



Attracting and Avoiding Grantor Trust Status

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Section 671

- > 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.

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

- > If grantor has retained a reversionary interest under Section 673.
- > If grantor or non-adverse party has certain powers over the beneficial interests in the trust under Section 674.
- > If certain administrative powers over the trust exist under which the grantor can or does benefit under Section 675.

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

- > If the grantor or a nonadverse party has a power to revoke the trust or return the corpus to the grantor under Section 676.
- > 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.

Who is the grantor?

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

What is a Gratuitous Transfer?

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

What about a Trust to Trust Transfer?

- > Grantor of the transferor trust will be treated as the grantor of the transferee trust.
- > Except if a person exercises a general power of appointment in favor of another trust.

Is the “Grantor” taxed?

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

What are the obligations of a Grantor?

- > A grantor can have the obligation to file tax returns with respect to the trust (e.g. under Section 6048 for a foreign trust).
- > 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.

Will a 678 power make you a Grantor?

- > No.
- > 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.

What about the “portion” rule?

- > 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.

What about the “portion” rule?

- > 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.

What about the “portion” rule?

- > 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.

Exercise of a General Power

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

Collateral Tax Effects of Creating a Grantor Trust under Rev. Rul. 2004-64

- > Neither grantor nor any beneficiary is treated as making a taxable gift.
- > Discretionary power of reimbursement, by itself, will not cause estate tax inclusion.

Additional Requirements under Rev. Rul. 2004-64

- > If trustee has a discretionary power to reimburse the grantor
 - Grantor may not act as a trustee.
 - Grantor may not remove and replace trustees with related and subordinate parties.
 - State law must prohibit creditors from accessing the trust by reason of the reimbursement power.
 - No implied understanding.

Other consequences of creditors' rights

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

What if trustee must reimburse?

- > Automatic estate tax inclusion
 - BUT should it be 100% since the effective tax rate is not 100%?
 - 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.

Creating a Grantor Trust

- > Powers of disposition
- > Spouse as a discretionary beneficiary
- > Power of substitution
- > Power to add beneficiaries
- > Power of appointment
- > Actual borrowing
- > Power to borrow
- > Decanting

Power of Disposition by a Related and Subordinate Party

- > 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.

Adverse Party/Nonadverse Party

- > 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 GPA is a beneficial interest, but not automatically substantial.
- > A nonadverse party – Everyone else.

Independent Trustee Exception

- > 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.

672(c) – Related and Subordinate Party

- > 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.
- > Related and subordinate party is presumed subservient unless shown not to be by a preponderance of the evidence.

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.

Reasonably Definite Standard

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

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.

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.

Query

> What estate tax implication would that have?

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.
- > Would that apply to a power exercisable in favor of persons other than the grantor?

Rev. Rul. 95-58

- > 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.
- > Rev. Rul. 95-58 does not address the initial appointment of a related and subordinate trustee.

Estate of Vak

- > 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.

Toggling Off

- > Grantor could retain the power to remove the related and subordinate trustees and replace them with an independent trustee.
- > BUT the grantor cannot have the power to toggle back on by appointing related and subordinate trustees because of Rev. Rul. 95-58.

Problem for an ISGT 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.

Good for an ILIT

- > 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.
- > 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.

Grantor's spouse as a discretionary beneficiary under 677(a)(1) or (2)

- > “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.

677(a)(1) and (2)

- > 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.

Wholly Grantor Trust

- > If the trust is to be WHOLLY grantor, need the power 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.
- > 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).

Toggling Off

- > 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.
- > Even the relinquishment of a discretionary interest by the spouse may have gift tax consequences (albeit difficult to quantify).
- > 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.

Other Problem

- > Grantor trust status would terminate at the spouse's death.

Gift-Splitting Issues?

- > Spouse cannot split a gift to a trust where spouse's interest cannot be quantified.
- > 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 does not implicate 2036 or 2038.

Power of Substitution

- > **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.”**

Two Problems

- > Is the power really held in a non-fiduciary capacity?
- > Does the existence of the power held in a non-fiduciary capacity create estate tax inclusion concerns?

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.

Estate of King

- > *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.
- > Each trust provided for income to child for life and remainder to child's issue, per stripes.
- > 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.

Estate of King

- > Court held the grantor was constrained by NY law, and his actions were subject to the review of a court in equity.
- > 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.
- > HELD, no estate tax inclusion.

Estate of Jordahl

- > *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.

Estate of Jordahl

- > Court held that substitutions of property of equal value could not result in shifts of beneficial interests.
- > Powers would have to be exercised in good faith in accordance with fiduciary responsibility.
- > Equivalent to a power to direct investments.

Estate of Jordahl

- > Power to substitute policies is not an incident of ownership under 2042.
- > The requirement of equal value would seem to demand equal cash surrender and face value, comparable premiums and a similar form of policy.

What are the limits on a substitution power?

- > Can you substitute high income assets for low income assets with an equal fair market value?
- > It seems that you can substitute one publicly traded stock for another.

Revenue Ruling 2008-22

- > I think they are trying to help.
- > Deals only with Section 2036 and 2038.
- > May not deal with Section 2036(b).
- > Does not deal with Section 2042.

Revenue Ruling 2008-22

- > 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.

Revenue Ruling 2008-22

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

Revenue Ruling 2008-22 – Facts

- > Trust for D's descendants.
- > D is prohibited from serving as trustee.
- > D must certify in writing that the substituted property and the trust property are of equivalent value.
- > The trustee has a duty of impartiality in investing and managing trust assets.
- > 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.

Revenue Ruling 2008-22 -- Analysis

- > Trustee has duty to “prevent” the exercise of the power if assets being substituted have a lesser value.
- > Therefore, D cannot exercise power in a manner that would reduce the value of the trust corpus.
- > Duty of impartiality requires T to prevent shifting of benefits between or among the beneficiaries.

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.

Revenue Ruling 2008-22

- > What is meant by “shifting benefits”?
 - Either trustee has duty of impartiality and can reinvest, or
 - 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.
- > Extended to life insurance by Rev. Rul. 2011-28.

What about using a third party?

- > Statute refers to “any person” which appears to override the use of the word “reacquire”.
- > Third party with a substitution power should not be a trust beneficiary without special drafting to avoid Sections 2041 and 2042.
- > Alternatively, use the spouse.

Power to Add to Class of Beneficiaries

- > Exception to the exception appears five times in Section 674.
- > *Madorin* court assumed the power conferred grantor trust status and relinquishment of the power eliminated grantor trust status
- > But a 679 perspective would say if you can add someone, that person is already deemed to be a beneficiary.
- > But it must mean something.

Power to Add to Class of Beneficiaries

> Other difficulties

- Fiduciary discomfort
- Do the persons added have to receive something for it to be real

> Some solutions

- Give the power to a non-fiduciary
- 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
- Require some distributions to the persons added to the class

Power of Appointment

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

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

- > 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.

Actual Borrowing

- > 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.

Actual Borrowing

- > Applies to “spouse” as defined in 672(e)(2) meaning married to and not legally separated from the grantor.

Rev. Rul. 85-13

- > Rev. Rul. 85-13 stands for the proposition that transactions between a grantor and her grantor trust are ignored for income tax purposes.
- > 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.
- > Facts of 85-13, unsecured promissory note with adequate interest.

Rev. Rul. 85-13

- > IRS views the transaction as an indirect borrowing.
- > Be aware that the *Rothstein* case in the 2nd Circuit 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.

What about Rosen?

- > If the loan is without adequate security, does *Rosen* say that it is not arms length, bona fide and for full and adequate consideration?
- > If you use a related and subordinate party trustee maybe that raises other concerns because it is a transaction with the grantor.
- > So the issue arises have you cleared the 2036 and 2038 hurdles?

Rev. Rul. 86-82

- > States that the trust is a grantor trust for the entire year.
- > Does that permit you to reverse engineer grantor trust status?

Grantor trust to what extent?

- > Appears, under *Bennett*, that the trust may be a grantor trust only as to the portion directly or indirectly borrowed.
- > Therefore, to make the trust wholly grantor, must borrow/purchase the entire corpus.
- > May present practical obstacles or valuation issues.

Power to Borrow

- > 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.
- > 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.

Power to Borrow

- > Need to negate the general lending power.
- > Should use only an independent trustee to avoid 2036 and 2038 implications.
- > Probably should only permit loans to the grantor without adequate security.
- > 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).

Decanting to Achieve Grantor Trust Status

- > States with a statute:
 - Alaska, Arizona, Delaware, Florida, Illinois, Indiana, Kentucky, Michigan, Minnesota, Missouri, Nevada, New Hampshire, New Mexico (pending), New York, North Carolina, Ohio, Rhode Island, South Carolina, South Dakota, Tennessee, Texas, Virginia, Wisconsin, Wyoming

What is Decanting?

- > *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.
- > Is in the nature of a power of appointment.
- > Can be used to confer a power of appointment.

GST concerns?

- > Depends on whether the trustee is deemed to have had the power since the inception of the trust.
- > Issues are shifting beneficial interests to lower generations or extending the time for vesting.
- > If converting to a grantor trust is not a gift, should not be a GST event.

Adding powers to cause grantor trust status

- > Could the trustee do this without the grantor's consent?
- > Would the trustee do this without the grantor's consent?
- > What is the effect of the grantor's actual or implied consent?

If you don't have decanting in your State

- > Add a clause to your governing instrument.
- > Change situs and governing law to a State that permits decanting – may require court approval depending on the governing instrument.
- > Probably best to have the power in the hands of an independent trustee in any event.

Section 677(a)(3)

- > 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.

677(a)(3)

- > In general, under old case law, thought to require the trust actually to own a policy – see *Rand v. Comm’r* and *Iverson v. Comm’r*.
- > Actual payment of premiums, even if in violation of the trust agreement, may nevertheless cause grantor trust status – PLR 8839008.

677(a)(3)

- > **DANGER – IRS NSAR 20062701F**
 - Provisions of foreign trust authorizing the purchase of life insurance on the grantor's life caused the trust to be a grantor trust.

Section 678(a)

- > A person other than the grantor shall be treated as the owner of any portion of a trust with respect to which:
 - Such person has a power exercisable solely by himself to vest the corpus or income therefrom in himself, or
 - 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.

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.

Genesis of Section 678

- > *Mallinckrodt v. Nunan* (8th Cir. 1945)
 - 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.
 - Trustees were to distribute trust income to the beneficiary upon his request.

678 and Ascertainable Standard

- > Under *U.S. v. De Bonchamps* (9th Cir.) and *Funk v. Comm’r* (3rd Cir.), an ascertainable standard (needs, maintenance and comfort) bars income taxation to the beneficiary.

What about Trumping?

- > In PLR 200730011 (not precedent), 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).

What Happens When the Grantor Dies?

- > Who knows?
- > Two rulings issued on same facts where wife created a trust for husband and gave husband a 30 day power of withdrawal.
 - PLR 9026036 says powerholder becomes the owner under 678(a).
 - PLR 9321050 says powerholder does not become the owner.
- > PLR 201633021

Using Section 679

- > 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.
- > Can make a trust a foreign grantor trust by giving a foreign person a veto power over a substantial power over the trust.

Difficulties with Section 679

- > Substantial reporting obligations.
- > Need a relationship with a foreigner.
- > Section 684 could apply on the grantor's death to cause an income recognition event.

Conclusions

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



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