 5% of the value of the property subject to the reversion at the time the reversionary interest is created.
- The grantor has an absolute **power to control the beneficial enjoyment** of the principal or income of the trust. An example of a power to control beneficial enjoyment is a power to distribute principal or income to an individual other than the income beneficiary and the remainder beneficiary.
- The grantor has the **power to borrow principal or income** without payment of adequate interest or without giving adequate security, unless the non-grantor trustee may make such loans to any person under a general lending power.
- The grantor retains a **power to reacquire principal** by substituting property of equivalent value.
- The grantor retains a **power to revoke** the trust.
- The grantor retains an **income interest** in the trust.

In each of the situations described in the above Example, it is fair to conclude that the grantor is, at least to some extent, "holding on" to the trust principal and/or the trust income by retaining some substantial interest in or substantial power over the trust principal or income. If individual tax rates exceed trust tax rates, it is also fair to conclude that a principal purpose of a grantor in creating a trust subject to one or more of these retained rights or powers is to avoid federal income tax by shifting income to a lower-bracket taxpayer.

As explained, the federal income tax laws see the grantor and the grantor trust as the same taxpayer. Thus, the tax elections and opportunities available to the grantor should be available to the grantor trust. Likewise, transactions between the grantor and the grantor trust are disregarded because the federal income tax laws see the transactions as occurring between the same taxpayer. For instance, where the grantor's property is involuntarily converted and the grantor trust purchases replacement property, the trust's purchase can qualify the grantor's gain for nonrecognition under §1033 since the federal income tax sees the grantor as the taxpayer purchasing the replacement property. See Rev. Rul. 88-103, 1988-2 C.B. 304.

The regulations provide that if the grantor is the deemed owner of the entire trust, then the grantor takes into account all of the trust's tax items (income, deductions, credits) "to which he would have been entitled had the trust not been in existence during the period he is treated as the owner." Reg. §1.671-3(a)(1). This language stops short of saying that the grantor trust is a disregarded entity, but regulations outside of Subpart E clearly indicate that such is the case. As one commentator concludes, "notwithstanding the lack of more specific language in the statute, a grantor trust typically is disregarded for federal tax purposes." Jeffrey L. Rubinger, *Making Something Out of Nothing (and Vice Versa)—Inconsistent Treatment of 'Tax Nothings,'* 99 J. Tax'n 288, 289 (November 2003). Thus, where a taxpayer formed a grantor trust which purchased an interest in a partnership, it was proper for the grantor to deduct losses incurred by the partnership on the taxpayer's individual return. Reg. §1.1001-2(c). And where all or a portion of the assets of a domestic or foreign grantor trust are transferred to a foreign corporation in a §367(a)(1) exchange, the transfer is considered to have been made by the grantor. Reg. §1.367(a)-1T(c)(4)(ii). So if, for example, a corporation formed a grantor trust in which it is the sole beneficiary and transferred its own stock to the trust, dividends paid on the stock should not be taxable to the corporation or to the trust because the corporation is, from an income tax perspective, paying dividends to itself. See Matthew A. Stevens, *A Grantor Trust Visits Subpart F: Ruminations on* Textron v. Commissioner *and Other Anomalies*, 21 Va. Tax Rev. 507, 519 (2001).

II. TO BE OR NOT TO BE (A GRANTOR TRUST)

Whether a client should structure a particular trust as a grantor trust depends on the client's objectives in creating the trust. This section of the materials identifies both situations when a grantor trust works well and situations when a traditional, nongrantor trust is better.

A. WHERE GRANTOR TRUST STATUS WORKS WELL

1. Intent to Minimize Federal Income Tax

Clearly the signature advantage of grantor trust status relates to the federal income taxation of the trust's income. Having the grantor pay tax on the income from a grantor trust generally results in less federal income tax paid.

EXAMPLE: In 2023, the taxable income of G, an individual, is $100,100. Trust has gross income of $100,100 and no deductions or credits attributable to its assets. Assuming Trust is a separate taxable entity and that G is not the owner of any portion of Trust under §671 for 2023, the total tax liability of G and Trust is $52,568.50:

Analysis for G		Analysis for Trust	
Taxable Income	$100,100	Gross Income	$100,100
		Less Exemption	($100)
2023 Tax Liability	**$ 17,424**	Taxable Income	$100,000
		2023 Tax Liability	**$ 35,144.50**

Aggregate 2023 Tax Liability: $52,568.50

EXAMPLE: Same facts as the prior Example, except that under §671, G is treated as the owner of Trust for federal income tax purposes. The income attributable to Trust's assets is imputed to G. G's tax liability for 2023 is $44,295.50, while the trust has no liability for federal income tax in 2023:

Analysis for G		Analysis for Trust
Taxable Income	$200,200	None. All income imputed to G for 2023.
2023 Tax Liability	**$ 42,896**	

Aggregate 2023 Tax Liability: $42,896

This result applies no matter whether Trust distributes income or principal to G or to anyone else.

Because the federal income tax disregards a grantor trust as an entity separate from the grantor, the grantor does not make a completed gift to the trust by paying the federal income tax on the trust's income. As far as the income tax is concerned, the income is that of the grantor and not the trust. Rev. Rul. 2004-64, 2004-2 C.B. 7.

2. Intent to Engage in Transactions with the Trust

Grantor trust status is also valuable where the grantor intends to sell appreciated assets to the trust. In Revenue Ruling 85-13, 1985-1 C.B. 184, the Service confirmed that transactions between a grantor trust and its grantor are disregarded for federal income tax purposes. The result makes sense since the federal income tax sees no distinction between the grantor trust and the grantor. Since one cannot transact with oneself (not in a taxable sense, at least), transactions between grantor trusts and grantors are likewise "tax nothings."

The symbiotic relationship between a grantor and a grantor trust offers tremendous flexibility for the estate planner.

> EXAMPLE: G creates a grantor-retained annuity trust (GRAT) designed to produce a taxable gift of zero. G funds the trust with discounted assets, such as nonvoting interests in a business. The Service disputes the valuation discount applied to the business interests, and ultimately G and the Service settle on a more modest discount. The result of the settlement is that the trust must pay a larger annuity amount than was originally forecast. Should this happen, the trustee might opt to transfer some of the business interests back to G in order to satisfy the increased payment requirement. Doing so does not trigger adverse income tax consequences since there is no taxable transfer between the grantor trust and G. See Neil H. Weinberg, *GRAT Hand Off*, 144 TRUSTS & ESTATES 52 (2005).
>
> If properly structured, the increase in the annuity amount payable from a GRAT will not affect the zeroing-out of the taxable gift. The GRAT should "express the annuity in terms of a percentage of the value of the property transferred to the GRAT, as finally determined for federal gift tax purposes. Thus, if the value of the transferred property increases, so does the annuity. The GRAT, therefore, remained 'zeroed-out' even if the value of the underlying property transferred to it is increased on audit." Daniel L. Daniels & Michael N. Delgass, *Design GRATs to Reap Court-Approved Extra Tax Savings*, PRACTICAL TAX STRATEGIES 324, 325 (December 2003).

For situations in which transactions between a grantor and a grantor trust yield substantial benefits, see Part IV-D. of these materials.

B. WHERE GRANTOR TRUST STATUS DOES NOT WORK

One might rightly wonder that if the grantor trust usually results in less federal income tax and facilitates tax-free transactions between grantor and grantee, why anyone would create a trust treated as a separate taxable entity. Sometimes, the planner has no choice. A valid charitable remainder trust (CRT), for instance, cannot be a grantor trust. See Reg. §1.664-1(a)(4);

Mitchell M. Gans, Stephanie E. Heilborn & Jonathan G. Blattmachr, *Some Good News About Grantor Trusts: Rev. Rul. 2004-64*, 31 Estate Planning 467, 469 (October 2004).

Where the planner does have a choice between creating a grantor trust and a nongrantor trust, generally speaking, there are a handful of situations where traditional, nongrantor trusts might be attractive.

1. Intent to Defer or Avoid State Income Tax

Beyond the federal income tax reasons, there may be compelling state income tax reasons for parking assets in a nongrantor trust. Some states determine the residence of a trust based on the residence of the grantor. Of those that follow this approach, some will not assert jurisdiction to tax the income of the trust if there are no resident trustees, no tangible assets physically located in the state, and no in-state income that would subject a nonresident to taxation. See, e.g., New York Tax Law §605(b)(3)(D) and New York Reg. §105.23.

> EXAMPLE: G, a resident of New York, irrevocably transfers intangible assets to a nongrantor trust and names a Washington (State) resident as trustee of the trust. Assuming the intangible assets do not give rise to New York-source income, New York will not tax the income from the trust's assets, although the trust will be liable for payment of federal income tax. If the trust's income consists mostly of capital gains and qualified dividend income, however, the total tax liability of the trust will be very nearly (if not exactly) equal to the amount of federal income tax that G would have paid on the trust's income if the trust was a grantor trust.

Thus in some cases grantors might seek nongrantor trust status in order to reduce the state income tax bite that would apply if the income was taxed directly to the grantor. It should be noted that some states (including New York) have a throwback rule under which the accumulated income of such a trust will be taxed by the state when such income is distributed to an in-state beneficiary. See, e.g., New York Tax Law §612(b)(40).

To save on the federal gift tax bite from forming a nongrantor trust to save on state income tax, some planners recommend use of an "incomplete nongrantor trust," often seen in print as an "ING trust." The idea here is for the grantor to surrender enough control over the trust assets such that the trust is not a grantor trust for income tax purposes while still retaining enough control over the trust assets such that the grantor does not make a completed gift of the trust assets at formation of the trust.

> EXAMPLE: G transfers property to a trust that will pay the income to G or accumulate it in the discretion of the trustee. G also retains a testamentary power to appoint the remainder among G's descendants. This limited power of

appointment renders the transfer an incomplete gift for federal gift tax purposes. See Reg. §25.2511-2(b). To ensure the trust is not a grantor trust, the trust instrument requires a "distribution committee" of adverse parties (defined below) that must approve any income distributions the trustee proposes to make to G. The Service has consistently ruled that trusts like that in this example are nongrantor trusts the transfer of property to which is not a completed gift. See, e.g., Private Letter Rulings 200731019, 200715005, 200647001, 200637025, 200612002, 200502014, 200247013, and 200148028.

Not every state has sanctioned the use of ING trusts. In 2014, New York's legislature enacted a law applicable to trusts created on or after June 1, 2014, wherein the income from an ING is taxed to the grantor, effectively neutering the ING. New York Tax Law §612(b)(41). Thus, to save on New York income tax, a grantor must make a completed gift for federal gift tax purposes. See Timothy P. Noonan and Catherine B. Eberl, *Trust Us: New York's Residency Rules For Trusts Are Complicated*, STATE TAX NOTES, August 22, 2016, 631 – 634. For residents of other states, though, ING trusts can be effective in deferring or eliminating state income tax. See Richard W. Nenno, *Minimizing or Eliminating State Income Taxes on Trusts*, West's Estate, Tax, and Personal Financial Planning, August 2018, at 12; Gordon P. Stone, III, *Tax Planning Techniques for Client Selling a Business*, 43 ESTATE PLANNING 3 (Oct. 2016); Robert W. Wood, *Sellers and Settling Litigants Lured by Tax Savings of NING and DING Trusts*, 77 STATE TAX NOTES 565 (Aug. 10, 2015).

Because states vary on the criteria for determining whether there is jurisdiction to tax, one must consult applicable state laws in designing any particular ING trust. For an excellent guide to the various bases on which states will tax the income of a nongrantor trust, see Richard W. Nenno, *Bases of State Income Taxation of Nongrantor Trusts for 2018* (2019), online at: https://www.actec.org/assets/1/6/Nenno_state_nongrantor_tax_survey.pdf.

2. Intent to Maximize the Deduction for Qualified Business Income

Enacted as part of the 2017 Tax Cuts and Jobs Act, §199A allows S corporation shareholders, partners, and sole proprietors (but not employees, C corporations, or C corporation shareholders) to deduct up to 20 percent of their "qualified business income." For an individual in the highest tax bracket, the deduction effectively reduces the tax rate on qualified business income from 37 percent to 29.6 percent.

Generally, "qualified business income" is the net amount of income, gain, loss, and deduction from an eligible trade or business, *except that* items of capital gain and loss (whether short-term or long-term) are excluded. The term also does not include certain dividends from real estate investment trusts, cooperatives, and publicly-traded partnerships, as those items are subject to special rules. If the net amount from all eligible businesses is a net loss, that net loss carries over to the next taxable year as a loss from a separate qualified trade or business.

Compensation paid to the taxpayer from the business (and guaranteed payments paid to a partner by a partnership) are not qualified business income.

Whether a taxpayer may take the deduction, and the exact amount of the deduction, is a function of the taxpayer's taxable income without regard to the deduction. Very generally, taxpayers in the four lowest tax brackets may claim the deduction without limitation. Taxpayers with taxable incomes in the three highest brackets (i.e., in 2018, taxable incomes above $157,500 for unmarried taxpayers and $315,000 for joint filers; in 2019, taxable incomes above $160,700 for unmarried taxpayers and $321,400 for joint filers) face additional limits and phaseouts on the deduction. These limitations depend on the amount of W-2 wages paid by the business and the aggregate unadjusted bases immediately after acquisition of all tangible depreciable property used in the business that is on hand on the last day of the taxable year.

Trusts and estates have the same thresholds applicable to individuals, though for purposes of determining whether the entity has taxable in excess of this threshold, taxable income is to be computed before the application of any distribution deduction. Some clients might be tempted to transfer some portion of a business to one or more trusts so as to take advantage of multiple thresholds.

> EXAMPLE: G, who had three children, operates a real estate business that generates $500,000 in qualified business income, but G's taxable income exceeds the applicable threshold described above. As a result, G faces additional limits and restrictions on the §199A deduction. G thus creates three separate nongrantor trusts, one for the benefit of each child. G then gifts a 30-percent interest in the business to each trust, keeping a 10-percent interest outright. Each trust recognizes $150,000 of income (30% x $500,000) which is less than each trust's taxable income threshold for purposes of §199A purposes. As a result, each trust may claim a full 20-percent deduction for the qualified business income and none of the additional limitations and phaseouts come into play.

Regulations finalized early in 2019 provide that "formed or funded with a principal purpose of avoiding, or of using more than one, threshold amount for purposes of calculating the deduction under §199A will not be respected as a separate trust entity for purposes of determining the threshold amount for purposes of §199A." Reg. §1.199A-6(d)(3)(vii). This regulation thwarts the planning detailed in the Example immediately above, as the facts in the Example contemplate that the only reason for the creation and funding of each trust was to multiply the number of "threshold amounts" applicable for one business activity.

Furthermore, new Regulation §1.643(f)-1 provides that where two or more trusts have substantially the same grantor(s) and substantially the same primary beneficiary or beneficiaries, the trusts will be treated as a single trust for federal income tax proposes if a principal purpose of the establishing multiple trusts is the avoidance of federal income tax. While the proposed

version of this regulation contained a rule providing that any tax savings triggered a presumption that federal income tax avoidance is a principal purpose for the use of multiple trusts, the final regulation does not contain this rule. This regulation seems easier to avoid, in that a grantor often can easily name different individuals as the beneficiary of each trust, making it so the trusts do not have "substantially the same primary beneficiary or beneficiaries."

3. Intent to Maximize the Federal Income Tax Deduction for State and Local Taxes

For 2018 through 2025, the 2017 Tax Cuts and Jobs Act limits the total deduction a taxpayer can claim for state and local taxes unrelated to the taxpayer's trade or business or other profit-seeking activity to $10,000, and the deduction for foreign real property taxes on property unrelated to a business or investment activity is repealed entirely.

Some practitioners suggest placing personal residences into a limited liability company and then transferring the LLC interests into one or more trusts taxed as separate entities. Each such trust can then claim up to $10,000 in state and local real property taxes. See Blattmachr, Shenkman and Gans, *Use Trusts to Bypass Limit on State and Local Tax Deduction*, 45:4 ESTATE PLANNING 3 (April 2018).

> EXAMPLE: G owns two residences, each of which requires that G pay $20,000 annually in property taxes. G transfers the two residences to a limited liability company, along with other investment assets that generate roughly $40,000 in annual income. G then gives 25-percent interests in the LLC to four separate nongrantor trusts. Through this strategy, each trust has around $10,000 in annual income, offset by its $10,000 share of the property tax deduction. Effectively, then, the entire $40,000 in property taxes may be deducted each year, and G still has the opportunity to deduct another $10,000 in personal state and local tax.

While the regulations under §199A have a specific rule deterring the use of nongrantor trusts to maximize the §199A deduction, there is no analogous rule in §164 or the regulations against using nongrantor trusts to maximize the deduction for personal state and local taxes. That said, there is still Regulation §1.643(f)-1, explained above. Remember that where two or more trusts have substantially the same grantor(s) and substantially the same primary beneficiary or beneficiaries, the trusts will be treated as a single trust for federal income tax proposes if a principal purpose of the establishing multiple trusts is the avoidance of federal income tax. If each trust has its own, separate beneficiaries, it would be difficult for the Service to apply this regulation.

There are other potential hurdles to consider, including the federal income tax consequences from a sale of the residences, the need to stuff income-producing assets into the

LLC to offset the claimed deductions, and the need for consent from banks on the transfer of mortgaged property.

4. Intent to Deduct Tax Preparation Fees and Miscellaneous Itemized Deductions

One commentator observes that trusts now have advantages over individuals when it comes to claiming deductions:

> There are, of course, costs to set up the trust and annual tax preparation fees. The good news is that while tax preparation fees and miscellaneous itemized deductions are no longer deductible by individuals, trusts can continue to deduct tax preparation fees in full. In addition, trusts are allowed to deduct expenses "not commonly incurred by individuals." This includes trustee fees and other costs to administer the trust. As is the case with individuals, investment advisory fees for trusts are not deductible. Therefore, if you have a trustee that also provides investment advisory services, ask him or her to "unbundle" these fees. If the trustee can do so in a "reasonable method," there may be some extra deductions for the taking."

Scott Testa, *Setting up Non-grantor Trusts for Income Tax Savings Under TCJA*, January 22 2019, available at: https://www.friedmanllp.com/insights/setting-up-non-grantor-trusts-for-income-tax-savings-under-tcja.

5. Intent to Maximize Tax Benefits of Family Charitable Giving

On page 121 of his *Estate Planning Current Developments and Hot Topics* (July 2019), Steve R. Akers explains an interesting technique using nongrantor trusts to achieve the full tax benefit from charitable contributions in a world where more taxpayers are foregoing itemized deductions in favor of a larger standard deduction:

> For a client that is taking the standard deduction and cannot benefit from charitable deductions, consider creating a simple non-grantor trust providing that the trustee can make distributions in its discretion to the client's children or to charities (specific charities could be listed if desired). If the client anticipates making charitable contributions of $10,000 per year, the trust might be funded with $250,000, which could be expected to produce $10,000 of income per year (ordinary income plus capital gains). The trust would be entitled to a §642(c) deduction for charitable distributions made from income. Furthermore, the DNI is determined after taking the §642(c) deduction, so any distributions to children would likely have little (if any) DNI carryout to the children.

See also Howard Essner, *Charitable Giving under the 2017 Tax Cut and Jobs Act* (May 23, 2018, available at: https://ancora.net/charitable-giving-2017-tax-cut-jobs-act/).

III. "THIRD-PARTY" GRANTOR TRUSTS

Subpart E does not apply exclusively to trusts where the grantor is the deemed owner of all or a portion of the trust under §§671 – 677. It also applies to trusts where beneficiaries are the deemed owners (under §678) and to certain foreign trusts with United States beneficiaries (under §679). Both of these creatures are distinct from the traditional grantor trust at focus in these materials, but a brief discussion of them may be helpful.

A. SECTION 678 TRUSTS

Under §678(a), there are situations where a beneficiary will be the deemed owner of the trust for federal income tax purposes. Most often, planners refer to trusts described in §678(a) as "beneficiary deemed owner trusts" (or "BDOTs"). Other names include "beneficiary grantor trusts," "*Mallinckrodt* trusts," "demand trusts," and "pseudo grantor trusts." These materials refer to them as §678 trusts simply to be clear that the beneficiary's deemed ownership arises under §678.

1. The Beneficiary as the Deemed Owner

A trust beneficiary will be treated as the owner of the trust if the beneficiary has the sole power to vest in the beneficiary's self the principal or income of the trust, or if the beneficiary has partially released or modified such power in a way that the retained power would (under the principles of the grantor trust rules) make the grantor the owner if such retained power were held by the grantor. Section 678(a).

> EXAMPLE: G creates a trust for the benefit of A. Although G's spouse, S, is trustee, A has the sole power to require S to distribute income to anyone A chooses, including A. If A does not make such demand currently, the income will be accumulated. A will be treated as the deemed owner of the trust's income because of A's power to withdraw the income. Accordingly, A will be taxed on the trust's income even if no current distribution is made.

> EXAMPLE: Same facts as the immediately prior Example, except that five years after trust formation, A releases the power to receive income at A's demand but retains the right to require income distributions to others, including A's lineal descendants. A is still the deemed owner of the trust's income even though A has released the power to receive income directly. This is because A has retained the

power to allocate income among others, a power similar to a §674(a) power to control beneficial enjoyment.

2. Transactions Involving a Section 678 Trust

Just as the traditional grantor trust and the grantor are seen as the same taxpayer, the §678 trust and the beneficiary are viewed as one. Consequently, a §678 trust's sale of the beneficiary's principal residence should be eligible for the §121 exclusion to the extent the trust meets the required ownership test and the beneficiary meets the required use test. See Revenue Ruling 85-45, 1985-1 C.B. 183 (§678 trust permitted to utilize beneficiary's one-time exclusion of gain under former §121 upon the sale of a residence occupied by the beneficiary).

3. Planning Opportunities with a Section 678 Trust

The planner who seeks to make the grantor the deemed owner of the trust should avoid giving a beneficiary any power that would convert the trust to a §678 trust, whether in whole or in part. But a §678 trust can offer some benefits in certain situations.

a. S Corporation Shareholder

Since the §678 trust is ignored for federal income tax purposes, it qualifies as an S corporation shareholder, assuming the beneficiary is a United States citizen or resident and not a nonresident alien individual. Section 1361(c)(2)(A)(i). The §678 trust is thus an effective device for holding S corporation stock in trust for the beneficiary's benefit.

b. Assignment of Income

If the trust beneficiary is in a lower federal income tax bracket than the grantor, use of the §678 trust can effectively and legally assign income to the beneficiary.

B. SECTION 679 TRUSTS

1. The General Rule

Under §679(a)(1), a United States person (meaning a citizen or resident of the United States) who directly or indirectly transfers property to a foreign trust shall be treated as the owner of that portion of the trust attributable to the transferred property if there is any United States beneficiary of any portion of the trust. The impact of this general rule can only be appreciated with some knowledge of the terminology.

A **foreign trust** is any trust unless *both* of the following conditions are present: (i) a United States court may exercise "primary supervision over the administration of the trust"; *and* (ii) one

or more United States persons have the authority to control all substantial decisions of the trust. Sections 7701(a)(30)(E); 7701(a)(31)(B). See also Reg. §301.7701-7. Thus, one can create a foreign trust simply by giving a foreign person (a nonresident alien individual or a foreign corporation) some substantial decision-making power, even if all other aspects of the trust (the grantor, the assets, the beneficiaries) have wholly domestic connections.

> EXAMPLE: G, a United States person, creates a trust that pays income to A, a United States person, for A's life. At A's death, the trust will terminate and the remainder will be paid to B, a United States person, or B's estate. G funds the trust with assets located and managed in the United States. The trust instrument gives F, a foreign person, a power to invade principal for the benefit of B during A's lifetime. Although this trust has significant domestic ties, it is a foreign trust.

If the trust accidentally becomes a foreign trust because a United States person with authority to control a substantial trust decision becomes a foreign person, the regulations give the trust 12 months to make whatever changes are needed to return control over all substantial decisions to United States persons. Reg. §301.7701-7(d)(2).

A trust is treated as having a **United States beneficiary** if income or principal may be accumulated or paid to or for the benefit of a United States person, or if, in the year of termination, any part of the income or principal could be paid to or for the benefit of a United States person. Section 679(c)(1).

2. Taxation of the Grantor

The mixing of three ingredients (a United States person as transferor, at least one United States beneficiary, and a foreign trust) can result in a bitter taste. In these situations, United States transferors to foreign trusts will either recognize gain on the transfer to the trust or be treated as the owner of at least a portion of the trust under Subpart E. See M. Read Moore, *Don't Even Go There—Federal Income Tax Aspects of Transfers to Foreign Trusts*, International Trust and Estate Planning (ALI-ABA, August 2005); Ellen K. Harrison, Elyse G. Kirschner and Carlyn S. McCaffrey, *U.S. Taxation of Foreign Trusts, Trusts with Non-U.S. Grantors and Their U.S. Beneficiaries*, INTERNATIONAL TRUST AND ESTATE PLANNING (ALI-ABA, August 2004).

a. Transfers to the Trust

Mere creation of a foreign trust is not a taxable event to the grantor, but transfers of property to a foreign trust may be taxable under §684. This result can also apply when any United States person transfers property to a foreign trust, even if such transferor is not the trust's grantor. Under §684, the transfer of property by a United States person to a foreign trust is treated as a sale or exchange for an amount equal to the property's fair market value. Any realized gain is recognized, but realized losses are not recognized. Gain recognition is avoided,

however, to the extent that any person (whether or not such person is the transferor) is the deemed owner of the trust under Subpart E. Section 684(b). So here's the deal: if someone will be the deemed owner of the trust under §671, then there is no tax on the transfer of appreciated property to a foreign trust. But if the trust is a separate taxable entity, transfers of appreciated property to the trust are taxable.

b. Trust Income

A United States person who directly or indirectly transfers property to a foreign trust shall be treated as the owner of that portion of the trust attributable to the transferred property if there is any United States beneficiary of any portion of the trust. Section 679(a)(1). Deemed ownership will not result if the transfer to the trust was a sale for fair market value. Section 679(a)(3)(B). If the trust gave a note as payment for the transfer, the note will be disregarded (meaning the sale will not have been at fair market value) unless the note meets certain requirements. Section 679(a)(3)(A)(i). To be respected, the note must meet the following requirements: (i) it must be reduced to writing by an express written agreement; (ii) it must not exceed five years; (iii) all payments must be denominated in United States dollars; (iv) the yield to maturity must not be less than 100 percent of the applicable Federal rate and not greater than 130 percent of the applicable Federal rate; (v) the transferor must agree to extend the period for assessment of any income tax or transfer tax attributable to the transfer and any consequential income tax changes for each year that the obligation is outstanding to a date not earlier than three years after the maturity date of the obligation; and (vi) the transferor must report the status of the loan, including principal and interest payments, on Form 3520 for each year that the loan is outstanding. Reg. §1.679-4(d).

Deemed ownership results from direct and indirect transfers to foreign trusts. Section 679(a)(1). The regulations define an indirect transfer to include a transfer made by a United States person through an intermediary if the United States person is related to a trust beneficiary (or bears some other relationship with a beneficiary that establishes a reasonable basis for the transferor making a gratuitous transfer to the foreign trust) and the United States person cannot prove, among other things, that it was the intermediary who acted independently of the United States person and not as the United States person's agent. Reg. §1.679-3(c)(2)(i).

The determination of whether a foreign trust has a United States beneficiary occurs annually. If a foreign trust has no United States beneficiaries in one year and acquires one in the next year, the United States transferor will be required to include in the next year's gross income an amount equal to all the undistributed net income of the trust at the end of the prior year attributable to his or her transfer(s) to the trust. Section 679(b).

c. Cessation of Grantor Trust Status

Section 679(a) will cease to apply on January 1 of the year following the year when it no longer has United States beneficiaries. The grantor will then be treated as transferring assets to the foreign trust on January 1, triggering §684, which will require the transferor to realize and recognize gain as if the transferred assets had been sold at that time. Reg. §1.679-2(c)(2). Similarly, the death of the grantor will trigger §684 unless the trust has been converted to domestic trust status before such time. See Moore, *supra*. If the trust is a foreign trust only because a foreign person holds some substantial decision-making power, the trust can be reclassified as a domestic trust is the foreign person relinquishes that power.

IV. HOW TO CREATE A GRANTOR TRUST

Whether one seeks to create a grantor trust or to avoid grantor trust status, one must be closely familiar with the list of powers that make the grantor (or another) the deemed owner of all or a portion of a trust. This portion of the materials offers a detailed guide to these powers. To understand how these powers work, however, one must first understand how the Internal Revenue Code classifies the types of individuals who may hold (or block the exercise of) the powers.

A. THE SUBPART E CAST OF CHARACTERS

Many of the rules in Subpart E involve more than just the **grantor**, the tax term for the settlor or creator of the trust. Deemed ownership of trust property and the income therefrom often turns on the presence and role of certain other persons. Accordingly, §672 offers definitions for other important players featured in Subpart E.

1. Adverse Party (AP) and Nonadverse Party (NAP)

An **adverse party** (AP) is anyone with a *substantial beneficial interest* in the trust that would be *adversely affected* by the exercise or non-exercise of a power with respect to the trust. Section 672(a). Not surprisingly, a **nonadverse party** (NAP) is anyone who is not an AP. Section 672(b). Generally, if a trust-related power may be exercised only with the consent or permission of an AP, such power by itself will not render the powerholder the tax owner of the portion of the trust to which the power relates.

What does it mean to have a "substantial beneficial interest" in the trust? We know from the Code that a general power of appointment over all or a portion of the trust property is sufficient. Section 672(a). Beyond that, however, Treasury will only say that "[a]n interest is a substantial interest if its value in relation to the total value of the property subject to the power is not insignificant." Reg. §1.672(a)-1(a). The regulations state that a contingent income beneficiary can qualify as an AP, Reg. §1.672(a)-1(c), but case law indicates otherwise. See, e.g.,

Fulham v. Commissioner, 110 F.2d 916 (1st Cir. 1940) (contingent income beneficiary not an AP); *Holt v. United States*, 669 F. Supp. 751, 752 (W.D. Va. 1987) (contingent remainder beneficiaries who also served as trustees were not APs because they held "an extremely remote contingent interest … and … not … a 'substantial interest'"). Because there is no definite threshold for having a "not insignificant" interest, one must proceed with caution in all but the most obvious cases.

Furthermore, merely having a substantial beneficial interest in the trust does not make a person an AP. To be an AP, that beneficial interest must be "adversely affected" by the exercise or non-exercise of a power over the trust. In most cases, a beneficiary is an AP because that beneficiary would be hurt by the grantor's exercise of a power over the trust. But if the beneficiary only holds a partial interest in the trust, the beneficiary may be an adverse party only as to some portion of the trust.

> EXAMPLE: G created a trust that pays income in equal shares to Mo, Larry, and Curly. G may, with the consent of Mo, revoke the trust. G will be treated as the owner of two-thirds of the trust because the power to revoke triggers grantor trust status, see §676(a), and because Mo is adverse to the exercise of the revocation power only as it affects Mo's one-third share of the income. Mo is not an AP with respect to the other two-thirds of the trust. Consequently, two-thirds of the trust's income will be taxed to G. See Reg. §1.672(a)-1(b).

2. Related or Subordinate Party (RSP)

In some cases, powers held or actions performed by a **related or subordinate party** (RSP) will be imputed to the grantor. A person is an RSP (with respect to the grantor) if such person meets two tests. First, such person must be a NAP. The definition of a NAP is supplied above. Second, such person must bear one of the following eight relationships to the grantor: (1) the grantor's spouse; (2) the grantor's parent; (3) the grantor's issue; (4) the grantor's sibling; (5) the grantor's employee; (6) a corporation in which either or both the grantor and the trust have "significant" voting power (a "controlled corporation"); (7) an employee of a controlled corporation; or (8) an employee of a corporation in which the grantor is an executive. Section 672(c).

Curiously, no partnership in which the grantor or the trust is a partner will qualify as an RSP. The same is true of most limited liability companies, at least those that are treated as partnerships or sole proprietorships for federal tax purposes. (Recall that Reg. §301.7701-3 classifies most unincorporated domestic business entities as partnerships where there are two or more owners or as sole proprietorships where there is a single owner, though in either case the business may elect to be treated as a corporation for federal tax purposes.)

3. Subservient RSP

In some cases, powers and actions of RSPs will be imputed to the grantor only if the RSPs are **subservient** to the grantor with respect to the exercise or non-exercise of a power. An RSP is presumed subservient only for purposes of §§672(f), 674, and 675. Section 672(c). That presumption may be rebutted only upon a showing by the preponderance of the evidence that such person is not subservient. *Id.*

B. POWERS CONFERRING GRANTOR TRUST STATUS

Subpart E enumerates several powers, any one of which will render the grantor or some other person as the owner of all or a portion of the trust for federal income tax purposes. This portion of the outline describes several powers that a grantor may hold and, for each, indicates whether the power creates a grantor trust for federal income tax purposes and whether holding the power triggers inclusion in the grantor's gross estate for federal estate tax purposes.

1. Reversions

A reversion is a power to reclaim possession or enjoyment of the trust property. To the extent the grantor has a decent chance of reclaiming possession of property held in trust, it is fair to consider the grantor as owner of the property subject to the reversion.

a. Income Tax Aspects

If the grantor holds a reversionary interest in any portion of the trust's principal or income, the grantor will be treated as the owner of that portion of the trust if, at the inception of that portion of the trust, the value of the reversion exceeds five percent of the value of the trust portion to which the reversion relates. Section 673(a). Planners seeking to avoid grantor trust status should thus make sure either that the grantor retains no reversionary interest at all or that the value of the grantor's reversion is limited to no more than five percent of the value of the trust portion to which the reversion relates.

Planners seeking grantor trust status through use of a reversion should be careful of a three-part exception. If the beneficiary of the trust is a lineal descendant of the grantor, *and* if that beneficiary holds all present interests in any portion of the trust, *and* if the grantor's reversion takes effect upon the beneficiary's death if death occurs before the beneficiary reaches age 21, then the grantor is not treated as the owner of such portion of the trust. Section 673(b).

b. Estate Tax Aspects

A reversionary interest sufficient to trigger grantor trust status typically is also sufficient to trigger inclusion in the grantor's gross estate. Section 2037. Where one intentionally seeks

gross estate inclusion of the trust assets at the grantor's death, then, giving the grantor a reversion is a viable strategy.

Gross estate inclusion under §2037 results when both the *survivorship test* (§2037(a)(1)) and the *reversion test* (§2037(a)(2)) are met. In order to meet the survivorship test, a beneficiary's possession or enjoyment of the property at issue must be obtainable only by surviving the grantor. The reversion test is met if the grantor retained a reversionary interest in the subject property and the value of the reversion immediately before the grantor's death exceeded five percent of the value of the subject property. If §2037(a) applies, the amount includible is the value of all property subject to the grantor's reversionary interest.

(1) Survivorship Test

The survivorship test requires that a beneficiary be able to take *only* by surviving the grantor. If the beneficiary can take ownership by any other means, such as through the exercise of a general power of appointment, the survivorship test is not met. Section 2037(b).

EXAMPLE: G creates an irrevocable trust that pays income to A for life and the remainder to G if G is then living. If G is not then living, the remainder will be paid to B or B's estate. The trust instrument also gives A a power to appoint all or any portion of the trust property to anyone A chooses during A's lifetime. Because A could appoint the trust property to B during A's lifetime, it is not necessary for B to survive G in order to obtain ownership of the property. Thus, no matter whether A in fact exercises this power in favor of B, the survivorship test is not met. So if G predeceases A and B, §2037(a) will not apply to include the value of B's contingent remainder in G's gross estate.

(2) Reversion Test

The reversion test is met when the grantor retained a reversion, whether expressly or by implication or by operation of law. Thus, it is not necessary for the instrument of transfer to explicitly refer to the grantor's reversion. Reg. §20.2037-1(c)(2). If the grantor's reversion affects only the rights to income from the transferred property, however, the reversion test is not met. Section 2037(b); Reg. §20.2037-1(c)(2).

EXAMPLE: G creates an irrevocable trust that pays income to A for A's life, then income to G if G is then living. If G is not then living (or upon the death of G), the trust shall terminate and the remainder shall be paid to B or B's estate. G's reversion relates only to the income interest. Accordingly, the reversion test is not met so §2037 does not apply. Of course, G's retained right to income might

implicate §2036(a), as discussed below in the context of powers to control beneficial enjoyment.

Under §2037(b)(2), the grantor's power to allocate the property between two or more beneficiaries is treated as a reversionary interest. This makes sense because the power to choose the appointee of property is akin to ownership of the property.

EXAMPLE: G creates an irrevocable trust that pays income to A for A's life and the remainder to either B or C, to be chosen by G either during G's lifetime or in G's will. If G fails to appoint the remainder by the time A dies, the remainder will be paid in equal shares to B and C (or their estates if they do not survive A). G's power to appoint the remainder as between B and C is treated as a reversionary interest, so the reversion test is met. In addition, the survivorship test is met because B and C must survive G to know if there will be an interest to take. Assuming the value of G's "reversion" exceeds five percent of the value of the trust property, the value of the remainder interest must be included in G's gross estate under §2037.

(3) Valuation Issues

As mentioned above, §2037 does not apply if the value of the grantor's reversionary interest does not, because of the contingencies affecting the likelihood of occurrence, exceed five percent of the value of the transferred property immediately before the grantor's death. In determining whether the value of the reversion exceeds this five-percent threshold, the value of the reversion is compared to the value of the transferred property, including those interests not dependent upon surviving the grantor. Reg. §20.2037-1(c)(4). The value of the reversion is computed with reference to mortality tables and actuarial principles set forth in the regulations to §2031. Section 2037(b); Reg. §20.2037-1(c)(3). On the income tax side, one assumes "the maximum exercise of discretion in favor of the grantor" when valuing the grantor's reversionary interest. Section 673(c).

2. Powers to Control Beneficial Enjoyment

Generally, the power to dispose of the beneficial enjoyment of trust property is equivalent to ownership of the trust property. Not surprisingly, holding such a power triggers grantor trust status and the risk of estate tax inclusion upon the power-holder's death.

a. Income Tax Aspects

The grantor will be considered as the owner of that portion of the trust where beneficial enjoyment of the principal or income therefrom is subject to a power of disposition that is

exercisable by the grantor or an NAP (or both) without the consent or approval of any AP. Section 674(a).

> EXAMPLE: G creates a trust that pays income to A for A's life. At A's death, the trust will terminate and the remainder will be paid to B or B's estate. G retains a power to appoint income or principal to C during the shorter of A's life or G's life. Because G retains the absolute power to dispose of income or principal in favor of C, the trust is a grantor trust. There are also estate tax implications to holding this power, as explained below.

> EXAMPLE: G creates an irrevocable trust for the benefit of G's sibling, S. G names a NAP as trustee. The trustee has the power to add one or more §501(c)(3) organizations as beneficiaries to the trust. G is treated as the owner of the trust for federal income tax purposes. *Madorin v. Commissioner*, 84 T.C. 667 (1985). Assuming G has no retained interest in the trust and no direct power to alter or amend the terms of the trust, no portion of the trust will be included in G's gross estate.

The Code contains a number of exceptions to this general rule. For ease of reference, these exceptions have been categorized into three groups based on the identity of the power-holder: (1) powers which will not trigger grantor trust status regardless of who holds them; (2) powers of trustees that will not trigger grantor trust status if at least half of the trustees are independent and the grantor is not a trustee; and (3) powers that will not trigger grantor trust status if they are held by trustees other than the grantor or the grantor's cohabitating spouse.

(1) Non-Triggering Powers Held by Anyone

Certain powers to affect beneficial enjoyment of trust property will not trigger grantor trust status even if they are held by the grantor, an AP, an NAP, an RSP, some other person, or some combination of the foregoing.

(a) Powers to Apply Income to Support a Dependent

The grantor is not considered to own any portion of a trust merely because someone other than the grantor holds a discretionary power to pay income for the support of a beneficiary the grantor is legally obligated to support. See §§674(b)(1); 677(b); Reg. §1.674(b)-1(b)(1). Such a power, however, will trigger inclusion in the grantor's gross estate under §2036. See Reg. §20.2036-1(b)(2) and the discussion below.

Note that if a power to pay income for the support of someone the grantor is legally obligated to support is actually exercised, the grantor may be taxed on the income so used to furnish support. Section 677(b).

(b) Powers Affecting Enjoyment Only After a Period

The grantor is not considered to own currently any portion of a trust that is subject to a power to affect beneficial enjoyment of the income received after some event occurs, provided that the power (if it were a reversion) would not give rise to current ownership under §673. Section 674(b)(2); Reg. §1.674-1(b)(2).

> EXAMPLE: G creates a trust in Year One that pays income to G's child annually. The trust instrument gives G a power to substitute beneficiaries of the income interest and/or the remainder interest beginning in Year Eleven. G is not considered the owner of the trust's income from Year One through Year Ten, but G will be considered as the owner beginning in Year Eleven unless G surrenders the power to substitute beneficiaries before then.

(c) Testamentary Powers

In most cases the grantor is not considered the owner of a trust where a power to control beneficial enjoyment of the trust is exercisable only by will. Section §674(b)(3); Reg. §1.674(b)-1(b)(3). This exception does not apply, however, to a power to appoint trust income (whether allocated to income or principal) accumulated for disposition under the grantor's will, whether such accumulation is required by the trust instrument or occurs in the discretion of the grantor or an NAP (or both) without the consent of an AP.

> EXAMPLE: G creates a trust that accumulates income during G's life. The trust instrument gives G a testamentary power to appoint such accumulated income and provides for a taker in default of appointment. G is treated as the owner of the trust.

> EXAMPLE: G creates a trust that pays income to A or A's estate during G's life. The trust instrument gives G a testamentary power to appoint the remainder of the trust and provides for a taker in default of appointment. Under local law and the trust instrument, capital gains are allocated to principal. G is considered the owner of that portion of the trust to which capital gains have been allocated. Reg. §1.674-1(b)(3).

(d) Powers to Pick Charitable Beneficiaries

A power to determine the beneficial enjoyment of income or principal that has been irrevocably dedicated to a charitable organization or an employee stock ownership plan will not cause the grantor to be treated as owner of any portion of the trust. Section 674(b)(4); Reg. §1.674(b)-1(b)(4).

EXAMPLE: G creates an irrevocable trust that pays income annually to any charitable organization(s) of G's choosing each year, provided that such organizations are described in §170(c). Although G has the power to affect beneficial enjoyment of the trust's income, this power alone will not trigger grantor trust status.

(e) Powers to Distribute Principal

A power to distribute trust principal to an identified beneficiary or among a class of beneficiaries will not cause the grantor to be treated as the owner of the trust to any extent, provided this power is limited by a "reasonably definite standard" set forth in the trust instrument. Section 674(b)(5)(A). This exception does not apply to a power to *add* beneficiaries, unless the power is limited to the addition of after-born or after-adopted children. See §674(b)(5), flush; Reg. §1.674(d)-2(b).

"A clearly measurable standard under which the holder of a power is legally accountable is deemed a reasonably definite standard for this purpose." Reg. §1.674(b)-1(b)(5)(i). Thus, a power to distribute principal for the maintenance, education, support, or health of a beneficiary will not trigger grantor trust status. Likewise, the regulations state that principal distributions for "reasonable support and comfort" will qualify for the exception, as well as distributions that allow the beneficiary to "maintain his accustomed standard of living." *Id.* Powers to distribute principal for "happiness," "desire," or "pleasure," however, are listed as examples of standards that will not qualify as reasonably definite. See, e.g., Reg. §1.674(b)-1(b)(5)(iii), Ex. (2) ("happiness").

Powers to distribute principal that are not limited by a reasonably definite standard will not trigger grantor trust status if such distributions may be made only to current income beneficiaries and only if such distributions are "chargeable against the proportionate part of corpus held in trust for payment of income to that beneficiary as if it constituted a separate trust." Reg. §1.674(b)-1(b)(5)(ii). See §674(b)(5)(B).

(f) Powers to Withhold Income Temporarily

A power to determine whether to pay income to (or withhold income from) the income beneficiary will not trigger grantor trust status, provided any accumulated income is ultimately

paid to the income beneficiary (or to such beneficiary's estate or appointees). See §674(b)(6); Reg. §1.674(b)-1(b)(6)(i). This rule acknowledges that a mere power to affect the *timing* of the enjoyment of income does not rise to a level of ownership sufficient to impute trust income to the grantor. Where there is more than one current income beneficiary, the power to accumulate income can qualify for this exception even if the income is ultimately payable on termination of the trust to the current income beneficiaries in a manner irrevocably specified in the trust instrument. See §674(b)(6)(B); Reg. §1.674(b)-1(b)(6)(i)(*c*).

> EXAMPLE: G creates a trust that pays income in equal shares to A and B until B reaches age 30. At that time, the trust will terminate and the remainder will be paid in equal shares to A and B (or their estates). The trust instrument also gives G the power to withhold from either A or B any part of their respective shares of income in any year and add such amounts to the principal of the trust. G routinely exercises this power by withholding the income payable to A and adding it to principal. Upon termination of the trust, A and B will each take one-half of the principal (which includes A's income that was accumulated). Even though G's power effectively allowed G to shift half of the accumulated income from A to B, G is not deemed to be the owner of the trust at any time under these facts. Reg. §1.674(b)-1(b)(6)(ii), Ex. (1).

(g) Powers to Withhold Income During Disability

A power to withhold income during an income beneficiary's disability will not trigger grantor trust status. Section 674(b)(7). This exception also applies to a power to withhold income from a minor. The exception does not require that any accumulated income be held for ultimate distribution to the income beneficiary; any accumulated income may be added to principal and distributed to the remainder beneficiaries even if they are not the same as the income beneficiary. Reg. §1.674(b)-1(b)(7).

> EXAMPLE: G creates a trust that pays income to G's minor child, C, for C's life. At C's death, the remainder will be paid to G's then living grandchildren. The trust instrument gives G the power to accumulate income and add it to principal while C is under age 21. G is not considered the owner of the trust to any extent.

(h) Power to Allocate Between Income and Principal

To the extent the identity of the income and remainder beneficiaries are different, the power to allocate receipts between income and principal is certainly a power that affects the beneficial enjoyment of the trust's receipts. Yet such a power will not, by itself, trigger grantor trust status, even if such power is held in a non-fiduciary capacity. Section 674(b)(8); Reg. §1.674(b)-1(b)(8).

(2) Non-Triggering Powers Exercisable Only by Independent Trustees

Certain powers to affect beneficial enjoyment will not give rise to grantor trust status provided such powers are held and exercisable only by independent trustees. Specifically, an independent trustee's power to pay or accumulate income or principal to a beneficiary or to a class of beneficiaries will not impute ownership of the trust assets to the trustee or to any other person, provided the independent trustee may not add to the class of permissible beneficiaries. Section 674(c). For this purpose, the grantor is not an independent trustee, and a person who is an RSP subservient to the grantor is not an independent trustee. If there is more than one trustee, *more than half* of the trustees must be independent trustees in order for this exception to apply. Reg. §1.674(c)-1.

> EXAMPLE: G creates a trust that will pay income to A, B, and C as determined by the trustee. G names an independent trustee. No one is the deemed owner of the trust for federal income tax purposes because the power to allocate the income among A, B, and C rests with an independent trustee.

> EXAMPLE: Same facts as the immediately prior Example, except that G names two trustees, T (an independent trustee) and R (an RSP who is subservient to G). G is the deemed owner of the trust's income for federal income tax purposes because only half of the trustees are independent of G.

If the grantor holds a power to remove, replace, or add trustees, such power might preclude the application of this exception if the exercise of the power would violate the independent trustee requirement. Reg. §1.674(d)-2(a).

> EXAMPLE: G creates a trust that gives the trustee the power to pay income to A or, alternatively, to accumulate the income and add it to principal. At A's death, the trust will terminate and the remainder will be paid to B or B's estate. G names T, an unrelated individual, as the initial trustee, but the trust instrument gives G the power to replace T and name any other person as trustee. G is deemed the owner of the trust's income for federal income tax purposes because G holds a power to replace T with a subservient RSP (or even to name G as trustee), and that trustee would have the power to control beneficial enjoyment of the trust's income.

(3) Non-Triggering Powers Over Income Exercisable by Trustees Other Than Grantor or Spouse

A power to pay, allocate, or accumulate income according to "a reasonably definite external standard … set forth in the trust instrument" shall not give rise to grantor trust status as long as such power is held and exercisable (without anyone's approval or consent) by a trustee or trustees, none of whom is the grantor or the grantor's cohabitating spouse and provided such power does not include a power to add beneficiaries. Section 674(d); Reg. §1.674(d)-2(b). A standard that meets the requirements of §674(b)(5)'s "reasonably definite standard" is sufficient to meet the "reasonably definite external standard" imposed here. See Reg. §1.674(d)-1.

b. Estate Tax Aspects

Generally, the power to control beneficial ownership of trust property will require inclusion in the grantor's gross estate under either §2036 or §2038 (or both).

(1) Inclusion Under §2036(a)

Among other things, §2036(a) includes in the grantor's gross estate the value of any property gratuitously transferred by the grantor in which the grantor retained the right to designate who shall receive the income from (or the possession or enjoyment of) the transferred property for either the grantor's life, for a period not ascertainable without reference to the grantor's death, or for a period which does not in fact end before the grantor's death.

> EXAMPLE: G transfers property to an irrevocable trust. At G's death, the trust will terminate and the remainder will pass in equal shares to G's children, J and K. The trust instrument gives G the power to allocate the trust's annual income between J and K in G's sole discretion. If G dies survived by J and K, G's gross estate will include the value of the property transferred to the trust because G retained the power to control enjoyment of the income from the transferred property for G's life.

> EXAMPLE: Same facts as the immediately prior Example, except that the trust instrument gives G the power to allocate the trust's annual income between J and K in G's discretion, but only for a 10-year period beginning upon formation of the trust. G dies on the sixth anniversary of the trust's formation. Because G retained the power to allocate income for a period that did not end prior to G's death, §2036(a) requires inclusion of all trust property in G's gross estate.

If the grantor's retained power to affect beneficial enjoyment does not affect another's prior income interest in the same property, the amount included in the gross estate is the value

of the transferred property less the value of such outstanding income interest. Reg. §20.2036-1(a).

EXAMPLE: G transfers property to an irrevocable trust. The trust instrument provides that income from trust property shall be paid annually to A for A's life, then to whomever G decides if G is then living. Upon the death of both A and G, the remaining trust property shall be distributed to B or B's estate. G dies survived by A. Although G retained the power to allocate income from the transferred property, the power only related to income paid after A's income interest expired. Thus, the amount included in G's gross estate is equal to the value of the trust property less the value of A's income interest as of the date of G's death.

A grantor's retained power to choose among beneficiaries, even if such power is exercisable only in the capacity of a trustee, will generally trigger gross estate inclusion under §2036(a). Reg. §20.2036-1(b)(3)(ii). The grantor's power to choose, however, must have some effect on the enjoyment of the income earned from the trust property. Reg. §20.2036-1(b)(3). If the grantor's power does not affect the enjoyment of the income, §2036(a) will not apply (though most likely §2038 will apply, as explained below). Often, this problem is solved by naming an independent trustee. But §2036(a) will still apply even with an independent trustee if the grantor retains the power to replace the trustee and the class of permissible successors includes the grantor or an RSP. See, e.g., *Rev. Rul. 95-58*, 1995-2 C.B. 191.

LEAD EXAMPLE: G creates an irrevocable trust that gives A or A's estate the right to income for G's life. Upon G's death, the trust will terminate and the remainder will pass to B or B's estate. The trust instrument names G as the trustee, and it gives the trustee the power to invade principal at any time for the benefit of B. Although G's power is exercisable only in G's capacity as trustee, G has effectively retained the power to designate who will enjoy the trust property and the income therefrom (either A or B). Thus, §2036(a) applies and the value of the entire trust corpus will be included in G's gross estate.

EXAMPLE: Same facts as the Lead Example, except that instead of having the power to invade principal for B, the trust instrument gives G (as trustee) the power to accumulate income and add it to corpus. Here again, G effectively holds the power to decide whether the income will be paid to A or added to the amount that B will take. Accordingly, the result is the same: the value of the trust property will be included in her gross estate. *United States v. O'Malley*, 383 U.S. 627 (1966).

EXAMPLE: Same facts as the Lead Example, except that instead of having the power to invade principal for B, the trust instrument gives G (as trustee) the power to invade principal for the benefit of A. Although G holds the power to decide who

ultimately enjoys the trust property, §2036(a) does not apply in this example because G's power has no effect on the enjoyment of the income earned on the property. No matter whether G exercises the power, A or A's estate will enjoy the income from the property contributed to the trust. Accordingly, no portion of the trust property is included in G's gross estate under §2036(a). Reg. §20.2036-1(b)(3).

EXAMPLE: Same facts as the Lead Example, except that the trust instrument names T, who is not an RSP with respect to G, as the trustee and the trust instrument gives the trustee no power to invade principal or accumulate income. No portion of the trust property will be included in G's gross estate unless the trust instrument gives G the power to substitute G or an RSP as trustee. Reg. §20.2036-1(b)(3); *Rev. Rul. 95-58*, 1995-2 C.B. 191.

Where the grantor insists on serving as trustee, the trustee's discretion to distribute income or principal to beneficiaries should be limited to an ascertainable standard related to the maintenance, education, support, or health of a beneficiary. When a trustee's discretion is so limited, the trustee is seen as having merely a ministerial power and not a discretionary power to control beneficial enjoyment of trust property. *Jennings v. Smith*, 161 F.2d 74 (2d Cir. 1947).

(2) Inclusion Under §2038

Section 2038 is commonly understood to include revocable transfers in the gross estate, but §2038 is not limited to situations where the grantor holds a power to revoke the wealth transfer. Powers to alter or amend a transfer of property also trigger gross estate inclusion under §2038, even if the transfer is otherwise irrevocable. Thus, to the extent powers to control beneficial enjoyment of trust income or principal are also powers to alter or amend the grantor's wealth transfer, such powers will cause inclusion of the trust property in the grantor's gross estate.

EXAMPLE: G transfers property to an irrevocable trust that requires income to be paid to A for G's life. Upon G's death, the remainder of the trust estate is to be distributed to B or B's estate. The trust instrument gives G the power to name a new remainder beneficiary. If G dies never having executed this power, G's gross estate nonetheless includes the value of B's remainder interest (here, the entire value of the trust property, because the income interest has expired at G's death) because it was subject to G's power of alteration.

The capacity in which a power to alter or amend a trust is of no consequence. Thus, even if the transferor holds a power to alter or amend in a fiduciary capacity, §2038 still applies. Moreover, even if the grantor is not the named trustee of a trust, the grantor still risks inclusion

under §2038(a)(1) if the grantor retains the power to substitute himself or herself as trustee, provided the trustee has some power to alter or amend the beneficial enjoyment of the trust property. Reg. §20.2038-1(a)(3).

Avoiding inclusion under §2038 is similar to avoiding §2036 inclusion: where the grantor of a trust also wants to serve as trustee, the trustee's discretion to distribute income or principal to beneficiaries should be limited to an ascertainable standard related to the maintenance, education, support, or health of a beneficiary. When a trustee's discretion is so limited, the trustee is seen as having merely a ministerial power and not a discretionary power to alter or amend the original transfer (which would cause inclusion under §2038) or a power to control beneficial enjoyment of trust property (which would cause inclusion under §2036). See *Jennings v. Smith*, *supra*.

Even the mere power to alter the *timing* of a beneficiary's interest is enough to trigger the application of §2038(a) if all other requirements are met. For instance, where the grantor created a trust that paid income to a non-dependent beneficiary for a term of years before distributing the corpus to that same beneficiary (or that beneficiary's estate), the grantor's retained power (as trustee) to accumulate trust income and add it to corpus was enough to cause inclusion of the trust property in the grantor's gross estate under §2038(a) because the grantor died during the trust term with a power to control the timing of when the beneficiary would receive the income (either currently or upon termination of the trust term). *Lober v. United States*, 346 U.S. 335 (1953). Likewise, where the grantor retained a power to invade principal for the benefit of the term income beneficiary who was also the remainder beneficiary of the trust, the value of the remainder interest was included in the grantor's gross estate because of the grantor's power to alter the timing in which the principal is distributed to the beneficiary. *Rev. Rul. 70-513*, 1970-2 C.B. 194.

Where the grantor dies holding mere administrative powers with respect to transferred property, §2038(a) should not apply. Thus, if a grantor-trustee held the power to invest trust assets and allocate receipts between income and principal, these powers alone should not cause inclusion under §2038(a).

(3) Overlap Between §§2036(a) and 2038

Because both §§2036(a) and 2038 look to retained powers over gratuitously transferred property, it should come as no surprise that inclusion of the same property may be required by both Code sections. Where that happens, of course, the value of the property is only included in the gross estate once.

LEAD EXAMPLE: G creates an irrevocable trust that pays income to A or A's estate for G's life. At G's death, the trust will terminate and the remainder will be paid to B or B's estate. In addition, G, as trustee of the trust, holds the power to invade

the principal of the trust for the benefit of C. G's power to invade the principal of the trust renders A's income interest and B's remainder interest vulnerable to G's power, so if G dies holding this power to "alter" the transfer, the trust assets will be included in G's gross estate under §2038. In addition, §2036(a) would apply because of G's retained power to control enjoyment of the trust assets for a period measured by her life. Although both §§2036(a) and 2038 require inclusion in G's gross estate, the trust property will be included only once.

EXAMPLE: Same general facts as the Lead Example, except that G's power as trustee is to substitute C for B as the remainder beneficiary. Under §2038, G still holds a power to "alter" the enjoyment of the remainder interest so the value of the remainder interest (which will be the value of the entire trust property since A's income interest expires at G's death) will be included in G's gross estate. But §2036(a) would not apply because G's power does not affect enjoyment of the income received by A or A's estate during G's lifetime. If the grantor's retained interest does not affect the right to income from the transferred property, §2036(a) does not apply. Although §§2036(a) and 2038 reach opposite results, the value of the remainder interest is included in G's gross estate, for inclusion is required if any one Code provision supports it.

EXAMPLE: Same general facts as the Lead Example, except that G names D, an unrelated individual who is not an RSP, as the trustee. D thus holds the power to invade the principal for the benefit of C. Since G has retained neither a power to alter, amend, revoke, or terminate the trust nor retained a power to control beneficial enjoyment of the trust property, neither §2036(a) nor §2038 applies. No portion of the trust property will be included in G's gross estate.

3. Administrative Powers

Normally, mere administrative powers would not give rise to deemed ownership. Administrative powers usually do not affect beneficial enjoyment of the property and do not represent a retained interest in the trust assets. Where an administrative power gives the grantor the opportunity to engage in some non-arms-length transactions with the trust, however, that power is sufficiently equivalent to ownership that it is fair to treat the grantor as the owner of that portion of the trust to which the power relates.

Section 675 lists six administrative powers that give rise to grantor trust status. Planners seeking grantor trust status, therefore, may obtain it by adding one of these powers to the trust instrument, although it should be noted that the addition of some of these powers alone will not make the grantor the deemed owner of the entire trust, since the powers may only relate to a portion of the trust (i.e., income or principal). On the other hand, planners seeking to avoid

grantor trust treatment should make sure that the following powers are not included in the trust instrument.

The possession of administrative powers over a trust at death does not typically result in gross estate inclusion of the trust assets. But this general statement has little probative value. Each trust administrative power held by a decedent should be examined to determine whether gross estate inclusion is required. Accordingly, this section will pair the estate tax implications of possessing the powers identified in §675 as giving rise to grantor trust status for income tax purposes.

a. Transactions for Less Than Full Consideration

Income Tax. The grantor will be treated as the deemed owner of the trust where the grantor or a NAP (or both) may exercise a power, without the approval or consent of an AP, to enable anyone to purchase, sell, exchange, or otherwise deal with or dispose of trust principal or income for less than "an adequate consideration in money or money's worth." Section 675(1). A trustee does not hold this power merely because a trust instrument grants broad powers to the trustee to deal with trust property, but where a trustee engages in non-arms-length transactions in the actual administration of the trust pursuant to such a broad grant of power, the Service may infer that the trustee indeed has the power to deal trust assets for less than adequate consideration. Reg. §1.675-1(c).

Gross Estate Inclusion? A grantor who dies holding a power to deal trust property for less than full consideration might face gross estate inclusion of the trust property subject to the power under §2036(a), for the grantor has arguably retained a right to designate who can enjoy trust property. If the grantor surrendered this right (which might jeopardize grantor trust status for income tax purposes, remember) within three years of death, the trust assets will still be includible in the grantor's gross estate. See §2035(a).

Since §2036(a) cannot apply if the power to designate enjoyment of trust property is held by anyone other than the decedent, Reg. §20.2036-1(b)(3), a planner can keep trust assets outside the grantor's gross estate by giving a NAP the power to deal trust property for less than full consideration. This would make the grantor the owner of the trust for income tax purposes under §675(1) but would not run the risk that the trust assets would be included in the grantor's gross estate at death. The NAP does not face gross estate inclusion either because the NAP was not the party that made the "transfer" to the trust, as required by §2036(a).

b. Borrowing Without Adequate Interest or Security

Income Tax. The grantor will be treated as the deemed owner of at least a portion of the trust where the grantor or an NAP (or both) may exercise a power that enables the grantor to borrow principal or income without having to pay adequate interest or without having to give

adequate security for the loan. Section 675(2). This rule will not apply, however, where a trustee (other than the grantor) has a general power under the trust instrument to make loans to anyone without regard to the payment of adequate interest or the giving of adequate security. *Id*. See also Reg. §1.675-1(b)(2). Furthermore, if the grantor-trustee has a general power under the trust instrument "to determine interest rates and the adequacy of security," it does not necessarily follow that the grantor holds a power to borrow principal or income without adequate interest or security. Reg. §1.675-1(b)(2).

Borrowing on a below-market interest basis, however, is fraught with income and gift tax consequences. See §7872. Accordingly, most planners seeking to create a grantor trust through a §675(2) borrowing power should provide that any such loans must require the grantor to pay adequate interest. As long as the grantor (or the NAP or both) has an express power to borrow from the trust on an unsecured basis, grantor trust status exists.

Gross Estate Inclusion? A power of the grantor to borrow from the trust without having to pay adequate interest or without having to give adequate security should not cause gross estate inclusion of the trust property. Such a power does not affect beneficial enjoyment of the trust property and does not constitute a power to alter or amend the terms of the trust. This power is thus a good candidate for planners seeking to create a "defective grantor trust," one where the grantor is the deemed owner of the assets for income tax purposes though such assets will not be included in the grantor's gross estate.

c. Loans Outstanding at End of Year

Income Tax. The grantor will be the deemed owner of at least a portion of the trust to the extent the grantor or the grantor's spouse has actually borrowed principal or income from the trust and has not completely repaid the amount borrowed (including interest) before the start of the taxable year. Section 675(3). Deemed ownership will not occur, however, if the loan provides for both adequate interest and adequate security, assuming the loan was made by a trustee other than the grantor, the grantor's spouse, or an RSP subservient to the grantor. Reg. §1.675-1(b)(3).

At least one court has held that "the borrowing of trust property or trust income by the grantor at any time during the taxable year will result in the taxability of the grantor on the income of that year." *Mau v. United States*, 355 F. Supp. 909 (D. Hawaii 1973). This suggests that a grantor could borrow trust assets on an unsecured basis on the last day of the taxable year with the result that the trust would be a grantor trust for the entirety of that taxable year.

Furthermore, in Revenue Ruling 86-82, 1986-1 C.B. 253, the Service ruled that the grantor was the deemed owner of a portion of a trust as a result of borrowing from that portion of the trust during the taxable year, even though the grantor repaid the loan with interest during the same year. The Service rejected the taxpayer's argument that §675(3) did not apply since the loan was not outstanding on either the first day or the last day of the year.

Gross Estate Inclusion? Merely borrowing from the trust would not necessarily indicate that the grantor has retained ownership of the trust property sufficient to warrant inclusion in the gross estate. For instance, where the grantor borrows trust principal from an independent trustee on an unsecured basis but has agreed to pay adequate interest to the trust, it is difficult to see how §2036 or §2038 (or any other gross estate inclusion provision) would be invoked. Thus, this power is also a good candidate for planners seeking to create an irrevocable grantor trust that will avoid gross estate inclusion. In fact, this is likely a better power than the §675(2) power to borrow without adequate interest or security, for grantor trust status can be turned "on" or "off" as desired by the grantor in advance of each year, as explained below.

d. Power to Vote Stock

Income Tax. Any person's power (exercisable in a nonfiduciary capacity and without anyone's consent) to vote or direct the vote of corporate stock or securities held by a trust in will make the grantor the deemed owner of such stock for income tax purposes if the combined holdings of the grantor and the trust are "significant" in terms of voting control. Section 675(4)(A). If this power is held by a trustee, the regulations presume that the power to vote or direct the vote is exercisable in a fiduciary capacity, a presumption rebuttable "only by clear and convincing proof that the power is not exercisable primarily in the interests of the beneficiaries." Reg. §1.675-1(b)(4). There is no official guidance as to how much voting power the grantor and the trust must together possess in order to be "significant." This may be because planners seeking grantor trust status likely want such status to extend beyond the stock held by the trust, so they might prefer to use a different administrative power to achieve the desired result.

Gross Estate Inclusion? A retained power to vote stock can pose gross estate inclusion risks under §2036(a), especially since grantor trust status requires the exercise of such a power in a nonfiduciary capacity. Where the grantor gratuitously transfers stock in a "controlled corporation" but retains the right to vote the transferred shares, whether directly or indirectly, the grantor is considered to have retained the enjoyment of the transferred stock. Section 2036(b)(1). Consequently, the grantor's gross estate must include the value of the stock transferred to the trust in this situation under §2036(a). Generally, a corporation is "controlled" if the grantor owned or had the right to vote stock possessing at least 20 percent of the total combined voting power of all classes of stock at any time following the gratuitous transfer to the trust (or, if longer, the three-year period ending on the decedent's death). Section 2036(b)(2). In determining the number of shares owned by the grantor during this testing period, the attribution rules of §318 are applied, meaning that the grantor will be treated as owning shares formally owned by certain family members and other entities in which the grantor and/or certain family members have majority interests.

Because of the risk of gross estate inclusion, an already unattractive method for securing grantor trust status (because it is limited to deemed ownership of the stock and not other trust

assets) may become that much uglier. Of course, if the power to vote the stock in a nonfiduciary capacity were given to someone other than the grantor, there is no risk of gross estate inclusion for the grantor (and likely not for the person who holds the power either, since the powerholder was not the person who transferred the property to the trust by gift).

e. Power to Control Trust Investments in Stock

Income Tax. A power, exercisable in a nonfiduciary capacity by any person without anyone's consent or approval, to control the investment of trust funds (either by directing investments, directing reinvestments, or by vetoing proposed investments or reinvestments), to the extent that the trust funds consist of corporate stocks or securities in which the combined holdings of the grantor and the trust are "significant" in terms of voting control, will cause the grantor to be the deemed owner of such stocks and securities. Section 675(4)(B). Here, too, it is presumed that a trustee would exercise such a power in a fiduciary capacity, and one seeking to prove grantor trust status in such a case would have to show otherwise by clear and convincing proof. Reg. §1.675-1(b)(4).

Gross Estate Inclusion? Because the power to direct trust investments in corporate stock and securities is not a power to vote the shares, there is less risk for inclusion in the grantor's gross estate if the grantor holds such a power. Again, if the grantor does not hold the power, there is no risk for inclusion in the grantor's gross estate at all, and the powerholder should not face gross estate inclusion either since the powerholder was not the person who made the gratuitous transfer to the trust in the first place.

f. Power to Reacquire Trust Assets by Substitution

Income Tax. A power held by anyone in a nonfiduciary capacity to "reacquire the trust corpus by substituting other property of an equivalent value" will cause the grantor to be the deemed owner of the trust property. Section 675(4)(C). The same presumption that a trustee would exercise such a power in a fiduciary capacity applies here. Reg. §1.675-1(b)(4). Estate planners commonly refer to this "power to reacquire through substitution" as a "swap power."

The use of the word "reacquire" connotes that only the grantor could have a swap power, since no one else can "reacquire" property transferred by the grantor. But the statute expressly states that the power may be held by "any person" and the Service has informally concluded that grantor trust status occurs even when someone other than the grantor holds the swap power. See Private Letter Ruling 9037011.

Gross Estate Inclusion? Prior to 2008, it was the consensus (if not unanimous) view among commentators that a swap power would not cause gross estate inclusion since a right to swap assets allows the grantor to neither supplement nor diminish the value of the trust's holdings. In support of this position, practitioners often cited *Estate of Jordahl v. Commissioner*, 65 T.C. 92

(1975), acq. 1977-1 C.B. 1. In *Jordahl*, the Tax Court held that the power to reacquire trust assets through substitution was not a power to alter beneficial enjoyment under §2036(a) or §2038(a) in that there could be no economic benefit to the grantor. Furthermore, the court held that there was no incident of ownership of life insurance by virtue of the substitution power, thus negating inclusion under §2042 where the trust owned a policy of insurance on the grantor's life. See also Private Letter Ruling 9227013. But some practitioners believed the *Jordahl* case was not very helpful because the grantor in that case arguably held the swap power in a fiduciary capacity. (If that's the case, then the trust is not a grantor trust for income tax purposes.)

Then there were two letter rulings from 2006 that further muddied the waters. In the first, Private Letter Ruling 200603040, the grantor contributed cash and stock to a trust and retained a swap power, but the trust instrument expressly provided that the swap power could only be exercised in a *fiduciary* capacity. (At the risk of further flailing a deceased equine, remember that if a swap power is exercisable only in a fiduciary capacity, such power does not serve to make the trust a grantor trust for income tax purposes. This is because §675(4)(C) states that a trust is a grantor trust where a swap power is exercisable in a "nonfiduciary" capacity.) The Service ruled that the grantor's retention of the swap power did not cause the trust property to be included in the grantor's gross estate under §2033, §2036(a), §2036(b), §2038 or §2039. In addition, the Service ruled that the grantor's exercise of the swap power would not constitute a gift to the trust by the grantor for federal gift tax purposes, and neither the grantor nor the trust will recognize gain or loss from exercise of the swap power.

A similar result followed in the second ruling, Private Letter Ruling 200606006. Here, the grantor contributed cash and stocks to an unrelated party as trustee of an irrevocable trust. The trustee had discretion to distribute income and principal to the grantor's spouse both during the grantor's life and following the grantor's death. The spouse held a testamentary power of appointment over the trust; to the extent the power was not exercised, trust assets were to pass to the grantor's issue. The spouse also held a *Crummey* power with respect to trust contributions. The grantor also had the power to swap assets of equivalent value, although the power was exercisable only in a fiduciary capacity (i.e., undertaken in good faith, in the best interests of the trust and its beneficiaries, and subject to state law standards applicable to fiduciaries). The grantor in the ruling planned to exercise the swap power by transferring shares of one publicly-traded company into the trust in exchange for the trust's shares of another publicly-traded company. If necessary to equalize the value of the swapped assets, the grantor would add cash to the trust or withdraw cash from the trust. The Service ruled that the swap power did not cause the inclusion of the trust's assets in the grantor's gross estate under §2033, §2036, §2038, or §2039. The Service also ruled that the proposed swap would not be a gift to the trust by the grantor for federal gift tax purposes.

Some thoughtful practitioners read these two private rulings to mean the Service could reach a different result if the swap power in either case were held in a nonfiduciary capacity (which, again, is often the case since the swap power is added principally to qualify a trust as a

grantor trust). But there appears to be no basis for treating nonfiduciary swap powers any differently. Presumably, a swap power is exercisable in a fiduciary capacity if its exercise is in the best interests of the trust's beneficiaries and is consistent with duties applicable to fiduciaries. For example, one holding a swap power exercisable in fiduciary capacity could apparently "swap in" a more productive asset in exchange for an unproductive asset because such an exchange would improve the value of the beneficiaries' interests (it is better to hold a productive asset than an unproductive asset, even if the assets have equivalent values), but could not swap in an unproductive asset in exchange for a productive asset because that would undermine the beneficiaries' interests.

One holding a swap power in a nonfiduciary capacity, however, could exercise the power without regard to whether doing so is helpful or harmful to the interests of the beneficiaries. In other words, the power-holder could act in his or her self-interest. It is hard to see how that fact alone should cause the trust assets to be included in the grantor's gross estate where the grantor holds the power. Although the grantor holds the power to control the ultimate beneficial enjoyment of property contributed to the trust (he or she can always get it back for whatever reason by exercise of the swap power), the same is true of trust assets subject to a fiduciary swap power. The only difference is that a fiduciary swap power requires the grantor to part with an "as-good-or-better" asset to reclaim the trust property, while a nonfiduciary swap power permits the grantor to exchange a "worse" asset for the trust property subject only to the constraint that the "worse" asset have the same value as the trust property to be "swapped out."

The requirement (applicable to fiduciary swap powers and nonfiduciary swap powers) that the exchanged assets have equivalent values is the key. A swap power does not permit the grantor to add to or subtract from the value of the trust's holdings. There is, therefore, no ability to play with the ultimate value transferred to the trust. Sure, to the extent the grantor can "swap in" unproductive property and "swap out" productive property, the grantor can affect the future income stream of the trust and perhaps the long-term appreciation in the value of the trust's principal. Under that view, a retained right to control future income and long-term appreciation might constitute sufficient control over the trust property to justify inclusion of the trust assets in the grantor's gross estate under §2036(a). But this is true of both fiduciary swap powers and nonfiduciary swap powers; the fact that the grantor's exercise of the swap power is constrained by the best interests of the beneficiaries does not change the fact that the grantor still controls the trust's future income stream and long-term principal growth. The rulings reach the correct result in finding that the trust assets are not includible in the grantor's gross estate. But these conclusions are not dependent on the fact that the swap powers in both rulings were exercisable in a fiduciary capacity.

Although there was no estate tax risk in giving the substitution power to the grantor, some practitioners preferred, in an abundance of caution, to give the power to someone other than the grantor. This preserves the grantor trust status of the trust and ensures that there is no possible way the grantor could face estate tax inclusion.

Luckily, the Service clarified that in the lion's share of cases a swap power will not cause gross estate inclusion. In *Revenue Ruling 2008-22*, the Service concluded that a swap power:

> will not, by itself, cause the value of the trust corpus to be includible in the grantor's gross estate under §2036 or 2038, provided the trustee has a fiduciary obligation (under local law or the trust instrument) to ensure the grantor's compliance with the terms of this power by satisfying itself that the properties acquired and substituted by the grantor are in fact of equivalent value, and further provided that the substitution power cannot be exercised in a manner that can shift benefits among the trust beneficiaries.

This language imposes two conditions on those seeking certainty from gross estate inclusion under §2036 or §2038. The first condition requires that the trustee have a fiduciary obligation to ensure that the assets being swapped have equal values. This duty must be imposed under local law or the trust instrument. Most local laws would probably impose this duty to the trustee, albeit generally as part of the trustee's general duty to act in the interests of the beneficiaries. Some practitioners have decided to add specific language to their grantor trust instruments that impose the required duty on the trustee. But that can be dangerous because if the trust is supposed to be a grantor trust, the swap power must be exercisable "without the approval or consent of any person in a fiduciary capacity." Section §675(4). If the trust instrument makes the exercise of the swap power specifically contingent on the trustee's approval, there is great risk that the grantor will not be the deemed owner of the trust's assets. If the practitioner wants to add specific language to the trustee's powers to meet this first condition, therefore, it should be expressed as a duty to ensure that the grantor properly exercises the swap power by exchanging property of equivalent values. For example, the trust could provide that if the trustee suspects that the property to be received in exchange for the property to be returned to the grantor is not of equivalent value, the trustee must obtain a court determination that the properties have equivalent value.

It's the second condition—that the power cannot be exercised so as to shift the relative benefits of the beneficiaries—that is key to the Service's conclusion. It is apparent that the Service is concerned with situations where the grantor could, for instance, reacquire income-producing property by substituting non-income-producing property of equal value. This would give the grantor the power to control an income beneficiary's stake, and that would normally trigger gross estate inclusion. But if the grantor cannot exercise a swap power in this manner, the swap power should not trigger gross estate inclusion.

The ruling gives two examples that meet this second condition. In the first example, "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." So if the grantor reacquires income-producing property by substituting non-income-producing property, no gross estate

inclusion is required if the trustee converts the new property into income-producing property so as to protect an income beneficiary's interest.

In the second example, "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." This is a very helpful example, for most irrevocable trusts are either structured as unitrusts or as trusts with only discretionary distributions. So in most cases, compliance with this second condition will not be problematic.

Importantly, Revenue Ruling 2008-22 spoke only of inclusion under §§2036 and 2038. It did not address possible gross estate inclusion under §2042. Some planners worried that a swap power could be seen as an "incident of ownership" in a life insurance policy, thus causing inclusion of the policy's death benefit in the grantor's gross estate.

The concern was misguided. Remember that *Jordahl* involved a trust with life insurance policies and the Tax Court (in a reviewed opinion) held against inclusion. In its acquiescence to the *Jordahl* result, the Service specifically noted that "it was Congresses [sic] intent that Code §2042 should operate to give insurance policies estate tax treatment roughly parallel to the treatment given other types of property under Code §§2036, 2037, 2038, 2041." Under this reasoning, if a swap power does not cause gross estate inclusion under §2036 or §2038, it should not cause inclusion under §2042 either.

The Service effectively confirmed this conclusion in Revenue Ruling 2011-28, which states that a swap power will not, by itself, cause the value of a life insurance policy to be included in the grantor's gross estate under §2042 provided it meets the same two conditions imposed in Revenue Ruling 2008-22 (namely, that that the trustee has a fiduciary obligation to ensure that the assets being swapped have equal values and that the power cannot be exercised so as to shift the relative benefits of the beneficiaries).

4. Powers to Revoke

A power to revoke the trust, not surprisingly, triggers both deemed ownership for income tax purposes and gross estate inclusion for estate tax purposes.

a. Income Tax Aspects

The grantor is the deemed owner of the trust where the grantor or a NAP may, at any time, revoke the trust and revest the property in the grantor. Section 676(a). If the grantor or NAP holds the power to revoke only a portion of the trust, then the grantor is the deemed owner of only that portion of the trust subject to possible revocation. A power to revoke will not make

the trust a grantor trust if the power can only affect the beneficial enjoyment of the income received after some event occurs, provided that the power (if it were a reversion) would not give rise to current ownership under §673. See §676(b).

> EXAMPLE: In Year One, G creates a trust that pays the income to A or A's estate for a term of 20 years. At the end of the term, in Year Twenty-One, the trust will terminate and the remainder will be paid to B or B's estate. The trust instrument gives G the power to revoke the trust anytime after Year Ten. G is not the deemed owner of the trust until Year Eleven. If G relinquishes the power to revoke before Year Eleven, the trust will never be a grantor trust.

b. Estate Tax Aspects

Holding a power to revoke a trust at death requires inclusion of the trust assets in the grantor's gross estate under §2038. Consequently, a power to revoke is a poor choice for planners seeking to design a grantor trust that will avoid gross estate inclusion. Relinquishing the right to revoke the trust may be an option, but if the grantor dies within three years of relinquishing the power to revoke, the trust assets will nonetheless be included in the decedent's gross estate. See §2035(a).

Gross estate inclusion only results if the grantor holds the power to revoke. It is possible to preserve grantor trust status by giving the power to revoke to a NAP, and doing so keeps the trust property from inclusion in the grantor's gross estate. The NAP should not face inclusion in the NAP's gross estate either, for the NAP did not "transfer" the property by gift to the trust in the first place, a threshold requirement for the application of §2038. Reg. §20.2038-1(a)(3). If a planner opts to give a NAP a power to revoke in order to create a "defective grantor trust," the planner should make sure that there is no power in the grantor to remove or discharge the NAP and become the powerholder. Such a power to replace the NAP as the holder of the power to revoke would be sufficient to cause inclusion of the trust property in the grantor's gross estate, even if the power is unexercised.

5. Rights to Income

The grantor may, directly or indirectly, retain the right to enjoyment of the trust's income. Where such is the case, grantor trust status (and gross estate inclusion) likely result.

a. Income Tax Aspects

Not surprisingly, a retained right to income from the trust will cause the grantor to be treated as the owner of the trust for federal income tax purposes in most cases. But §677(a) will also trigger grantor trust status when the grantor has certain indirect rights to income. Specifically, grantor trust status results where, without the consent or approval of an AP, trust

income is (or, at the discretion of the grantor or an NAP, may be): distributed to the grantor or the grantor's spouse; accumulated for the benefit of the grantor or the grantor's spouse; or used to pay premiums on a policy insuring the life of the grantor and/or the grantor's spouse. Reg. §1.677(a)-1(b)(2).

Grantor trust status does not result, however, if, in the discretion of someone other than the grantor, income may be paid for the support of a beneficiary the grantor is legally obligated to support. Section 677(b). However, to the extent the income is in fact so used, the grantor is the deemed owner of such income.

In addition, a grantor's power to receive income will not make the trust a grantor trust if the power can only affect the beneficial enjoyment of the income received after some event occurs, provided that the power (if it were a reversion) would not give rise to current ownership under §673. Section 677(a); Reg. §1.677(a)-1(e).

EXAMPLE: G creates a trust in Year One that pays income annually to A for A's life. The trust instrument states that beginning in Year Eleven, income may be paid, in G's discretion, to A or G. The trust is not a grantor trust until Year Eleven. If G relinquishes the right to appoint income between A and G before Year Eleven, the trust will not be a grantor trust at any time.

b. Estate Tax Aspects

A grantor's retention of the right to all of the trust's income will, if held at death or for a period not ascertainable without reference to the grantor's death, cause inclusion in the grantor's gross estate of the entire trust property under §2036(a). If the grantor holds a limited right to income (like the right to one-half of the income), the extent of gross estate inclusion may be less (like one-half of the value of the property held by the trust).

The power to use trust income to pay premiums on insurance policies insuring the life of the grantor or the grantor's spouse will not risk gross estate inclusion if the grantor has no "incidents of ownership" over the policy itself. Section 2042. There is some concern that the power to apply trust income to premium payments results in grantor trust status only if income from the trust might actually be applied to the payment of insurance premiums (i.e., actual insurance policies held by the trust still have premium amounts still owing). Several old decisions by the Board of Tax Appeals and the Tax Court held (under a predecessor statute similar to §677(a)(3)) that the grantor was taxable only on the trust income that was actually used or could be used to pay premiums and not on other trust income. See *Iversen v. Commissioner*, 3 T.C. 756 (1944); *Weil v. Commissioner*, 3 T.C. 579 (1944); *Moore v. Commissioner*, 39 B.T.A. 808 (1939), acq. 1939-2 C.B. 25; and *Rand v. Commissioner*, 40 B.T.A. 233 (1939), acq. 1939-2 C.B. 30, aff'd, 116 F.2d 929 (8th Cir. 1941), cert. denied, 313 U.S. 594 (1941). In Private Letter Ruling 8839008, the Service ruled that even when trust language prohibited use of trust income to pay premium

amounts but nonetheless trust income was used to pay premium amounts, the grantor(s) will be treated as the owner(s) to the extent income was actually paid as premium payments. Because it is not entirely certain that a trust will be a grantor trust merely because a trustee may apply trust income to the payment of premiums, planners seeking grantor trust status should couple this power with other Subpart E powers and, when possible, actually apply trust income to the payment of life insurance premiums.

C. RECAPPING – GRANTOR TRUST POWERS THAT CAUSE GROSS ESTATE INCLUSION AND THOSE THAT DO NOT

After digesting 20 pages of exposition about the powers that confer grantor trust status, it might be helpful to chart the grantor trust powers that cause gross estate inclusion and those that do not. This chart attempts to provide such a summary. Necessarily, the chart is a summary; it states rules in general terms and without reference to the various, nuanced exceptions set forth in the preceding 20 pages. Planners should read the materials related to any specific power before selecting them for use in a particular trust.

	Powers Causing Gross Estate Inclusion	**Powers NOT Causing Gross Estate Inclusion**
Powers Causing Grantor Trust Status	• Most reversions • Most powers to control distributions of principal or income during grantor's life • Power to appoint accumulated income by will • Grantor's power to deal trust property for less than fill consideration • Grantor's power to vote controlled corporation stock in nonfiduciary capacity • Retained right to income	• NAP power to deal trust property for less than full consideration • Power to borrow trust assets without adequate interest or security • Actual loan without adequate interest or security to grantor or grantor's spouse that is still outstanding • Third party power (held in nonfiduciary capacity) to vote stock or control investments in stock • Most swap powers (power to reacquire trust property by substituting equivalent value assets) • Power to use income to pay premiums on policies insuring grantor and/or grantor's spouse
Powers NOT Causing Grantor Trust Status	• Power to control distributions of principal or income exercisable by will • Power to appoint income or principal to a charity of the grantor's choosing • Power to control timing of income distributions	• Mere administrative powers (power to invest, power to allocate between income and principal) • Third party power to pay income for the support of individual grantor is legally obligated to support • Power to affect beneficial enjoyment following a contingency • Power to distribute principal limited by an ascertainable standard • Power to withhold income during minority or disability • Independent trustee power to distribute income or principal (unless grantor can replace trustee) • Trustee power to distribute income according to a reasonable definite standard (unless grantor or spouse is trustee)

In the chart, the powers in the upper right corner (those causing grantor trust status for income tax purposes but not causing gross estate inclusion for estate tax purposes) are those used to create what are commonly called "defective grantor trusts" or sometimes "intentionally defective grantor trusts." When the federal estate tax had a lower applicable exclusion amount, defective grantor trusts were the popular choice, as most individuals wanted both to avoid gross estate inclusion and to have the trust income taxed to the grantor. As the applicable exclusion amount increases, individuals start to prefer powers that cause gross estate inclusion so as to take advantage of the step-up in income tax basis for property included in a decedent's gross estate. See §1014(b)(9).

D. EXERCISING SWAP POWERS

The grantor never has to exercise the swap power in order to achieve grantor trust status, but there are situations in which a grantor should exercise the swap power. Exercising a swap power can be a good technique for leveraging the benefit of a stepped-up basis at death. One of the first articles to elaborate on this strategy was Kuno S. Bell, *Use Defective Grantor Trusts for an Effective Triple Play*, PRACTICAL TAX STRATEGIES 12 (July 2005). This portion of the materials considers five situations where the exercise of a swap power could be advisable (though there may be more). It also considers the risks involved and ideas for mitigating those risks.

1. Near-Death Swaps to Leverage the §1014 Step-up

Assets held in a properly structured "defective grantor trust" will not be included in the grantor's gross estate at death. But that means the assets will not be eligible for the §1014(a) step-up in basis. Instead, the bases of the trust assets will be unchanged as a result of the grantor's death. In most cases, the trust assets will have the same basis that the grantor had in the assets at the time of contribution to the trust. Since the grantor will normally fund a grantor trust with rapidly appreciating assets in order to maximize the benefit of the estate planning strategies utilizing grantor trusts (most notably GRATs and installment sale transactions), it is not uncommon for the trust to hold low-basis assets shortly before the grantor's death or the scheduled termination of the trust.

If the grantor's death is anticipated in the short-term, the grantor might exercise the swap power by exchanging high-basis assets for the trust's low-basis assets. This way, the grantor dies holding low-basis assets that will be eligible for the §1014(a) step-up. The high-basis assets swapped into the trust will not be included in the grantor's gross estate, and the exchange of assets is not a taxable event. See *Rev. Rul. 85-13*, 1985-1 C.B. 184. Since those high-basis assets have the same value as the low-basis assets, the grantor has preserved the asset appreciation inside the trust while maximizing use of the basis step-up at death for assets included in the gross estate.

EXAMPLE: G transferred $1 million in non-depreciable assets (with an aggregate basis of $100,000) to an irrevocable trust in Year One. The trust instrument gave G a swap power. By the end of Year Seven, the assets had grown in value to $3 million. G owned $3 million in cash outside of the trust. G expected to die early in Year Eight, so at the end of Year Seven, G transferred the $3 million in cash to the trust in exchange for the trust's assets. At G's death in Year Eight, the $3 million in low-basis assets is included in G's gross estate, but the $3 million in cash, now held by the trust, is not included. The basis in the assets included in G's gross estate is stepped up to $3 million. By making the swap shortly before death, G maintains the same size of gross estate ($3 million), but is able to get a $2.9 million increase in income tax basis.

In other contexts, attempts to get a last-minute step-up in basis are often thwarted through §1014(e). This provision states that if a donor makes a gift to a donee who dies within a year of the gift, the gifted property will not receive a step-up in basis to fair market value if the property is bequeathed or devised back to the donor. This rule does not apply to the exercise of a swap power because there is no "gift" of the low-basis assets to the grantor. Put another way, since the grantor and the trust are the same person for federal income tax purposes, there cannot be the gift required to invoke §1014(e).

2. Near-Death Swaps to Preserve Loss

While we often refer to §1014(a) as the "step-up" in basis, planners should never forget that there can be a step-down in basis too. If the grantor owns a loss asset (one with a basis in excess of value) outright, he or she should consider reacquiring one or more low-basis assets from the grantor trust by substituting the loss asset. This way, the loss is preserved in the trust.

3. Swaps to Elude the Three-Year Rule

Suppose the grantor owns an insurance policy outright but has other assets sitting in a defective grantor trust. The current fair market value of the policy might be substantially less than the promised death benefit but the grantor might not want to create an irrevocable life insurance trust because there is concern that the grantor may not survive for the requisite three years following the transfer of the policy. See §2035(a). The grantor could swap the policy into the trust to avoid inclusion of the death benefit in the grantor's gross estate. The three-year rule does not apply because, for transfer tax purposes, the exchange between the grantor and the trust is a sale for full and adequate consideration. Section 2035(d). Moreover, as explained elsewhere in these materials, the exchange will not trigger the "transfer for value" rule, meaning the death benefit will still be excluded from gross income for federal income tax purposes.

4. Swaps to Control Cash Flow

Asset swaps can be helpful in situations outside the defective grantor trust context. For example, a GRAT is not a defective grantor trust because the trust's assets will be included in the grantor's gross estate if the grantor dies before the end of the annuity term. But the GRAT regulations do not prohibit giving the grantor a swap power, and doing so could prove useful if the assets inside the GRAT do not appreciate as expected or do not generate the cash flow required to make the GRAT successful. See Alev T. Lewis, *Planning in Turbulent Times: GRATs*, 33 Tax Adviser 664, 667 (October 2002).

An asset swap might also be desirable near the end of a GRAT's term or just after the conclusion of an installment sale to a defective grantor trust. If the grantor wants to keep the asset(s) transferred to the trust at the start of the strategy for whatever reason, the grantor could swap in other assets at such time and reacquire the desired property.

5. Swaps of a Residence

Conventional wisdom says that a client's personal residence should be placed into a qualified personal residence trust, assuming the client has a taxable estate. That's fine, of course, but there are limits on what a qualified personal residence trust can do: the client has to survive the trust term in order for the arrangement to work and it is impossible to make a zeroed-out gift of the residence to the trust. But a swap of the client's residence into an existing defective grantor trust eliminates these hurdles while preserving the income and transfer tax benefits of the qualified personal residence trust strategy. Swapping the home into the defective grantor trust is not a gift (remember, it's a sale for full and adequate consideration for transfer tax purposes) and is not an income-recognition event (it's still a transfer between the grantor and the grantor trust).

In order for the swap to be meaningful, the client will have to pay rent to the trust if the client continues to reside in the home following the swap. This is perhaps a wonderful accident, since other cash payments to the trust would probably be considered gifts. Rent payments are not gifts yet they increase the amount of cash held in the trust.

6. Risks of Exercising Swap Powers

There is one significant caveat to the exercise of a swap power: the values of the exchanged assets need to be identical. Swaps involving easily valued assets (cash, marketable securities) present no problems, but swaps involving real property, closely-held business interests, or other assets often appraised by professionals invites dispute.

If the values of the exchanged assets are off by even a little bit, adverse tax consequences can follow. For instance, if the value of the reacquired property (the asset(s) reclaimed from the

grantor trust) turns out to be less than the value of the substituted property (the asset(s) transferred to the grantor trust), the grantor has made a gift of the difference in value to the trust. Likewise, if the value of the reacquired property is greater than the value of the substituted property, there is very likely a gift from the beneficiaries of the trust to the grantor, and that's usually a wealth transfer in the wrong direction.

The moral here is that appraisals of the reacquired property and the substituted property are absolutely vital. Planners may also consider written agreements between the grantor and the trustee providing that if the finally-determined values of the swapped assets do not match, the over-compensated party shall pay cash or transfer other assets to the under-compensated party in an amount necessary to equalize the transfers.

Actual swaps can also invite disputes. One example stems from *In re The Mark Vance Condiotti Irrevocable GST Trust*, No, 14CA0969 (Col. App. 2015), an unpublished opinion from the Colorado Court of Appeals. In the case, the grantor attempted to exercise a swap power by delivering to the trustees a promissory note in the face amount of $9.5 million, the value of the trust's assets. The court held that the trustees properly refused the note, concluding the grantor was in fact trying to borrow the trust's assets on an unsecured, interest-free basis, a power the trust instrument specifically forbade.

Moreover, swaps must follow requisite formalities. In *Schinazi v. Eden*, 338 Ga. App. 793, 729 S.E. 2d 94 (Ga. Ct. App. 2016), the grantor attempted to exercise a swap power by delivering to the trustee a promissory note in the amount of $58.29 million in exchange for limited partnership interests held by the trust. The court held that the swap was ineffective because the proposed transfer of limited partnership interests by the trust to the grantor was precluded under a provision in the partnership agreement that permitted transfers of partnership interests only under certain conditions that had not been met in this case.

V. GRANTOR TRUST DRAFTING ISSUES

A. CRUMMEY POWERS

Some commentators express concern about inserting *Crummey* powers into grantor trust instruments so that gifts to the trust can qualify for the federal gift tax annual exclusion. The concern stems from §678(a). It says that the *beneficiary* (not the grantor) will be treated as the owner of the trust if the beneficiary has a "power exercisable solely by himself to vest the corpus or the income therefrom in himself." In the eyes of many commentators, a *Crummey* power is a power of the beneficiary to vest corpus in himself (or herself), meaning §678(a) would apply. In public pronouncements, the Service has supported this view. In Revenue Ruling 81-6, 1981-1 C.B. 620, the Service concluded that a beneficiary was taxable under §678(a) because the beneficiary held a *Crummey* power, even though the beneficiary was a minor and thus unable to exercise the power without the appointment of a legal guardian.

If the ruling is correct, this has profound consequences. For one thing, it means the beneficiary (not the grantor) is to be taxed on at least some portion of the trust's income. Unfortunately, Revenue Ruling 81-6 did not indicate how the beneficiary was to be taxed. Regulations suggest that we apply the trust income to a fraction, the numerator being the amount subject to the *Crummey* power and the denominator being the fair market value of the principal as of the date the *Crummey* power arose. Reg. §1.671-3(a)(3). In essence, therefore, the beneficiary will be taxed on a proportionate amount of trust income.

EXAMPLE: G creates a grantor trust and, in 2019, transfers $150,000 worth of income-producing property to the trust. There is one beneficiary of the trust, Child. So that the first $15,000 of Grantor's gift qualifies for the federal gift tax annual exclusion, Child is given a *Crummey* power. Specifically, for 30 days following Grantor's contribution, Child has the power to withdraw up to $15,000 from the trust. Child's withdrawal right lapses in 2019. For the 2019 taxable year, the trust has income of $20,000, $1,000 of which was earned during the 30-day period that Child's withdrawal right existed. Because Child had the right to withdraw $15,000 from the trust but allowed the right to lapse, Revenue Ruling 81-6 and Regulation §1.671-3(a)(3) suggest that Child will be taxed on a proportionate share of the trust's income. Child's share is determined by the following fraction:

$$\frac{\text{Amount subject to withdrawal}}{\text{FMV of trust at contribution}} \times \text{trust income} = \text{A's income share}$$

Thus Child is taxed on ten percent of the trust income, but what we do not know for sure is whether Child is taxed on ten percent of $20,000 (trust income for the year) or ten percent of $1,000 (trust income during the period that the withdrawal right existed).

From a technical standpoint, the beneficiary should only be taxed on income that accrued while his or her withdrawal right was open. After all, under §678(a)(1), the beneficiary only has the requisite "power…to vest the corpus or the income therefrom" during the period that the Crummey power is effective. At all other times, the beneficiary has no such power, so §678(a)(1) should not apply. Under §678(a)(2), the beneficiary will be treated as the owner for income tax purposes even if he or she has released the power to access trust funds, but only if the beneficiary "retains such control as would…subject a grantor of a trust to treatment as the owner thereof." When the right to withdraw lapses, a beneficiary retains no ongoing control over the trust corpus or income; thus, §678(a)(2) should not apply to cause the beneficiary to be taxed. Even if the beneficiary had a "hanging power" with respect to the trust property, the beneficiary should be

taxed only on his or her proportionate share of trust income that accrues during the period in which the "hanging power" can be exercised.

Another profound consequence of concluding that §678(a) applies to *Crummey* powers in grantor trusts relates to installment sale transactions involving grantor trusts. If the grantor is no longer the deemed owner of the entire trust that purchased property from the grantor, the grantor likely must recognize at least a portion of the realized gain from the sale to the trust. But the exact amount of gain that the grantor would have to recognize is uncertain. Assume that Grantor from the previous example sold $1 million worth of assets (with a basis of $200,000) to the trust for a promissory note. Grantor did not recognize gain from the sale because the trust was a grantor trust. Must Grantor now recognize any portion of the $800,000 gain because Child is treated as a part-owner of the trust under §678(a), though perhaps for only one month of each year? Certainly if Child were treated as a ten-percent owner at all times during the trust's existence, the answer would be easy: Grantor should recognize ten percent of the gain (or $80,000). But since Child is only the owner for one month (and in this case, for a period that ended prior to the sale), would we say that Grantor should recognize 1/12 of ten percent of the gain? Maybe it would be cleaner and simpler answer to say that Grantor should not recognize the gain if Child's withdrawal right is not in existence at the date of the sale.

Because of the uncertainty here, one might think it best to leave *Crummey* powers out of grantor trust instruments. But some practitioners take solace in §678(b). It says that the general rule of §678(a) does not apply "with respect to a power over income … if the grantor of the trust … is otherwise treated as the owner under the provisions of this subpart other than this section." In other words, §678(a) does not apply "with respect to a power over income" if the trust is a grantor trust with respect to income. This *may* mean that a beneficiary will not be taxed on the trust's income if the *Crummey* power relates to income and the grantor has a power over trust income described in Subpart E. But most *Crummey* powers relate to principal: the beneficiary is typically given a power to withdraw and aliquot share of the principal contributed to the trust. The *Crummey* power is typically, therefore, a power over principal and not a power over income. So not everyone is convinced that §678(b) makes for the safe use of *Crummey* powers in grantor trusts.

The Service, however, appears to have a relaxed and favorable interpretation of §678(b). In Private Letter Ruling 200606006, the grantor contributed cash and stocks to an unrelated party as trustee of an irrevocable trust. The trustee had discretion to distribute income and principal to the grantor's spouse both during the grantor's life and following the grantor's death, making the trust a grantor trust for income tax purposes under §677(a). The spouse held a testamentary power of appointment over the trust; to the extent the power is not exercised, trust assets are to pass to the grantor's issue. The spouse also held a *Crummey* power with respect to trust contributions. The Service ruled that although the spouse's *Crummey* power would normally cause the trust income to be taxed to her to some extent under §678(a), the trust will still be a wholly grantor trust under §677, thanks to the exception in §678(b). Although the spouse's

Crummey power, by definition, is not simply a power over income, the Service is apparently willing to read the §678(b) exception broadly enough such that the addition of *Crummey* powers in a defective grantor trust will not prevent the trust from being a wholly grantor trust for income tax purposes.

The Service reached similar results in a series of 12 related private letter rulings issued on the same day. See Private Letter Rulings 200729005 – 200729016. In each of the rulings, one or more grantors created a trust that provided for discretionary distributions to other beneficiaries. The grantor(s) in each ruling retained a swap power. Each trust instrument required the trustee to divide the trust assets into sub-trusts, one for each beneficiary. Each beneficiary was also given a *Crummey* power. Each of the grantors sought a ruling that they were the deemed owners of the trust for federal income tax purposes, including the 100-shareholder limitation applicable to S corporations, even though the beneficiaries had withdrawal powers that would appear to be governed by §678(a). The Service, citing §678(b), gave them each the ruling they sought. Accordingly, the beneficiaries were not the deemed owners of the trusts.

Similarly, in *Private Letter Ruling 200840025*, a trust created by the grantor gave a nonadverse trustee the power to make unsecured loans to the taxpayer. That made the trust a grantor trust under §675(2), but the trust also stated that when a beneficiary attains a certain age, the beneficiary may withdraw all or any portion of the trust assets allocated to that beneficiary's separate share. The Service ruled that because the trust is otherwise a grantor trust under §675(2), grantor trust status will not be lost when a beneficiary reaches the designated age for withdrawal. It also concluded that the trust could hold S corporation stock as long as a nonadverse trustee had the power to make unsecured loans to the grantor.

Although these rulings indicate the Service's favorable position on the application of §678(b) to *Crummey* powers, one should keep in mind that private rulings are not binding authority and generally cannot be cited as precedent. The only public, binding interpretation of the issue is *Revenue Ruling 81-6* and, as discussed above, it only applies the general rule of §678(a). (The ruling would not have applied §678(b) one way or the other because the trust at issue was not a grantor trust.) Until the Service takes an official position on the matter, practitioners should not feel wholly confident about inserting *Crummey* powers into grantor trusts. *More* confident, perhaps—but not wholly confident.

B. LIFE INSURANCE AS A TRUST ASSET

Most irrevocable life insurance trusts (ILITs) are grantor trusts since these trust instruments typically provide that income may be applied toward the payment of premiums on policies insuring the grantor's life (or the grantor's spouse's life), which makes the trust a grantor trust under §677(a)(3). Giving the trustee this discretion does not constitute an "incident of ownership" to the grantor; thus, an ILIT with this provision will not inclusion in the grantor's gross estate. It is critical to note that the trust instrument must expressly allow the application of trust

income for this purpose. A trust instrument that is silent or that allows only the use of principal to pay premiums is not a grantor trust.

Most ILITs own nothing besides an insurance policy, so it's unusual for the trust to have taxable income. Still, one should one care whether an ILIT is a grantor trust because of the "transfer for value" rule in §101(a)(2). Under this rule, if a taxpayer transfers a life insurance policy for valuable consideration, the income tax exclusion for death benefits under §101(a)(1) will be limited to the amount of consideration paid. Since the value of most insurance policies is far less than the amount of the death benefits paid, application of this rule essentially converts tax-free death benefits into ordinary income to all but a very small extent. If the owner of a policy transfers it to a grantor trust, there is no risk that the transfer for value rule would apply.

Admittedly, few planners see clients transferring life insurance policies to ILITs "for valuable consideration." Usually the client just makes a gift of the policy to the trust, so the transfer for value rule would not apply in the first place. But grantor trust status still matters.

EXAMPLE: G owns an insurance policy on G's life that will pay a death benefit of $15 million. G is not expected to live for more than two years. If G gratuitously transfers the policy to an ILIT, G risks estate tax inclusion under §2035(a). Accordingly, G may fund an ILIT with cash transfers and, in the next taxable year, have the ILIT purchase the policy from G for the policy's fair market value. Assuming the transactions are sufficiently distinct to avoid application of the step transaction doctrine, the purchase of the policy by the trust will eliminate the risk of estate tax inclusion. This is because there has been a sale of the policy for full and adequate consideration in money or money's worth. See §2035(d).

If the ILIT is a grantor trust, the "transfer for value" rule will not apply and the ILIT will receive the $15 million free of federal income tax, since the trust is ignored and the transaction is treated as though G sold the policy to G (a non-event). If the ILIT is not a grantor trust, G would recognize gain to the extent the value of the policy exceeds the aggregate premiums paid by G, and the ILIT could exclude from gross income that portion of the death benefit equal to the amount paid for the policy and any subsequent premiums it paid.

There are other situations when structuring an ILIT as a grantor trust is helpful. Consider the facts from Revenue Ruling 2007-13, 2007-1 C.B. 684. In that ruling, a grantor created two trusts, cleverly titled TR1 and TR2. TR2 transferred a life insurance contract on the life of the grantor to TR1 in exchange for cash. TR1 was a grantor trust. The Service ruled that if TR2 is also a grantor trust, there is no "transfer for value" because the grantor is the deemed owner of both trusts. The transaction between two grantor trusts is disregarded because it is, in substance, a sale of the policy by the grantor to the grantor. The Service also ruled that if TR2 is not a grantor

trust, then the transaction will not be disregarded, but the transaction will still be excepted from the “transfer for value” rule because it is treated as a transfer to the grantor, the insured.

This ruling effectively green-lights a strategy for amending the otherwise irrevocable trust.

> EXAMPLE: G created an ILIT several years ago, but has since become unhappy with its dispositive provisions. G might contribute cash to a new ILIT with satisfactory terms. The new ILIT could then buy the policy from the old ILIT at fair market value. None of the proposed transactions is a “transfer for value” if both of the ILITs involved are grantor trusts. Further, there should be no inclusion in the grantor’s gross estate here because the transaction between the trusts is a sale for full and adequate consideration.

C. TAX REIMBURSEMENT CLAUSE

Recall that generally speaking, it is good that the grantor pays the tax on the grantor trust’s income. For one thing, as explained above, to the extent the income from a grantor trust is taxed to the grantor or some other individual, it is likely that less total federal income tax is paid. In addition, the grantor’s payment of the income tax attributable to the trust’s assets allows all of such income to remain in the trust without making any additional gift. Where the trust is a separate taxable entity, the grantor would have to make an additional wealth transfer to the trust to restore the amount lost to taxes. By paying the taxes directly, the grantor effectively makes a tax-free wealth transfer to the trust.

The grantor’s payment of federal income tax liability attributable to the grantor trust’s income has no adverse consequences. (Of course, the payment of the tax itself will be seen by some clients as an adverse consequence. But once the practitioner explains the income tax savings usually resulting from the grantor trust, a client should be convinced that this is the preferred result.) The tax liability belongs to the grantor, so the grantor’s payment of the tax is not extra income to the trust and it is not a gift to the trust’s beneficiaries. Treasury made this clear in Revenue Ruling 2004-64, 2004-2 C.B. 7, stating:

> When the grantor of a trust, who is treated as the owner of the trust under subpart E, pays the income tax attributable to the inclusion of the trust's income in the grantor's taxable income, the grantor is not treated as making a gift of the amount of the tax to the trust beneficiaries.

To allay the concerns of clients who fear they may lack sufficient resources to pay the tax on the grantor trust’s income, some trust instruments permit the trustee to reimburse the grantor for the extra income taxes attributable to the trust. So-called “tax reimbursement

clauses" became all the rage in the wake of Revenue Ruling 2004-64, supra, when the Service indicated that such clauses may not cause gross estate inclusion for federal estate tax purposes.

Specifically, Revenue Ruling 2004-64 holds that where the trust instrument requires the trustee to reimburse the grantor, the grantor has effectively retained the right to use trust property to discharge the grantor's obligation to pay federal income tax, meaning the full value of the trust assets must be included in the grantor's gross estate under §2036(a)(1). (The ruling offers one piece of good news here: the distribution from the trust is not an indirect gift *to* the grantor from the trust beneficiaries, since the distribution is required by the trust instrument.)

Where, however, the trust instrument gives the trustee the discretion to make reimburse the grantor from trust funds, then—assuming there is no express or implied understanding between the grantor and the trustee that the trustee will exercise its discretion in favor of the grantor—there is no inclusion of the trust's assets in the grantor's gross estate at death under §2036(a)(1), no matter whether the discretion is exercised and no matter whether the discretion is granted by the trust instrument or by virtue of state law. (Here, too, by the way, the Service said there is no indirect gift by the trust beneficiaries to the grantor if the trustee exercises its discretion to reimburse the grantor—this time because the transfer was made "pursuant to the exercise of the trustee's discretionary authority granted under the terms of the trust instrument.")

The facts of Revenue Ruling 2004-64 involve a discretionary reimbursement power held by a trustee that is not a "related or subordinate party." Some commentators wonder whether the Service would reach a different result if the trustee was a related or subordinate party. Alan Halperin & Andrea Levine Sanft, *2004-64 Sparks Applause But Leaves Questions*, 143 TRUSTS & ESTATES 22, 25 (September 2004). They conclude that the Service might be more inclined to conclude that a related/subordinate trustee and the grantor have an implied agreement regarding the exercise of the reimbursement power. But since gross estate inclusion normally does not hinge on the relationship between the trustee and the grantor, it seems unlikely that the Service would maintain this presumption.

The holdings in Revenue Ruling 2004-64 are correct and hardly surprising. To the extent the trust is required to reimburse the grantor for income taxes paid, the grantor clearly has a retained interest in the trust property that warrants inclusion in the gross estate under §2036(a) unless the grantor's right to reimbursement expires prior to the grantor's death. Discretionary tax reimbursements, however, should not be included in the gross estate because the grantor's interest in the trust property must go through a trustee. Unless the trustee has indicated that the trustee will always pay the reimbursement or will do so anytime the grantor makes a request, one cannot say that the grantor has formally retained any right to possess or enjoy the trust assets or the income therefrom. The ruling properly makes note of this exception in concluding that §2036(a)(1) does not apply.

At least one commentator prior to Revenue Ruling 2004-64 felt that a discretionary tax reimbursement clause triggered §2036(a) inclusion under Regulation §20.2036-1(b)(2) because the grantor effectively retained the right to have trust property "applied toward discharge of a legal obligation of the (grantor)." Roy Adams, *Today's Lesson: Paying Taxes for Grantor Trusts*, 141 TRUSTS & ESTATES 41, 41-42 (May 2002). But the regulation contemplates a *mandatory* tax reimbursement clause, for it requires inclusion of trust assets where the income or principal "*is* to be applied toward discharge of a legal obligation" (emphasis added). Under a discretionary tax reimbursement clause, trust property *may* be applied to satisfying the grantor's obligation, but it is not required. Thus, the regulation probably does not apply to discretionary tax reimbursement clauses, and *Revenue Ruling 2004-64* acknowledges this.

Although a discretionary tax reimbursement clause does not automatically cause inclusion in the grantor's gross estate, it does not follow that they should be used. Because the grantor's payment of the taxes attributable to the trust's income is not a gift, the grantor's payment is a good vehicle for effecting additional wealth transfers to the trust's beneficiaries at no transfer tax cost. Where the grantor has sufficient assets to pay the trust's tax liability, the use of a tax reimbursement clause might undermine the opportunity to effect the equivalent of a transfer-tax-free contribution to the trust. If the trustee reimburses the grantor for income taxes paid, one of two results will follow, and neither is pretty: either the trust will have less after-tax income available for the beneficiaries (whether distributed or accumulated), or the grantor will have to make a gift transfer to the trust in an amount equal to the reimbursement to keep the trust whole.

> EXAMPLE: G, an individual in the 37-percent federal income tax bracket, creates an irrevocable grantor trust for the benefit of G's heirs. The gross income for the trust in Year One is $50,000. Because G is the deemed owner of the trust, G must include $50,000 in gross income. G thus pays an additional $18,500 of federal income tax in Year Two attributable to the $50,000 of trust income from Year One (37% x $50,000 = $18,500). As a result of G's payment, the trust can accumulate or distribute the full $50,000 to the beneficiaries, not just an after-tax amount. And, as Revenue Ruling 2004-64 made clear, G's payment of the $18,500 is not a gift to G's heirs. But if the trust has a discretionary tax reimbursement clause and, in Year Two, the independent trustee distributes $18,500 to G to reimburse G for the taxes paid, the trust would have only $31,500 of after-tax income available to accumulate or distribute for the benefit of G's heirs. If G wants there to be $50,000 available after income taxes, G will have to make a gift transfer of $18,500 back to the trust.

Still, tax reimbursement clauses are common. If there is a chance that the tax burden associated with grantor trust status poses a cash-flow problem for the grantor, or if one fears unexpected events that may dramatically increase the tax burden associated with the trust (a surge in asset value or yield, a change in tax laws, or the like), a tax reimbursement clause makes

sense, though the analysis above suggests that trustees should be careful to exercise the reimbursement power only as absolutely necessary.

If the trust instrument gives the grantor a power to reacquire trust assets by substituting property of equivalent value, the grantor could also alleviate the income tax burden from the trust by exercising this power. If the tax burden is too high and the trust is not making payments to the grantor in some other capacity (like through an installment sale transaction), the grantor could swap in assets that will produce little or no taxable income and reclaim the income-producing assets that are triggering the adding tax liability. After the swap, the grantor will have the income from the assets that created this tax burden and thus will have the resources to pay the tax.

Another issue to consider is creditor protection. If the trustee has the discretion to reimburse the grantor from trust assets, perhaps state law might subject the trust property to the claims of the grantor's creditors. Practitioners might want to avoid a tax reimbursement clause if applicable state law would cause the assets to be available to the grantor's creditors. See Halperin & Sanft, supra, at 25. Some states have taken steps to keep creditors away from trusts that have tax reimbursement clauses. Delaware law, for example, provides that creditors cannot assert a claim against property transferred to an irrevocable trust simply because the instrument contains a provision allowing for:

> The transferor's potential or actual receipt of income or principal to pay, in whole or in part, income taxes due on income of the trust if such potential or actual receipt of income or principal is pursuant to a provision in the trust instrument that expressly provides for the payment of such taxes and if such potential or actual receipt of income or principal would be the result of a qualified trustee's or qualified trustees' acting: (A) In such qualified trustee's or qualified trustees' discretion; or (B) At the direction of an adviser described in paragraph (9)(c) of this section who is acting in such adviser's discretion. Distributions to pay income taxes made under discretion included in a governing instrument pursuant to … this subparagraph 9 of paragraph (10)(b) of this section may be made by direct payment to the taxing authorities.

Delaware Code §3570(10)(b)(9).

When it comes to drafting a tax reimbursement clause, the foregoing analysis suggests two important considerations. First, if the planner seeks to avoid inclusion of the trust's assets in the grantor's gross estate, there should not be a mandatory tax reimbursement clause. This is not a significant sacrifice, since mandatory tax reimbursement undermines some of the effectiveness of the grantor trust strategy in contemporary estate planning.

Second, discretionary tax reimbursement clauses are acceptable provided the trust has an independent trustee and measures are taken to ensure that the trustee will not automatically accede to every reimbursement request from the grantor. For example, the discretionary tax reimbursement clause might limit the trustee's exercise of discretion to an ascertainable standard, providing that the trustee may reimburse the grantor only where the trustee determines that such reimbursement is necessary to allow the grantor to maintain the grantor's accustomed standard of living or for the grantor's maintenance, education, support or health. This limitation on the trustee's discretion is not required by Revenue Ruling 2004-64, but it should be an adequate safeguard against an assertion that that trustee and the grantor had an implied arrangement that the trustee would routinely exercise its discretion in favor of the grantor.

More aggressive (but still perfectly ethical and responsible) planners might simply insert a discretionary tax reimbursement clause and be willing to fight if the Service alleges an implied arrangement between the grantor and trustee. Even this more aggressive strategy should employ an independent trustee; neither the grantor nor a "related or subordinate party" should be the trustee if the trust will contain a naked discretionary tax reimbursement clause.

Planners contemplating a tax reimbursement clause in a GRAT might want to limit the ability of the trustee to pay a reimbursement to the grantor to those situations where the trust's income exceeds the amount of income required to pay the annuity amount to the grantor. Such payments from excess income to the grantor will not jeopardize the qualification of the grantor's annuity right as a qualified annuity interest. Reg. §25.2702-3(b)(1)(iii). The tax reimbursement should not count against the amount required to the distributed to the grantor; any reimbursement must be in excess of the amount required to be paid under the qualified annuity interest. Of course, a tax reimbursement clause may not be required at all if the grantor intends to use all or a portion of the distributed annuity amount to satisfy the federal income tax obligation associated with including the trust's income as part of the grantor's income. If the maximum transfer benefit of a GRAT arises from leaving principal and excess income inside the trust, a tax reimbursement clause on top of the qualified annuity interest may be antithetical to the trust's purpose; on the other hand, the tax reimbursement clause can provide a means for effecting a larger-than-otherwise-allowed distribution to the grantor should the grantor have a sudden or unexpected need for a larger distribution.

For existing trusts, reformation to include a discretionary tax reimbursement clause should not have adverse tax consequences. In Private Letter Ruling 200822008, the grantor created an irrevocable grantor trust that named his spouse as trustee. The original trust instrument prohibited the trustee from reimbursing the taxpayer for any income tax the grantor paid on the trust's income. The trustee wanted to petition a court for a judgment to modify the trust so as to authorize (but not require) the trustee—with the approval of a "Reimbursement Committee" (to be initially comprised only of the grantor's attorney) and at least one child beneficiary of majority age who qualifies as an "adverse party"—to reimburse the grantor for any federal, state, or local income tax liability attributable to the trust's income. The Service ruled

that the proposed reformation would not, by itself, cause the assets of the trust to be included in the grantor's gross estate. In this particular case, "assuming there is no understanding, express or implied, between the [grantor], the members of the Reimbursement Committee and the trustee regarding the trustee's exercise of discretion," the grantor does not hold a retained interest that would trigger inclusion under §2036.

However, the Service warned:

> as noted in Rev. Rul. 2004-64, such discretion combined with other facts (including but not limited to: an understanding or pre-existing arrangement between [the grantor] and the trustee, or member(s) of the Reimbursement Committee regarding the trustee's exercise of this discretion; or applicable local law subjecting the trust assets to the claims of [the grantor's] creditors) may cause inclusion of Trust's assets in [the grantor's] gross estate for federal estate tax purposes.

Furthermore, said the Service, the proposed reformation will not affect the status of the trust as a grantor trust.

D. TOGGLING GRANTOR TRUST STATUS

Some clients and planners want to construct a "toggle switch" in the trust instrument that enables switching from grantor trust status to nongrantor trust status. For some extended thoughts on the issue, see Cororve and Radke, *It Toggles the Mind: Thoughts on Grantor Trusts and How to Turn Them On and Off*, State Bar of Texas, 26th Annual Advanced Planning and Probate Drafting Course (October 2015).

1. Turning Grantor Trust Status Off

In Private Letter Ruling 9304017, the Service ruled that the trusts at issue were grantor trusts where the trustee had the power to add or remove a beneficiary. The trust agreements also allowed the trustee to renounce this power irrevocably if done so in writing. Doing so would eliminate the power of control beneficial enjoyment of the trust property, so a waiver in compliance with the trust agreement would be effective in "turning off" grantor trust status.

There may be income tax consequences from turning off grantor trust status. If the grantor has sold property to the trust in a tax-free installment sale transaction, termination of grantor trust status may be a taxable event, as explored later in these materials. Furthermore, in Revenue Ruling 77-402, 1977-2 C.B. 222, the Service held that:

> when the grantor and owner of a trust which holds a partnership interest subject to liabilities renounces all grantor trust powers over that trust during life, the

> grantor is treated as having transferred the interest, and will recognize gain or loss. The ruling states that the result would also be the same if the trust were treated as a grantor trust by reason of powers exercisable by a party other than the grantor and ceased to be a grantor trust upon the release or renunciation of those powers by such other party or upon the expiration or lapse of such powers.

Chief Counsel Advice 201730012 (July 28, 2017).

Renouncing a power that triggers grantor trust status may not come so easily, however. In *Millstein v. Millstein*, 2018-Ohio-2295 (Ohio Ct. App. 2018), the grantor sought to modify the trust so as to convert the trust from a grantor trust to a nongrantor trust. The appellate court found that under the state's trust code only a trustee or beneficiary may seek modification, so the grantor lacked standing to modify the trust. The court had little sympathy for the grantor, finding he "voluntarily created the situation that he now claims in inequitable." The case is a good reminder that a power to renounce grantor trust status should be expressly included in the trust instrument.

2. Turning Grantor Trust Status On

One can properly draft a trust instrument so that grantor trust status starts at some point in the future and not upon formation of the trust. Structuring such a "springing power" presents a trickier drafting problem, but it should be possible. Presumably, the power would arise at a certain date or upon the occurrence of a stated event.

The trust could also be structured so that some person or persons hold the power to confer grantor trust status. Some have suggested the trustee could have the power to create grantor trust status (by giving the grantor a swap power, for example) that arises every two years. At such time, the trustee could decide whether to "turn on" grantor trust status. If the trustee decides against the power, the trustee simply refuses the power and waits two years for the power to arise again. This is an untried technique and its validity is certainly open to speculation. Yet as long as the trustee may exercise this power to "turn on" grantor trust status only in a fiduciary capacity, the trustee should not face adverse income, estate, or gift tax consequences.

The concern is that a trustee acting in the best interests of the beneficiaries will almost always want grantor trust status. ("Gee," thinks the trustee, "why should the trust pay the tax on its income when I can make the grantor pay the tax?") If the trustee has the power to give the grantor a swap power but refuses to do so, there might be a legitimate question as to why the trustee would prefer to have the taxes paid at the expense of the beneficiaries. For this reason, it might be safer to have an independent committee of non-fiduciaries with the power to give the grantor a swap power. But one may wonder, if the committee members have no fiduciary duties, what standards would apply to guide them in deciding whether and when to confer the

power to the grantor. Theoretically, therefore, a spring power is possible, but there is little firm guidance for how this is to be implemented in practice.

The Service has indicated that there is no federal income tax consequence to converting from nongrantor trust status to grantor trust status. In Chief Counsel Advice 201730012 (July 28, 2017), the Service said that "Given the lack of authority imposing [federal income consequences, we conclude that the conversion … from a non-grantor trust to a grantor trust will not be a transfer of property to Grantor from Trust under any income tax provision."

3. Turning Grantor Trust Status On and Off

Toggling between grantor trust and nongrantor trust status from year to year as circumstances dictate should be possible, and no special drafting should be required. As long as the grantor borrows principal or income from the trust and has not repaid the amount borrowed before the start of the trust's taxable year, the trust will be a grantor trust for that taxable year under §675(3). As explained above, however, deemed ownership will not occur if the loan provides for both adequate interest and adequate security, assuming the loan was made by a trustee other than the grantor, the grantor's spouse, or an RSP subservient to the grantor.

If the grantor wants to "turn off" grantor status, the grantor need only repay all amounts borrowed from the trust. If there are no loans outstanding, the grantor can "turn on" grantor trust status simply by borrowing from the trust in the year before the year in which the "turn on" is to occur. This ability to toggle back and forth from grantor trust status to non-grantor trust status is somewhat limited by the fact that grantor trust status is measured as of the *first* day of the taxable year. The grantor may not know at the beginning of the year whether grantor trust status would be desirable.

Toggling from grantor to nongrantor trust status can be accomplished in a more complicated way through decanting. In Private Letter Ruling 200848017, a trustee distributed assets from a nongrantor trust to one containing a swap power. The Service ruled the new trust was a grantor trust for federal income tax purposes.

VI. TECHNIQUES USING GRANTOR TRUSTS

A. INSTALLMENT SALES

One of the most popular estate planning techniques involves the sale of property to a "defective grantor trust." The transaction not only minimizes transfer tax exposure but also allows the grantor to minimize income tax exposure by escaping (or at least deferring) gain on the appreciation in assets contributed to the trust.

Installment sale transactions offer significant planning benefits even when not paired with grantor trusts. The principal benefit is the chance to freeze the estate tax value of assets sold, thereby removing future appreciation from the seller's gross estate. The post-sale appreciation escapes both gift and estate taxes. In addition, the amount of income tax paid by the seller is removed from the seller's gross estate. The installment sale can also enhance the seller's liquidity to the extent the seller disposes of an illiquid asset (like closely-held stock or real estate) in exchange for cash.

Traditional installment sale transactions also pose two significant drawbacks. First, the seller has to pay income tax on the resulting gain from the sale. Second, the seller loses all control over the transferred interests. If the buyers are inexperienced in management, this may pose a significant problem to the seller. This problem can be avoided if the seller sells only nonvoting stock or limited partnership interests and maintains an active role in the business by assisting the buyer in management of his or her affairs.

Use of the defective grantor trust can avoid both of these drawbacks. The grantor's installment sale of assets to a grantor trust is ignored for federal income tax purposes. *Rev. Rul. 85-13*, 1985-1 C.B. 184. Because the federal income tax laws see the grantor and the grantor trust as the same person, an installment sale between these parties is essentially a sale from the grantor to the grantor, a non-event. Thus, installment payments from the trust to the grantor, whether representing principal, interest, or both, will not be taxable to any extent.

The sale of property to a trust is not a gift because the trust is paying adequate and full consideration in the form of a promissory note. So long as the note bears the applicable Federal rate of interest, there are no federal gift tax consequences on the sale. Note that this rate will almost always be lower than the §7520 interest rate required for GRATs and other popular wealth-shifting techniques.

Some practitioners are concerned that the Service would scrutinize an installment sale transaction as not being at arms-length (thus posing potential gift tax consequences), since a reasonable seller might be disinclined to sell a substantial amount of assets to a buyer that likely holds no other equity. Since securing a personal guarantee from the trustee or from the beneficiaries may be unrealistic, these practitioners believe the defective grantor trust should be pre-funded with cash or other assets in an amount equal to about ten percent of the value of the property to be transferred by sale. Some commentators have observed a lemming approach—since so many practitioners advise their clients to make seed gifts to the defective grantor trust, making a seed gift may be the safest course of action. Others rationalize a seed gift by observing that an installment note from an undercapitalized buyer is sufficiently risky that the fair market value of the note would be less than its principal balance. And the exchange of property for an installment note worth less than the property's value (because of the risk discount) would be a gift to some extent that could trigger liability for gift tax.

Assuming the planner designed a suitable defective grantor trust, estate tax exposure for the grantor is minimized. If the grantor dies before the note has been repaid, the value of the note will be included in the grantor's gross estate. Notice this limits the possible gross estate inclusion to the fair market value of the transferred property as of the sale date; all future appreciation in value on the transferred assets passes to the trust beneficiaries free of transfer taxes.

No portion of the trust property is included in the grantor's gross estate under §2036(a) since the property was sold (not gifted) to the trust. This is true even if the grantor dies before the note has been repaid; all appreciation in the value of the transferred property will escape estate taxation.

Though very popular, installment sales to defective grantor trusts raise issues about which there is no clear answer.

1. Whether to Disclose the Sale on a Gift Tax Return

Since the installment sale transaction is a "tax nothing" in that it is neither a taxable sale nor a gift, there is no requirement to report the transaction to the Service. Nonetheless, many practitioners like to report the installment sale transaction on a federal gift tax return so as to start the statute of limitations as to the valuation of the property or properties involved in the sale. See Steve R. Akers, *Estate Planning Current Developments and Hot Topics* (July 2019) at 77. Given the relatively low audit rates for federal gift tax returns, this approach makes sense, though some clients may fear that disclosing the transaction unnecessarily exposes them to a risk of audit.

2. Gain Recognition at Grantor's Early Death?

If the client survives to the repayment of the note, of course, all is good. But the consequences that ensue when the client dies before the note has been repaid in full are not entirely certain. We know that upon the grantor's death, a grantor trust becomes a nongrantor trust unless some other person becomes the deemed owner. But now that the trust is a separate taxpayer, does that mean the installment sale transaction is now a taxable one, meaning there is recognized gain for income tax purposes from the sale?

Conventional wisdom says yes. The reasoning is straightforward: Revenue Ruling 85-13 concluded a sale to a grantor trust is ignored for income tax purposes because the trust and the grantor are effectively the same person; once the trust and the grantor are no longer the same person, it stands to reason the transaction would become a taxable sale, like any similar arrangement involving two taxpayers. This suggests the Service could require the grantor's final Form 1040 to report the gain from the sale. This position is also consistent with the rule treating the death of the grantor of a foreign trust as a deemed taxable transfer of the assets by the

grantor in the moments before death. See Stephen T. Dyer, *Planning With Grantor Trusts* (2018) at 46. Carol A. Cantrell states the argument well in her article, *Gain is Realized at Death*, Trusts & Estates 20 (February 2010):

> In my opinion, the available authorities now strongly suggest that the death of the grantor of an irrevocable grantor trust with an outstanding note balance is a "part sale-part gift" occurring on the last day of the grantor's taxable year. The grantor realizes gain equal to the excess of the note balance over his basis in the property. That gain constitutes [income in respect of a decedent], which the grantor's estate or successors recognize when they collect the note payments. And the trust's basis in the property is the greater of the note balance or the grantor's basis in the property on the date of death.

But several commentators have observed that reporting the gain on the grantor's frinal Form 1040 violates the spirit of Revenue Ruling 85-13, for reporting on the final Form 1040 assumes a sale in the moments before death, while the grantor is still alive. Any sale necessarily comes at or immediately after the grantor's death. This is consistent with Chief Counsel Memorandum 200923024 (June 5, 2009), in which the Service opined that termination of grantor trust status upon the death of the grantor "is generally not treated as an income tax event." Thus, say proponents from this camp, if the grantor's death is a taxable event at all, it must be taxable to the estate (or to the beneficiaries) on a Form 1041.

And yet, as explained below, most commentators feel that because the payments from the trust are not "income in respect of a decedent," there is no basis for reporting the gain on a Form 1041 either. This absence of a proper tax form for the gain (not the Form 1040 because the sale was not during the grantor's life, and not the Form 1041 because payments from the trust are not income in respect of a decedent) leads a number of commentators to argue that the grantor's death should not cause recognition of the gain from the sale. See, e.g., Laura H. Peebles, *Death of an IDIT Noteholder*, TRUSTS & ESTATES 28 (August, 2005); Blattmachr, Gans & Jacobson, *Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor's Death*, 97 J. TAX'N 149, 153 – 154 (September 2002); Shore & McClung, *Beyond the Basic SUPERFREEZE—An Update and Additional Planning Opportunities*, TAXES 41, 46 (January 1997). In their article, *No Gain at Death*, Trusts and Estates 34 (February 2010), Professor Mitchell Gans and Jonathan Blattmachr offer their conclusion:

> In a 2002 article, we examined at length the income-tax effects of the termination of a grantor trust by reason of the death of the grantor in the context of an installment sale. Acknowledging then that the law was unsettled, we considered the plausibility of various approaches. Still, we reached firm conclusions about two critical issues: first, that gain is not recognized at the time of the grantor's death; and second, that the income in respect of a decedent (IRD) regime, largely

contained in Internal Revenue Code Section 691, cannot apply. We continue to believe that these conclusions are correct.

3. Trust's Basis in Purchased Property After Grantor's Death

A related issue is determining the trust's basis in property purchased in an installment sale transaction when the grantor dies before repayment. For discussion of this issue generally, see Jeffrey Pennell, *Basis of Grantor Trust Assets Before the Grantor's Death* (January 20, 2019), available at SSRN: https://ssrn.com/abstract=3319242. We know from Revenue Ruling 85-13 that the once-grantor trust becomes a nongrantor trust for federal income tax purposes upon the death of the grantor. Now that it is a separate taxpayer, it becomes necessary to compute the trust's basis in the property purchased in the installment sale transaction. On this point, commentators take at least three different approaches.

a. Cost Basis?

The default rule for basis is §1012, which provides that a taxpayer's basis is its cost "except as otherwise provided." That, in turn, raises two questions: (1) What is the trust's "cost basis" in the property acquired in an installment sale transaction?; and (2) Do any exceptions to the cost basis rule apply? This section will look at the first question (the trust's "cost basis") and the next two sections consider two potentially applicable exceptions to the cost basis rule.

Arguably, the trust's basis in the assets acquired in an installment obligation should be the unpaid principal balance of the installment obligation as of the grantor's death. We only care about the trust's cost basis in property acquired from an installment sale once the trust ceases to be a grantor trust. Until that point, the trust is disregarded for income tax purposes. The grantor's death creates a new trust immediately holding assets for which it is now obligated to pay a purchase price to the grantor's successor in interest (the person or persons who receive the installment obligation from the grantor or the grantor's estate or the grantor's formerly revocable living trust). Traditional notions of tax cost indicate the trust takes a basis equal to the purchase price it must pay as a result of the installment sale transaction. This means the trust's "cost basis" is at least equal to the remaining principal balance of the installment obligation as of the grantor's death. Alas, there are no rulings or regulations confirming this approach, and few commentators raise it as a possible reporting position.

b. Fair Market Value at Grantor's Death Basis?

As stated above, §1012 states that a taxpayer's basis is equal to the taxpayer's "cost basis" in property except as otherwise provided. In this context, arguably, there are *two* exceptions. The first, discussed here, is §1014, which provides for a stepped-up basis in the case of property acquired from a decedent. Some commentators believe that because there is no "transfer" from the grantor to the trust until the grantor's death, the trust has acquired the property "from a

decedent" and thus is eligible for a stepped-up basis. See Blattmachr, Gans & Jacobson, *supra*, at 154 – 155. Because the transfer from the grantor at death is structured as a part-bequest, part-sale (because the trust is paying for the property with an installment note), the basis rules effectively award the trust a stepped-up basis.

> EXAMPLE: G created a defective grantor trust in 2012, and in that year G sold property worth $10 million to the trust in exchange for a balloon note from the trustee in the principal amount of $10 million. G's basis in the property was $1 million. The note provided for the payment of interest at the applicable Federal rate. G died in 2019 when the value of the property was $18 million. Some commentators conclude that the trust's basis in the property immediately following G's death is $18 million. This is because no transfer to the trust occurs until Grantor's death in 2019. At the time of the transfer, the trust receives property worth $18 million in exchange for a note in the principal amount of $1 million. The trust has a "cost" basis of $10 million. But the trust is also receiving a bequest in the amount of $7 million (the difference between the value of the property at the time of the "transfer" and the purchase price payable by the trust). Under §1014, the bequest portion of the transaction gets a fair market value basis. Thus, the trust gets another $7 million in basis, making its total basis in the property $18 million, the property's fair market value at death.

The weakness in this theory is that §1014(b) identifies exactly ten instances in which property is considered to have been acquired from a decedent for §1014(a) purposes, and property received by the new, nongrantor trust through a deemed transfer at the grantor's death does not clearly fall within any of them.

Since the property transferred to the trust at death is not included in the grantor's gross estate (it was a defective grantor trust, remember), §1014(b)(9) is not available. Nor is any of §§1014(b)(2) (property held by a revocable living trust), 1014(b)(3) (property held by a trust in which the decedent retained a power to alter or amend enjoyment), 1014(b)(4) (property passing for less than full consideration by testamentary exercise of a general power of appointment), 1014(b)(5) (a now-defunct rule for certain stock in a foreign personal holding company), 1014(b)(6) (the surviving spouse's share of community property), 1014(b)(7) (a pre-1947 rule for community property), 1014(b)(8) (a pre-1954 rule for joint and survivor annuities), and 1014(b)(10) (property includible under §2044 because of a marital deduction previously allowed).

Section 1014(b)(1) might come closest. It covers property "acquired by bequest, devise, or inheritance, or by the decedent's estate from the decedent." Yet it seems doubtful that the death-time transfer from the grantor to the trust, which occurs by operation of federal income tax law, could be classified as "bequest, devise or inheritance" from the grantor—the transfer is likely not provided for in the decedent's will and the transfer is not one resulting from the laws of intestate succession. At best, one could argue that the constructive transfer at death is really

a two-step dance: first, the decedent's estate acquired the property from the decedent (qualifying the property for the §1014 step-up); and, second, the estate then transferred the property to the trust immediately thereafter. This fiction seems a stretch, for it assumes the estate has rights to the property and perhaps that the fiduciary would agree to a sale of the property at less than arms-length.

c. Carryover Basis?

The other potential exception to the cost basis rule is §1015. Section 1015(a) is familiar turf for estate planners—we all know that a donee takes the donor's basis in gifted property (except when determining loss from the disposition of gifted property that had a basis in excess of its value at the time of the gift). But what is lesser known is §1015(b). It provides that property acquired "by a transfer in trust (other than … by a gift, bequest, or devise)" has the same basis as it would in the hands of the donor, increased by any gain (or decreased by any loss) recognized to the grantor upon such a transfer. Since the trust acquired the purchased assets through a transfer in trust, some commentators believe §1015(b) applies such that the trust takes the grantor's basis in the property purchased. See Laura H. Peebles, *Death of an IDIT Noteholder*, TRUSTS & ESTATES 28, 33 (August, 2005). See also Austin Bramwell and Stephanie Vara, *Basis of Grantor Trusts at Death: What Treasury Should Do*, Tax Notes (August 6, 2018) at 793. Although the transfer of the assets to the then-defective grantor trust was not recognized as a sale transaction for federal income tax purposes, it was, commentators say, a transfer to the trust nonetheless, triggering §1015(b).

4. Income Tax Consequences of Post-Death Note Payments

Then there is the issue of whether, going forward, the grantor's beneficiaries, now holders of the trust's promissory note, must report gain from the note as payments are made. Some commentators take the position that post-death payments on the note are income in respect of a decedent (IRD) and therefore taxable to the beneficiaries when they receive payments. Others conclude that the payments are not taxable to the beneficiaries, though their reasons for this conclusion are varied. Some say that because the payments would not be income to the grantor in the first place under *Revenue Ruling 85-13*, they could not be IRD under §691. See Blattmachr, Gans & Jacobson, *supra*, at 153 – 154. Others read Regulation §1.691-5 to say that the payments could be IRD under §691(a)(4) only if the original transaction with the grantor was properly reportable as an installment sale subject to §453. See Peebles, *supra* note 48, at 33. Since the original transaction was not subject to §453 (it was not even recognized at the time!), the payments to the beneficiaries of the note could not be IRD.

B. SALE TO A SPOUSAL GRANTOR TRUST

Some planners have extended the ordinary installment sale transaction by having one spouse sell property to an irrevocable trust wholly-owned by the other spouse (a "spousal

grantor trust"). The sale is not recognized for federal income tax purposes because it is, in essence, a transfer of property between spouses. See §1041. Beyond the traditional installment sale advantages described in Part A above, the spousal grantor trust allows the selling spouse to: (1) be a beneficiary; (2) serve as trustee; and (3) hold a testamentary limited power of appointment over the trust's assets. In effect, then, the selling spouse can retain an interest in (and some control over) the property sold to the trust without risking gross estate inclusion under §§2036 through 2038.

William R. Culp, Jr., Paul M. Hattenhauser, and Briani Bennett Mellen observe in their article, *The Tax and Practical Aspects of the Installment Sale to a Spousal Grantor Trust*, 44:1 ACTEC L. J. 63 (Winter 2019), that:

> For married clients who are reluctant to engage in a traditional grantor trust sale because of the loss of the economic benefit from, or control over, assets sold to the grantor trust, the spousal grantor trust sale offers a unique option to engage in sophisticated estate tax reduction planning without the perceived lifetime disadvantages of a traditional grantor trust sale. A sale of property to a spousal grantor trust in exchange for a cash down payment and promissory note, however, is not without its own unique set of tax issues, including the taxation of interest income on the installment promissory note, whether gain is recognized on the sale after the death of either spouse, and the risk of inclusion of the trust property in the selling spouse's gross estate.

Id. at 65. The authors conclude that the selling spouse does not recognize gain on the sale to the spousal grantor trust, even if the grantor spouse dies before the installment note has been repaid fully. They also contend that payments made on the note to the selling spouse after the death of the grantor spouse should continue to be tax-free. But they also state that "Prior to the selling spouse's death, payments received by the selling spouse should be received income-tax-free, although interest payments will be taxable to the selling spouse and may be deductible by the grantor spouse." *Id.* at 127.

C. GRANTOR-RETAINED ANNUITY TRUSTS

Under a "grantor-retained annuity trust" ("GRAT"), the trust pays an annuity to the grantor for a specified term. At the end of the term, the trust generally terminates and the remainder is paid to the designated beneficiaries.

The More You Know

For an excellent summary of the requirements and consequences of GRATs, as well as the planning opportunities they present, see Carlyn S. McCaffrey, *The Care and Feeding of GRATs—Enhancing GRAT Performance Through Careful Structuring, Investing and Monitoring*, 39 HECKERLING INSTITUTE ON ESTATE PLANNING 7-1 (Tina Portuando, ed., 2005).

The trust instrument must satisfy all of the requirements set forth in the regulations. See Reg. §25.2702-3. If the trust complies with these many requirements, the grantor's retained interest will be a "qualified annuity interest" eligible for valuation under §7520. If the trust does not comply with these requirements, the grantor's retained interest is valued at zero, so the grantor is deemed to make a gift equal to the full value of the property transferred to the trust even though the grantor has retained the right to payments from the trust.

1. Requirements for GRAT Status

The annuity amount must be payable at least annually, and it must be paid no matter whether the trust generated sufficient income to pay the required amount without dipping into principal. The annuity amount must be paid with 105 days following the anniversary date of the GRAT's creation, though certainly no later than the date on which the trustee must file the trust's income tax return (even though such amounts will be taxed to the grantor).

The trustee may not issue "a note, other debt instrument, option, or other similar financial arrangement in satisfaction of the annuity." Reg. §25.2702-3(b)(1)(ii). The annuity amount must be fixed, either in terms of a dollar amount or a percentage of the initial fair market value of property transferred to the trust.

Drafting Tip

If the grantor will transfer assets that may be difficult to value (or will prompt heightened scrutiny, like interests in family limited partnerships), it may be preferable to use the fixed percentage approach instead of the fixed dollar approach to minimize gift tax exposure in case the original valuation is determined to be in error.

If the trust instrument defines the annuity in terms of a fixed percentage of the initial value of the trust's assets, the trust instrument must contain an adjustment clause that permits the trustee to atone for valuation errors in previous payments. The fixed amount payable from the trust need not be the same each year; however, the amount paid in any given year may not be more than 120 percent of the amount paid in the prior year.

The trust instrument must prohibit additional contributions to the trust, as well as the trust's prepayment of the grantor's annuity interest. Until the annuity interest expires, the trust instrument must prohibit payments from the trust to any person other than the annuitant. Finally, the trust term must be expressed as either a term of years, the life of the annuitant, or the shorter of those two periods.

2. Consequences of GRAT Status

a. Income Tax Aspects

A GRAT will usually qualify as a grantor trust because the grantor's retained annuity right is a right to be paid from income. §677(a). If the trust instrument requires the trustee to pay the annuity from income first, grantor trust status is assured. But grantor trust status also arises if the trustee has the discretion to pay the annuity from income, provided the trustee is a NAP and the trustee does not need the consent of an AP.

Side Note

Some commentators claim that grantor trust status arises because the grantor's retained annuity is a reversion. See McCaffrey, *supra*. Thus, if the value of the grantor's annuity right exceeds 5% of the value of the property contributed to the trust, grantor trust status follows. This analysis likely assumes that the trust instrument requires the property to revert to the grantor's estate if the grantor dies before the end of the trust term. Some (but not all) GRAT forms include this reversionary feature.

Because the typical GRAT is a grantor trust, the usual consequences of grantor trust status will inure to the GRAT, subject only to the special limitations and requirements imposed on GRATs under the regulations.

> EXAMPLE: In 2018, G transferred stock to a trust that qualified as a GRAT. In 2022, the trustee was required to pay $100,000 to G but the trust lacked sufficient cash flow to pay the entire amount owed in cash. The trustee may transfer stock to G in satisfaction of all or a portion of the required annuity amount without recognizing gain because, for income tax purposes, the trust and the grantor are the same taxpayer. Accordingly, the federal income tax laws see no taxable disposition of the stock.

The GRAT is also a helpful device for transferring stock in an S corporation, for the transfer of S corporation stock to a GRAT will not jeopardize the S election if the GRAT is a grantor trust. See, e.g., *PLR 9519029*; *PLR 9504021*; *PLR 9451056*. Teri L. Sunderman, *GRAT Planning with S Corp. Stock*, THE TAX ADVISER 502, 506 (August 2004). (This assumes the grantor (or deemed owner) is an eligible shareholder. See §1361(c)(2)(A).)

b. Estate Tax Aspects

If the grantor survives the trust term, there is no inclusion in the grantor's gross estate. Death before the end of the trust term triggers gross estate inclusion under either or both of §2036(a) (because the grantor retained a right to enjoyment from property transferred to the

trust for a period that did not end before death) and §2039 (because the grantor held the right to receive annuity payments for a period that did not end before death, assuming annuity payments continue to be made after the grantor's death).

Some commentators believe that §2039 does not apply to fixed-term GRATs since the remainder beneficiary's right to take under the trust is not conditioned upon surviving the grantor; rather, the remainder beneficiary's right to take is conditioned on outlasting the trust term. See Deborah V. Dunn, *Coming to a Wal-Mart Near You: Tax-Free GRATs*, 140 TRUSTS & ESTATES 10, 12 (April 2001).

c. Gift Tax Aspects

Assuming the trust instrument complies with the requirements listed above, the grantor makes a gift equal to the value of the transferred property less the present value of the retained annuity interest. The present value of the grantor's retained interest is measured actuarially under the §7520 annuity tables. Thus, the amount of the gift will depend upon the amount of the annuity, the value of the property transferred to the trust, the estimated trust term, and the month of formation, since the §7520 tables assume an interest rate equal to 120 percent of the applicable Federal midterm rate.

3. Avoiding Gift Tax Upon Formation: The Zeroed-Out GRAT

It is possible to structure a GRAT where the grantor's taxable gift is zero. It all began with *Walton v. Commissioner*, 115 T.C. 589 (2000), when the Tax Court considered the validity of Example 5 in Regulation §25.2702-3(e). In this example, *A* transfers property to an irrevocable trust, retaining the right to receive a unitrust amount for 10 years. If *A* dies within the 10-year term, the unitrust amount is to be paid to *A*'s estate for the balance of the term. The example concludes that *A*'s interest is a qualified unitrust interest to the extent of the right to receive the unitrust amount for 10 years or until *A*'s prior death. The example also concludes, however, that the unitrust amount payable to *A*'s estate if *A* dies within the term of the trust is not a qualified interest. This had the effect of increasing the value of the GRAT remainder interest and precluded such remainder from being valued at zero, since there was always *some* chance that the grantor could die during the trust term.

After considering the legislative history and purpose of §2702, the court held that Example 5 was an unreasonable interpretation and invalid extension of §2702. The court concluded that a retained annuity payable for a specified term of years to the grantor, or to the grantor's estate if the grantor dies prior to expiration of the term, is a qualified interest under §2702 for the specified term of years, no matter whether the grantor survives such term.

Treasury then issued regulations revising Example 5 to conform to *Walton*. Under the example as revised, a unitrust amount payable for a specified term of years to the grantor, or to

the grantor's estate if the grantor dies prior to the expiration of the term, is a qualified interest for the specified term. Thus, the interest of *A* (and *A*'s estate) to receive the unitrust amount for a specified term of 10 years in all events is a qualified interest.

The zeroed-out GRAT eliminates one of the major drawbacks of the traditional GRAT; namely, that the grantor makes a taxable gift upon formation of the trust. If the grantor survives the trust term, there are no estate tax consequences and no gift tax consequences to shifting wealth through the GRAT. Consequently, many planners consider the zeroed-out GRAT one of the best arrows in the estate planner's quiver.

VII. TAX REPORTING WITH GRANTOR TRUSTS

As previously stated, the income tax items of a grantor trust are reported on the grantor's federal income tax return. As a result, it is not essential that the trustee obtain a separate employer identification number ("EIN") for the trust. That said, most trustees will want to secure an EIN for the trust. Trustees will find it much easier to have an EIN in hand when opening a bank account, as many banks balk at opening a trust account under the social security number of an individual. Further down the road, a separate EIN will be helpful in segregating the assets of the trust from those of the grantor. This will be helpful if the grantor's creditors come seeking assets. See generally Ivan Taback and Scott A. Bowman, *Frequently Asked Questions on Grantor Trust Tax Reporting*, 39:8 ESTATE PLANNING 34 (August 2012.)

A. REPORTING TRUST INCOME DURING THE GRANTOR'S LIFE

The proper method for reporting a grantor trust's taxable income depends fundamentally upon the number of deemed owners and whether those owners own specific trust assets or fractional shares of all trust property. See Taback and Bowman, supra, and Kathleen M. Weiden and Charles A. Barragato, *Get a Handle on Grantor Trust Tax Rules and Strategies*, PRACTICAL TAX STRATEGIES 87 (February 2005).

1. Extent of Deemed Ownership—All Assets, Some Assets, or a Fractional Share of All Assets?

If the grantor is deemed to own the entire trust, then all of the trust's income, gain, loss, deduction, and credit items are reported on the grantor's individual tax return. Reg. §1.671-3(a)(1). If the grantor is deemed to be the owner of a portion of the trust's assets, then the apportionment of income hinges on whether the grantor is deemed to own specific trust property or an undivided fractional interest in all assets. Where the grantor is the deemed owner of specific trust property, the items of income directly related to such property are reported on the grantor's return, as well as a portion of the income for items related to both the specific trust property and other trust property. Reg. §1.671-3(a)(2). Where, instead, the grantor is the deemed owner of an undivided interest in all trust property, all income, gain, loss, deduction,

and credit items must be allocated on a *pro rata* basis so that the grantor may report his or her share of the items on the grantor's personal tax return. Reg. §1.671-3(a)(3).

2. One Owner of All Assets

Where the grantor is the deemed owner of the entire trust, the trust must still report to the Service, and it generally has three options for doing so. Certain grantor, trusts, however, may use only the 1041 method described below. These include foreign trusts, qualified subchapter S trusts, and non-United States grantor trusts. Reg. §1.671-4(b)(6) – (7).

a. The 1041 Method

First, the trust may file a regular Form 1041, U.S. Income Tax Return for Estates and Trusts. The trustee leaves lines 1 – 30 (the lines for income, deductions, tax and payments) blank, then shows the trust's tax items on a separate statement attached to the return and delivered to the grantor. Reg. §1.671-4(a), (b).

b. The W-9 Method

Second, the grantor may submit a completed Form W-9, Request for Taxpayer Identification Number and Certification, to the trustee, followed by the trustee providing to each payor to the trust the name and taxpayer identification number of the grantor. Reg. §1.671-4(b)(2)(i)(A). If the grantor is not a trustee or co-trustee of the trust, the trustee(s) must also furnish the grantor with: (i) an annual statement listing items of income, gain, loss, deduction, and credit of the trust; (ii) the identity of each payor; (iii) enough information to allow the grantor to report all items properly; and (iv) a statement informing the grantor that items must be included on his or her individual return (collectively, the "required information"). Reg. §1.671-4(b)(2)(ii). This option is used most commonly for revocable living trusts. See Jennifer Pierce, *Tax Reporting for Grantor Trusts* (November 2017, available online at: https://www.mitchellwilliamslaw.com/getpdf.aspx?blog=8673).

c. The 1099 Method

Third, the trustee may provide all payors with the trust's taxpayer identification number and then file Forms 1099 for all income items, listing the trust as payor and the grantor as payee. Reg. §§1.671-4(b)(2)(i)(B); 1.671-4(b)(2)(iii)(A). As with the second option, the trustee(s) must furnish the grantor with the required information if the grantor is not a trustee. Reg. §1.671-4(b)(2)(iii)(B).

3. Multiple Owners of All Assets

Where there is more than one deemed owner of all of the trust's assets, the trust again has a reporting obligation, but here the trustee has only two options for filing: the 1041 method, Reg. §1.671-4(a), or the 1099 method, Reg. §1.671-4(b)(3).

4. One or More Owners of Less Than All Assets

If only a portion of the trust is treated as a grantor trust, then the trust must follow the 1041 method. Here, the items considered owned by the grantor or other owners are not reported on the trust's Form 1041 but instead are disclosed on a separate statement attached to the Form 1041, a copy of which is provided to the grantor or other owners. Reg. §1.671-4(a). Those items considered to be owned by the trust (the nongrantor trust portion) are reported directly on the Form 1041.

B. REPORTING TRUST INCOME AT AND AFTER DEATH

In the taxable year of the grantor's death, the trustee reports trust income in the same manner as used during the grantor's life. If the trustee files a blank Form 1041 using the default, "traditional" method, the due date for that return is April 15 in the year after the year of the grantor's death. That return must also indicate that it is the final Form 1041 to be prepared under the trust's EIN (or the grantor's social security number, if there was no EIN assigned to the trust during the grantor's life).

In taxable years after the year of the grantor's death, the trustee must report the trust's income, deduction, and credit items on a Form 1041, as the trust is no longer a grantor trust for federal income tax purposes. Trust income will thus be allocated between the trust and its beneficiaries based on the amounts of any distributions to the beneficiaries. For guidance on computing and paying federal income taxes after the grantor's death, see Ferguson and Ascher, FEDERAL INCOME TAXATION OF ESTATES, TRUSTS & BENEFICIARIES (Wolters Kluwer: 2018).