

ATTRACTING AND AVOIDING GRANTOR TRUST STATUS

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I. INTRODUCTION TO GRANTOR TRUSTS

A. Section 671 -- Tax Effect of Grantor Trust Status

- (1) When the grantor or another person is treated as the owner of any portion of a trust, the grantor (or other person) shall include [on the grantor's income tax return] those items of income, deduction, and credits against tax of the trust which are attributable to that portion.
- (2) What is "income"?

Treas. Reg. §1.671-2(b) states, "Accordingly, when it is stated in the regulations under subpart E that "income" is attributed to the grantor or another person, the reference, unless specifically limited, is to income determined for tax purposes and not to income for trust accounting purposes." To refer to income for trust accounting purposes, the phrase "ordinary income" is used.

B. Overview of the Rules – When is a Trust a Grantor Trust?

- (1) If grantor has retained a reversionary interest under Section 673.
- (2) If grantor or non-adverse party has certain powers over the beneficial interests in the trust under Section 674.
- (3) If certain administrative powers over the trust exist under which the grantor can or does benefit under Section 675.
- (4) If the grantor or a nonadverse party has a power to revoke the trust or return the corpus to the grantor under Section 676.
- (5) If the grantor or a nonadverse party has the power to distribute income to or for the benefit of the grantor or the grantor's spouse under Section 677.

C. Who is the Grantor?

- (1) The grantor is any person to the extent that person either:
 - (a) Creates a trust; or
 - (b) Directly or indirectly makes a gratuitous transfer of property to a trust.

D. What is a Gratuitous Transfer?

- (1) Any transfer other than a transfer for fair market value.
 - (a) Transfer does not need to be a completed gift.
 - (b) A transfer by an entity not for a business purpose is a transfer by the owners.

E. What about a Trust to Trust Transfer?

- (1) In general, the grantor of the transferor trust will be treated as the grantor of the transferee trust.
- (2) An exception applies if a person exercises a general power of appointment in favor of another trust.

F. Is the “Grantor” taxed?

- (1) Not necessarily because a person who is a grantor is not necessarily an “owner.”
- (2) To be an owner, one must make a gratuitous transfer to the trust.

G. What are the Obligations of a Grantor?

- (1) A grantor can have the obligation to file tax returns with respect to the trust (e.g. under Section 6048 for a foreign trust).
- (2) Thus, if an attorney creates a trust for a client with \$100 and is reimbursed, both are grantors, but only the client is an owner.

H. Will a 678 Power Make You a Grantor?

- (1) No.
- (2) For example, if a trustee exercises a power to create a second trust after the grantor’s death and retains the power to revoke the second trust, the grantor of the original trust is the grantor of the new trust, BUT the trustee is the “owner” of the new trust.

II. TO WHAT EXTENT IS A TRUST A GRANTOR TRUST?

A. The Extent of Grantor Trust Status Is Determined by the “Portion” Rule

- (1) Reg. §1.671-3 says a portion may consist of specific trust property, an undivided fractional interest, an interest represented by a dollar amount, only ordinary income or only income allocated to corpus.
- (2) A power over corpus can cause the grantor to be taxable on the ordinary income portion as well if ordinary income may be accumulated and thus become subject to the power over corpus.
- (3) If a grantor or another person is treated solely as the owner of the ordinary income portion, the grantor will be taxed in the same manner as a current income beneficiary, including expenses allocable to corpus which enter into the computation of distributable net income.

B. Exercise of a General Power

- (1) Makes the powerholder the grantor of the new trust, even if the original trust was a grantor trust.
- (2) It seems that no other power will change the grantor of the transferee trust.

III. COLLATERAL TAX EFFECTS OF CREATING A GRANTOR TRUST

A. Under Rev. Rul. 2004-64, 2004-2 C.B. 7

- (1) The fact that a trust is a grantor trust and the tax attributes of the trust are reported by the grantor will cause neither grantor nor any beneficiary to be treated as making a taxable gift to the trust.
- (2) Discretionary power of reimbursement for income taxes paid by the grantor, by itself, will not cause estate tax inclusion.

B. Additional Requirements under Rev. Rul. 2004-64

- (1) If trustee has a discretionary power to reimburse the grantor for income taxes paid.
 - (a) Grantor may not act as a trustee.
 - (b) Grantor may not remove and replace trustees with related and subordinate parties.
 - (c) State law must prohibit creditors from accessing the trust by reason of the reimbursement power.
 - (d) No implied understanding to exercise the power.

C. Other Consequences of Creditors' Rights

- (1) Gift to the trust is incomplete.
 - (a) If grantor can relegate her creditors to the trust then the grantor will be deemed to have retained dominion and control.
- (2) Some States have reversed this rule relative to a reimbursement power.

D. What if Trustee Must Reimburse?

- (1) Automatic estate tax inclusion
 - (a) BUT should it be 100% since the effective tax rate is not 100%?
 - (b) Maybe the fact that income allocated to corpus could produce a taxable gain in excess of accounting income is enough to capture the entire trust.

IV. CREATING A GRANTOR TRUST

A. What Methods Might Be Used to Create a Grantor Trust?

- (1) Powers of disposition
- (2) Spouse as a discretionary beneficiary
- (3) Power of substitution
- (4) Power to add beneficiaries
- (5) Power of appointment
- (6) Actual borrowing
- (7) Power to borrow
- (8) Decanting

B. Power of Disposition by a Related and Subordinate Party

- (1) 674(a) states that the grantor shall be treated as the owner of any portion of a trust in respect of which the beneficial enjoyment of the corpus or income therefrom is subject to a power of disposition, exercisable by the grantor or a nonadverse party, or both, without the approval or consent of any adverse party.
- (2) Adverse Party/Nonadverse Party

- (a) An adverse party is any person having a substantial beneficial interest in the trust which would be adversely affected by the exercise or non-exercise of the power which he possesses respecting the trust. A general power of appointment is a beneficial interest, but not automatically substantial.
 - (b) A nonadverse party – Everyone else.
- (3) Independent Trustee Exception
- (a) 674(c) says that 674(a) shall not apply to a power exercisable solely by a trustee none of whom is the grantor (or the grantor's spouse) and no more than half of whom are related and subordinate parties who are subservient to the wishes of the grantor.¹
- (4) 672(c) – Related and Subordinate Party
- (a) Grantor's spouse **who is living with the grantor**, grantor's father, mother, sister, brother, issue, employee, subordinate employee of a corporation in which grantor is an executive, a corporation or any employee of a corporation in which the stock holdings of the grantor and the trust are significant from viewpoint of voting control.
 - (b) Related and subordinate party is presumed subservient unless shown not to be by a preponderance of the evidence.
- (5) 672(e) – Spousal Unity Rule
- The spousal unity rule of under 672(e) says the grantor is treated as holding any power or interest held by any individual (i) who was the grantor's spouse at the time of the creation of the power or interest (but not considered married if legally separated) or (ii) who became the spouse after the creation of the power or interest.
- (6) Reasonably Definite Standard
- (a) 674(b)(5) creates an exception for a power to distribute **corpus** provided the power is limited by a reasonably definite standard that is set forth in the trust instrument.
 - (b) And 674(d) states that 674(a) shall not apply to a power exercisable by a trustee (not the grantor or spouse living with the grantor) to distribute, apportion or accumulate **income** to or for the

¹ Note that even if a trustee is technically independent, it may not be enough if the trustee consistently acts directly or indirectly, at the direction of the grantor. *Securities & Exchange Commission v. Wyly*, 56 F. Supp. 3d 394 (S.D.N.Y. 2014), *new trial denied*, 117 F. Supp. 3d 381 (S.D.N.Y. 2015).. See, generally, William E. Keenen and Diana S.C. Zeydel, "Is Designating an Independent Trustee a Tax Panacea?" 43 *Estate Planning* 3 (February 2016).

benefit of beneficiaries if such power is limited by a reasonably definite **external** standard which is set forth in the trust instrument.

(7) Conclusion

To achieve a wholly grantor trust, you need a power of disposition not limited by a reasonably definite (external) standard held by trustees more than half of whom are related and subordinate parties who are subservient to the wishes of the grantor.

(8) What Estate Tax Implication Would That Have?

- (a) Rev. Rul. 2004-64 implies that a trustee who is not independent may be presumed to exercise authority in the grantor's favor pursuant to an implied understanding that would attract 2036 inclusion.
- (b) Would that apply to a power exercisable in favor of persons other than the grantor?

(9) Rev. Rul 95-58, 1995-2 C.B. 191

- (a) Rev. Rul. 95-58 dealing with the donor's retention of a power to remove and replace the trustee states that a power to remove a trustee and replace that trustee with a person that is not related and subordinate to the donor (within the meaning of 672(c)) would not cause the donor to be treated as having retained the trustee's discretionary control over trust income.
- (b) Rev. Rul. 95-58 does not address the initial appointment of a related and subordinate trustee.
- (c) In *Estate of Vak. v. Commissioner*, 973 F. 2d 1409 (8th Cir. 1992), the initial trustees were related and subordinate trustees and the settlor retained the power to remove the trustees at any time and replace them with trustees who were not related and subordinate to the settlor. Court held the gift to the trust was complete.
- (d) Toggling Off
 - (i) Grantor could retain the power to remove the related and subordinate trustees and replace them with an independent trustee.
 - (ii) But the grantor cannot have the power to toggle back on by appointing related and subordinate trustees because of Rev. Rul. 95-58.

(10) Problem for an Installment Sale to a Grantor Trust

Generally want independent trustees engaging in the arms length sale of assets from the grantor to the trust to enhance the position that it is a bona fide sale for full and adequate consideration, arm's length and free from donative intent.

(11) Good for an Irrevocable Life Insurance Trust

(a) It might be the right power to use in an ILIT where you want to preserve your opportunities to shift around the policies under Rev. Rul. 2007-13, 2007-11, I.R.B. 684.

(b) Rev. Rul. 2007-13 says that moving a policy for value into a wholly grantor trust qualifies as a transfer to the grantor and is therefore excepted from the application of the transfer for value rule under section 101(a)(2) that would cause the proceeds of a policy that has been transferred for value to be includible in income. Exceptions to the rule exist for transfers to the insured, a partner of the insured, a partnership in which the insured is a partner, and a corporation in which the insured is a shareholder or officer, as well as transfers if the transferee has, at least in part, a carryover basis.

(12) Power over more than 5% of Corpus

(a) 674(b)(3) creates an exception to grantor trust status for a power which can affect beneficial enjoyment only after the occurrence of an event such that the grantor would be treated as an owner if the power were a reversionary interest.

(b) In PLR 200846001, the IRS ruled that a power not limited by a standard held by a related and subordinate trustee to distribute the income and principal of a GRAT upon the expiration of the GRAT term, where the actuarial value of the remainder interest exceeded 5%, was sufficient to cause the trust to be a wholly grantor trust. This type of power would also work well for a charitable lead annuity trust, although both GRATs and CLATs are less tax efficient if the remainder is not zero or near zero.

C. GRANTOR'S SPOUSE AS A DISCRETIONARY BENEFICIARY UNDER 677(a)(1) or (2)

(1) "Spouse" appears to mean person to whom you are married and the provision applies "during the period of the marriage" according to the regulations, but would include income accumulated for future distribution to the grantor's spouse after the grantor's death.

- (2) 677(a)(1) and (2) provide that the grantor is treated as the owner of any portion of a trust whose income, without the approval or consent of any adverse party, is or in the discretion of the grantor or a nonadverse party or both, may be, distributed to the grantor or the grantor's spouse or accumulated for future distribution to the grantor or the grantor's spouse.
- (3) Wholly Grantor Trust
 - (a) If the trust is to be WHOLLY grantor, the power needs to extend also to "taxable income" allocable to corpus. One possibility is to make the spouse a discretionary beneficiary as to both income and corpus.
 - (b) Alternatively, make the spouse a discretionary income beneficiary and give the spouse a special power of appointment over the corpus at his death (which would flunk the exception under 674(b)(3) applying the spousal unity rule as to income allocated to corpus that would be deemed accumulated for future disposition by the grantor).
- (4) Toggling Off
 - (a) May present a difficulty in toggling off if you use this method to achieve grantor trust status because the spouse must be removed as a beneficiary.
 - (b) Even the relinquishment of a discretionary interest by the spouse may have gift tax consequences (albeit difficult to quantify).
 - (c) One possibility would be to give an independent trustee the power to remove the spouse as a beneficiary, but consider the challenge the trustee would face exercising that power.
- (5) Other Problems
 - (a) Grantor trust status would terminate at the spouse's death.
 - (b) Spouse cannot split a gift to a trust where spouse's interest cannot be quantified.
 - (c) If the spouse splits gifts to the trust with the grantor, that will not have any implication other than for gift and GST tax purposes, e.g., if the spouse is a trustee with powers of disposition that do not implicate 2036 or 2038.

D. Power of Substitution

- (1) Under 675(4)(C), the power exercisable in a non-fiduciary capacity without the approval or consent of a person in a fiduciary capacity to “reacquire the trust corpus by substituting other property of an equivalent value.”
- (2) Two Problems
 - (a) Is the power really held in a non-fiduciary capacity?
 - (b) Does the existence of the power held in a non-fiduciary capacity create estate tax inclusion concerns?
- (3) PLR 20060304; PLR 200606006

IRS refused to rule favorably on the estate tax inclusion issues under 2033, 2036, 2038 and 2039 without a representation that the power was held in a fiduciary capacity.
- (4) Estate of King
 - (a) *Estate of King v. Commissioner*, 37 T.C. 973 (1962), decedent was in the professional banking business and retained investment control over the trust estate.
 - (b) Each trust provided for income to child for life and remainder to child’s issue, *per stirpes*.
 - (c) Government argued 2036(a)(2) and 2038 alleging the grantor could increase the interests of the life income beneficiaries to the detriment of the remainder beneficiaries, the grantor could dispose of the assets for little or no consideration, and the grantor had an unlimited right to substitute assets of unequal value.
 - (d) Court held the grantor was constrained by NY law, and his actions were subject to the review of a court in equity.
 - (e) Therefore, the grantor was in effect a fiduciary and was not at liberty to administer the trust for his own benefit or to ignore the rights of the beneficiaries, even though he no doubt would be permitted wide latitude in the exercise of this discretion as to the types of investments to be made.
 - (f) HELD, no estate tax inclusion.

- (5) Estate of Jordahl
- (a) *Estate of Jordahl v. Commissioner*, 65 T.C. 92 (1975) is to the same effect. Life insurance trust over which decedent retained a power of substitution not only as to the policies but also as to the securities and other property in the trust.
 - (b) Court held that substitutions of property of equal value could not result in shifts of beneficial interests.
 - (c) Powers would have to be exercised in good faith in accordance with fiduciary responsibility.
 - (d) Equivalent to a power to direct investments.
 - (e) Power to substitute policies is not an incident of ownership under 2042.
 - (f) The requirement of equal value would seem to demand equal cash surrender and face value, comparable premiums and a similar form of policy.
- (6) What are the limits on a substitution power?
- (a) Can you substitute high income assets for low income assets with an equal fair market value?
 - (b) It seems that you can substitute one publicly traded stock for another.
- (7) Revenue Ruling 2008-22, 2008-16 I.R.B. 796
- (a) We think they are trying to help.
 - (b) Deals only with Section 2036 and 2038.
 - (c) May not deal with Section 2036(b).
 - (d) Does not deal with Section 2042.
 - (e) Ruling provides guidance on whether the corpus of an *inter vivos* trust is includible in the grantor's gross estate under section 2036 or 2038 if the grantor retained the power, exercisable in a non-fiduciary capacity, to acquire property held in trust by substituting other property of equivalent value.
 - (f) Substitution will not, by itself, cause the value of the trust corpus to be includible in grantor's gross estate if the trustee has a

fiduciary obligation (under local law) to ensure the grantor's compliance with the terms of the power by:

- (i) Satisfying itself that the properties acquired and substituted are in fact of equivalent value; and
- (ii) The substitution power cannot be exercised in a manner that can shift benefits among the trust beneficiaries.

(g) Revenue Ruling 2008-22 – Facts

- (i) Trust for D's descendants.
- (ii) D is prohibited from serving as trustee.
- (iii) D must certify in writing that the substituted property and the trust property are of equivalent value.
- (iv) The trustee has a duty of impartiality in investing and managing trust assets.
- (v) Local law, without restriction in the trust instrument, confers on trustee power to acquire, invest, reinvest, exchange, sell, convey, control, divide, partition and manage the trust property.

(h) Revenue Ruling 2008-22 -- Holding

Trustee's fiduciary obligation to ensure grantor's compliance with the terms of the power may be under local law or the trust instrument.

(i) Revenue Ruling 2008-22 -- Analysis

- (i) Trustee has duty to "prevent" the exercise of the power if assets being substituted have a lesser value.
- (ii) Therefore, D cannot exercise power in a manner that would reduce the value of the trust corpus.
- (iii) Duty of impartiality requires T to prevent shifting of benefits between or among the beneficiaries.
 - What is meant by "shifting benefits"?
 - Either trustee has duty of impartiality and can reinvest, or

- (iv) Nature of trust investments or level of income does not impact the respective interests of the trust beneficiaries, such as when the trust is administered as a unitrust or when distributions from the trust are limited to discretionary distributions of principal and income.
- (j) Revenue Ruling 2011-28, I.R.B. 2011-49 (12/5/2011)
 - (i) Extends Rev. Rul. 2009-22 to a life insurance policy.
 - (ii) The ruling provides guidance regarding whether a grantor's retention of a power, exercisable in a nonfiduciary capacity, to acquire an insurance policy held by the trust by substituting other assets of equivalent value will cause the value of the insurance policy to be includible in the grantor's gross estate under section 2042 of the Code. The ruling provides that a grantor's retention of the power will not, by itself, cause the value of the insurance policy to be includible in the grantor's gross estate under section 2042, 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 trust beneficiaries.
 - (iii) See PLR 201235006 (February 27, 2012) for analysis of a life insurance trust created for the primary benefit of taxpayer which was not a grantor trust. Taxpayer formed a new trust which granted the taxpayer a power of substitution. Proposal was to sell the policy from the first trust to the second trust. IRS ruled favorably that the exception to the transfer for value rules for a transfer to the grantor under Section 101 applies, and the policy sale will not be treated as a transfer for value (which would otherwise cause a substantial portion of the policy proceeds to become subject to income tax) and that the policy would not become subject to inclusion in the taxpayers gross estate under Section 2042(2) (incidents of ownership) or Sections 2033, 2036 or 2038. The ruling also confirms that the application of Section 675(4) trumps the application of Section 678 with respect to the powers of withdrawal held by the beneficiaries in the second trust.

(k) Word of Caution

- (i) In PLR 200910008, the IRS in the facts recites that the grantor had a power of substitution which, pursuant to section 675(4), would cause the trusts to be grantor trusts. But the conclusion makes the alarming assertion that under the terms of the trusts “the power to reacquire assets of the trust by substituting property of equivalent value affects beneficial enjoyment. Accordingly, the grantors are treated as owners . . . under 674(a)”!

(l) Substitution Clause

(A) Substitutor Powers. With respect to each trust created under this agreement, the Substitutor shall have the power, exercisable at any time in a nonfiduciary capacity (within the meaning of Section 675(4) of the Internal Revenue Code), without the approval or consent of any person in a fiduciary capacity, to acquire or reacquire trust principal by substituting other property of an equivalent value, determined as of the date of such substitution (referred to in this Article as “the Substitution Power”), subject to the following:

(1) Any stock described in Section 2036(b) of the Internal Revenue Code that the Substitutor has transferred to the trust for purposes of Section 2036(b) of the Internal Revenue Code may not be acquired or reacquired by the Substitutor.

(2) Property shall not be deemed of equivalent value if it causes a shift of beneficial interests in any trust under this agreement by any means (directly or indirectly) within the meaning of Revenue Ruling 2008-22 and Revenue Ruling 2011-28, including, without limitation, by enhancing the economic interests of the current beneficiaries to the detriment of the remaindermen or vice versa, or by conferring an uncompensated economic benefit on the Substitutor, and the Substitution Power shall in no event be exercised in a manner that can shift benefits among the trust beneficiaries within the meaning of Revenue Ruling 2008-22 and Revenue Ruling 2011-28.

(3) Without reducing or eliminating the fiduciary duties imposed on the trustees under this agreement or applicable law, the Substitutor shall exercise this Substitution Power by certifying in writing that the substituted property and the trust property for which it is substituted are of equivalent value and the trustees shall have a fiduciary obligation to ensure the Substitutor’s compliance with the terms of this Substitution Power by being satisfied in advance of the completion of the substitution that the properties acquired and

substituted are in fact of equivalent value, within the meaning of Revenue Ruling 2008-22 and Revenue Ruling 2011-28.

(4) Without limiting the foregoing prohibition upon shifting benefits among trust beneficiaries, the trustees shall have (i) the power to reinvest the principal of the trust and (ii) the duty of impartiality with respect to trust beneficiaries at all times while this Substitution Power is in effect, unless the independent trustee has absolute discretion in making distributions of principal and income among the trust beneficiaries so that the power to reinvest the principal of the trust and the duty of impartiality are not required in order to avoid this Substitution Power potentially causing a shift of benefits among trust beneficiaries, all within the meaning of Revenue Ruling 2008-22 and Revenue Ruling 2011-28, in which case the independent trustee shall have the exclusive fiduciary obligation to ensure the Substitutor's compliance with the terms of this Substitution Power in accordance with the provisions of paragraph (3) of this Subdivision.

(5) The Substitutor may release all or a specific portion of the Substitution Power. Any such release shall be effected by a written instrument signed by the Substitutor and delivered to the trustees. Any such release, once given, shall be irrevocable and the Substitution Power shall not thereafter be exercisable by any person other than an individual appointed by the settlor to act as Substitutor pursuant to Subdivision (B) of this Article (if the appointment power has not been released by the settlor as to all successor Substitutors).

(6) This power is not assignable by the Substitutor, and any attempted assignment by the Substitutor will make this power void.

(7) The Substitution Power shall be exercisable only during the life of the settlor.

(B) Substitutor. The following person or persons shall be the "Substitutor" for purposes of this Article: the settlor, or if he/she has released the Substitution power or is unable to act, the settlor's spouse, _____, or if he/she has released the Substitution Power or is unable to act, the settlor's daughter, _____, or if she has released the Substitution Power or is unable to act, the settlor's son, _____.

(8) What about using a third party?

(a) Statute refers to "any person" which appears to override the use of the word "reacquire".

- (b) Third party with a substitution power should not be a trust beneficiary without special drafting to avoid Sections 2041 and 2042.
- (c) Alternatively, use the spouse.

E. Power to Add to Class of Beneficiaries

- (1) Exception to the exception appears five times in Section 674.
- (2) *Madorin v. Commissioner*, 84 T.C. 667 (1985) court assumed the power conferred grantor trust status and relinquishment of the power eliminated grantor trust status
- (3) A 679 perspective would say if you can add someone, that person is already deemed to be a beneficiary.
- (4) But it must mean something.
- (5) Other difficulties
 - (a) Fiduciary discomfort.
 - (b) Do the persons added have to receive something for it to be real?
- (6) Some solutions
 - (a) Give the power to a non-fiduciary.
 - (b) Draft the trust so that when a beneficiary is added something beneficial for the existing beneficiaries occurs – such as broader discretion to distribute or required distributions.
 - (c) Require some distributions to the persons added to the class.

F. Power of Appointment

- (1) A presently exercisable power of appointment held by a nonadverse party not acting as a trustee should make a trust a wholly grantor trust.
- (2) Should work even if the power holder would be considered independent.
- (3) Consider using a related and subordinate party in case the power is deemed held in fiduciary capacity.
- (4) Provide for succession of power holders.

G. Actual Borrowing by the Grantor or the Grantor's Spouse – 675(3)

- (1) 675(3) says that the grantor will be treated as the owner of any portion of a trust in respect of which the grantor has directly or indirectly borrowed the corpus or income and has not completely repaid the loan, including any interest, before the beginning of the taxable year.
- (2) Does not apply if the loan is made for adequate interest and adequate security, if the loan is made by a trustee other than the grantor and other than a related and subordinate trustee subservient to the grantor.
- (3) Applies to “spouse” as defined in 672(e)(2) meaning married to and not legally separated from the grantor.
- (4) Rev. Rul. 85-13
 - (a) Rev. Rul. 85-13, 1985-1 C.B. 184, stands for the proposition that transactions between a grantor and her grantor trust are ignored for income tax purposes.
 - (b) But it also states that if the grantor purchases all the assets of her trust for a note, the trust becomes a grantor trust simultaneously, and there is no gain recognition as a result of the purchase itself.
 - (c) Facts of 85-13, unsecured promissory note with adequate interest.
 - (d) IRS views the transaction as an indirect borrowing.
 - (e) Be aware that *Rothstein v. U.S.*, 735 F.2d 704 (2nd Cir. 1984) is to the contrary. Court held that the transaction constituted an indirect borrowing and caused the trust to become a grantor trust, BUT the transaction itself resulted in gain recognition.
- (5) What about Rosen?
 - (a) If the loan is without adequate security, does Rosen say that it is not arms length, bona fide and for full and adequate consideration?
 - (b) If you use a related and subordinate party trustee maybe that raises other concerns because it is a transaction with the grantor.
 - (c) So the issue arises have you cleared the 2036 and 2038 hurdles?
- (6) Rev. Rul. 86-82, 1986-1 C.B. 253
 - (a) States that the trust is a grantor trust for the entire year.
 - (b) Does that permit you to reverse engineer grantor trust status?

- (7) Grantor trust to what extent?
 - (a) Appears, under *Bennett v. Comm'r*, 79 T.C. 470 (1982), that the trust may be a grantor trust only as to the portion directly or indirectly borrowed.
 - (b) Therefore, to make the trust wholly grantor, must borrow/purchase the entire corpus.
 - (c) May present practical obstacles or valuation issues.

H. Power to Borrow

- (1) Section 675(2) covers a power exercisable by the grantor or a nonadverse party, or both, that enables the grantor to borrow the corpus or income, directly or indirectly, without adequate interest or without adequate security.
- (2) Exception where a trustee (other than the grantor) is authorized under a general lending power to make loans to any person without regard to interest or security.
- (3) Need to negate the general lending power.
- (4) Should use only an independent trustee to avoid 2036 and 2038 implications.
- (5) Probably should only permit loans to the grantor without adequate security.
- (6) See PLR 200840025 (non-adverse trustee with power to make loans, with or without security, to the settlor was sufficient to make the trust a grantor trust).

I. Decanting to Achieve Grantor Trust Status

- (1) States with a statute:
 - (a) Alaska,² Arizona,³ Delaware,⁴ Florida,⁵ Illinois,⁶ Indiana,⁷ Kentucky,⁸ Michigan,⁹ Minnesota,¹⁰ Missouri,¹¹ Nevada,¹² New Hampshire,¹³ New

² Alaska Stat. §§ 13.36.157, 13.36.158, 13.36.159 and 13.36.215(b).

³ Ariz. Rev. Stat. § 14-10819.

⁴ Del. Code Ann. tit. 12 § 3528.

⁵ Fla. Stat. § 736.04117.

⁶ 760 Ill. Comp. Stat. 5/§ 16.4 (enacted as of 1/1/13).

⁷ Ind. Code Ann. § 30-4-3-36 (West 2011).

⁸ Ky. Rev. Stat. § 386.175 (enacted as of 7/12/12).

⁹ Mich. Comp. Laws §§ 700.7820(a), 556.115a and 700.7103 (enacted as of 12/28/12).

¹⁰ Minnesota Statutes §502.851 (effective 1/1/16).

Mexico,¹⁴ New York,¹⁵ North Carolina,¹⁶ Ohio,¹⁷ Rhode Island,¹⁸ South Carolina,¹⁹ South Dakota,²⁰ Tennessee²¹, Texas,²² Virginia,²³ Wisconsin,²⁴ and Wyoming,²⁵

- (2) What is Decanting?
 - (a) *Phipps v. Palm Beach Trust*, 142 Fla. 782 (1940) held that a trustee with absolute discretion to distribute principal among a class of beneficiaries may distribute to a new trust for a member of the class.
 - (b) Is in the nature of a power of appointment.
 - (c) Can be used to confer a power of appointment.
- (3) GST concerns?
 - (a) Depends on whether the trustee is deemed to have had the power since the inception of the trust.
 - (b) Issues are shifting beneficial interests to lower generations or extending the time for vesting.
 - (c) If converting to a grantor trust is not a gift, should not be a GST event.
- (4) Adding powers to cause grantor trust status
 - (a) Could the trustee do this without the grantor's consent?
 - (b) Would the trustee do this without the grantor's consent?
 - (c) What is the effect of the grantor's actual or implied consent?
- (5) If you don't have decanting in your State

¹¹ Mo. Rev. Stat. § 456.4-419.

¹² Nev. Rev. Stat. 163.37

¹³ N.H. Rev. Stat. § 564-B:4-418.

¹⁴ Pending enactment of the Uniform Trust Decanting Act 1/1/2017.

¹⁵ N.Y. EPTL 10-6.6(b)-(s)

¹⁶ N.C.G.S. § 36C-8-816.1.

¹⁷ Ohio Rev. Code § 5808.18 (enacted as of 3/22/12).

¹⁸ R.I. Gen. Laws § 18-4-31 (enacted 6/23/12 and amended 7/15/13).

¹⁹ S.C. Code § 62-7-816A.

²⁰ S.D. Laws §§ 55-2-15 (amended by 2011 S.C. HB 1155).

²¹ Tenn. Code Ann. § 35-15-816.

²² Texas Prop Code §§112.071-112.087.

²³ Va. Code § 64.2-778.1 (enacted as of 10/1/12).

²⁴ Wisconsin Trust Code §701.0418.

²⁵ W.S. 4-10-816(a)(xxviii).

- (a) Add a clause to your governing instrument.
- (b) Change situs and governing law to a State that permits decanting – may require court approval depending on the governing instrument. Alaska permits decanting if the trust has an Alaska trustee and the trustees, by an acknowledged statement, shift the principal place of administration to Alaska.
- (c) Probably best to have the power in the hands of an independent trustee in any event.

J. Section 677(a)(3)

- (1) Grantor is treated as the owner of any portion of a trust whose income without the approval or consent of any adverse party is, or in the discretion of the grantor or a nonadverse party, or both, may be Applied to the payment of premiums on policies of insurance on the life of the grantor or the grantor’s spouse.
- (2) In general, under old case law, thought to require the trust actually to own a policy – *see Rand v. C.I.R.*, 40 B.T.A. 233 (1939), *aff’d*, 116 F.2d 929 (8th Cir. 1941) and *Iverson v. Comm’r.*, 255 F.2d 1 (8th Cir. 1958).
- (3) Actual payment of premiums, even if in violation of the trust agreement, may nevertheless cause grantor trust status – PLR 8839008.
- (4) DANGER – IRS NSAR 20062701F
 - (a) Provisions of foreign trust authorizing the purchase of life insurance on the grantor’s life caused the trust to be a grantor trust.

K. Section 678(a)

- (1) A person other than the grantor shall be treated as the owner of any portion of a trust with respect to which:
 - (a) Such person has a power exercisable solely by himself to vest the corpus or income therefrom in himself, or
 - (b) Such person has previously partially released or otherwise modified such a power and after the release or modification retains such control as would, within the principles of sections 671 to 677, inclusive, subject a grantor of a trust to treatment as the owner thereof.
- (2) Section 678(b)

Subsection (a) shall not apply with respect to a power over income, as originally granted or thereafter modified, if the grantor of the trust or a transferor (to whom section 679 applies) is otherwise treated as the owner under the provisions of this subpart other than this section.

(3) Genesis of Section 678

(a) *Mallinckrodt v. Nunan*, 146 F.2d 1 (8th Cir. 1945)

- (i) Held if grantor taxable as owner because grantor held certain broad powers then third person should also be taxable as a trust's owner if third person holds similar broad powers.
- (ii) Trustees were to distribute trust income to the beneficiary upon his request.

(4) 678 and Ascertainable Standard

Under *U.S. v. De Bonchamps*, 278 F.2d 127 (9th Cir. 1960 *en banc*) and *Funk v. Comm'r*, 184 F.2d 127 (3rd Cir. 1950), an ascertainable standard (needs, maintenance and comfort) bars income taxation to the beneficiary.

(5) What about trumping?

In PLR 200730011, the beneficiary of the trust had a 30 day power of withdrawal. The grantor's spouse (who was also the trustee) had the power to **withhold** distributions of trust principal (a power not excepted under section 674(b)). The IRS ruled that under Treas. Reg. 1.671-3(b)(3), the spouse's power over corpus includes both ordinary income and income allocable to corpus making the trust wholly grantor. Accordingly, the grantor was treated as the owner of the entire trust under Sections 674(a) and 678(b).

(6) What happens when the grantor dies?

- (a) Who knows?
- (b) Two rulings issued on same facts where wife created a trust for husband and gave husband a 30 day power of withdrawal.
 - (i) PLR 9026036 says powerholder becomes the owner under 678(a).
 - (ii) PLR 9321050 says powerholder does not become the owner.

(7) PLR 201633021 (April 29, 2016)

- (a) Trustee of Trust 1 proposed to transfer funds to Trust 2 for the benefit of the same beneficiaries. The Grantor of Trust 1 is deceased. Trust 2 provides that Trust 1 retains the power, exercisable by Trust 1, to revest the net income of Trust 2 in Trust 1, provided that such power shall lapse on the last day of the calendar year.
- (b) Trust 2 provides that income includes (i) any dividends, interest, fees, and other amounts characterized as income under Section 643(b) of the Code, (ii) any net capital gains realized with respect to assets held less than 12 months, and (iii) any net capital gains realized with respect to assets held longer than 12 months.
- (c) The IRS concludes that Trust 1 will be treated as a owner of the portion of Trust 2 over which Trust 1 has a power of withdrawal under Section 678(a). Accordingly, Trust 1 must take into account in computing its income tax liability those items which would be included in computing the tax liability of a current income beneficiary, including expenses allocable to which would enter into DNI, and Trust 1 will also take into account the net capital gains of Trust 2.

L. Using Section 679

- (1) If a U.S. person, directly or indirectly, transfers assets to a foreign trust and if there is a U.S. beneficiary of any portion of the trust, the trust is automatically a grantor trust under Section 679 with respect to the portion attributable to the property transferred.
- (2) Can make a trust a foreign grantor trust by giving a foreign person a veto power over a substantial power over the trust.
- (3) Difficulties with Section 679
 - (a) Substantial reporting obligations.
 - (b) Need a relationship with a foreigner.
 - (c) Section 684 could apply on the grantor's death to cause an income recognition event.

V. Avoiding Grantor Trust Status -- It Ain't Easy

ARTICLE I

Restrictions Relating to Settlor

(C) Termination of Grantor Trust Status. It is the settlor's intention that, if (i) the settlor's spouse shall cease to be a beneficiary of the trust under Article _____, (ii) the settlor's spouse and the settlor's children have effectively released the power of substitution under Article _____, and (iii) the trust estate no longer consists of a policy of insurance on the life of the settlor and/or the settlor's spouse, then thereafter, notwithstanding any other provision of this agreement: none of the settlor, any spouse of the settlor or any other "nonadverse party" as that term is used in Section 672(b) of the Internal Revenue Code shall have the power (i) to purchase, exchange or otherwise deal with or dispose of any principal or income of such trust hereunder for less than an adequate consideration in money or money's worth, or (ii) to borrow any principal or income of such trust hereunder, directly or indirectly, without adequate interest or adequate security; no person in a non-fiduciary capacity shall have the power (i) to vote or direct the voting of stock or other securities of a corporation in which the holdings of the settlor and such trust hereunder are significant from the viewpoint of voting control, (ii) to control the investment of any trust assets either by directing investments or reinvestment or by vetoing proposed investments or reinvestment, to the extent that the trust assets consist of stocks or securities of a corporation in which the holdings of the settlor and the trust are significant from the viewpoint of voting control, or (iii) to reacquire any trust assets or any portion thereof by substituting other property of an equivalent value; the trustees shall not use any income of such trust within the meaning of Section 677 of the Internal Revenue Code (including, without limitation, capital gain) directly or indirectly to pay premiums on policies of insurance on the life of the settlor and/or any spouse of the settlor (including, without limitation,

any form of split-dollar arrangement with respect to such insurance); no income or corpus shall be paid or appointed to or for the benefit of the settlor or any spouse of the settlor or the estate, creditors or creditors of the estate of the settlor or of any spouse of the settlor, or accumulated for the future benefit of or disposition by the settlor or by any spouse of the settlor; no court, other than a court within the United States, shall exercise primary supervision over the administration of such trust hereunder and no person, other than a United States person, shall have the authority to control any substantial decision of such trust hereunder, within the meaning of Section 7701(a)(30)(E) of the Internal Revenue Code. It is the settlor's intent that thereafter no part of the income, deductions or credits of any such trust shall be attributed to the settlor under subpart E of part I of subchapter J of chapter 1 of subtitle A of the Internal Revenue Code, and this agreement shall be construed and the trusts administered under this agreement to effectuate this intent.

(D) Limitations on Powers. Notwithstanding any other provision of this agreement to the contrary, no power enumerated in this agreement or accorded to trustees generally pursuant to law, singly or as a whole, shall be construed:

(1) to enable the settlor (i) to become a trustee under this agreement, (ii) to remove any trustee under this agreement other than an independent trustee, (iii) to vote any stock of any controlled corporation within the meaning of Section 2036(b) of the Internal Revenue Code which may at any time be directly or indirectly given to or held by any trust under this agreement, (iv) to exercise any power of appointment with respect to any trust under this agreement, (v) to exercise any power described in Sections 2036(a)(2) or 2038 of the Internal Revenue Code or to exercise, directly or indirectly, any other power with respect to any stock which would cause such stock to be includible in the estate of the settlor under Section 2036(b) of the Internal Revenue Code or (vi) to exercise any incident of ownership within the meaning of Section 2042 of the Internal Revenue Code with respect to any policy of insurance on his or her own life (other than as a party to a so-called "split-dollar" arrangement with the trustees); or

(2) to permit any trust distribution which would have the effect of discharging any legal obligation of the settlor (including any obligation which the settlor may have at any time relating to the support or education of any beneficiary hereunder).

If at any time any person other than the settlor makes a contribution to any trust created under this agreement (other than to a trust as to which such person then has any general power of appointment), such person (the “donor”) shall be deemed thereafter to be an additional “settlor” with respect to the addition to the trust receiving such gift (the “donee trust”) for the purposes of the restriction provisions set forth in this Article and for the purposes of all limitations, exceptions, restrictions and exclusions referring to the settlor contained in other provisions of this agreement (but only insofar as they relate to the donee trust and the additions made by such donor).

(E) Settlor’s Intent. It is the settlor’s intent that no portion of any trust hereunder be included in the gross estate of the settlor for federal estate tax purposes. Accordingly, and notwithstanding any provision of this agreement to the contrary, this agreement shall be construed and the trusts under this agreement administered in accordance with and to achieve the foregoing intent.

(F) Settlor’s Income Tax. The trustees shall not pay to the settlor or the settlor’s personal representatives any income or principal of any trust estate hereunder on account of or in discharge of the settlor’s income tax liability (whether Federal, state or otherwise), if any, in respect of property held in any trust hereunder and included in the gross income of the settlor.

VI. Conclusions

- A. Always best to use more than one method to create a grantor trust.**
- B. Make sure you have the flexibility to toggle off if the tax liability becomes too much generosity for the grantor.**

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