Chapter 4

Grantor Trusts*

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§ 4:1 Introduction

§ 4:1.1 Overview

The taxation of trusts discussed in chapter 3 applies generally when the grantor has parted with all interests in the trust corpus and income, as well as control over both. This scheme of taxation does not apply, however, to revocable trusts or other trusts if the grantor is considered to be the owner for tax purposes because of retained interests or powers or because of certain interests or powers granted to other people. Moreover, it is possible for a third party to be deemed the owner of a trust because of certain interests in or powers over a trust. Instead, in these circumstances, Subpart E of Subchapter J applies. These rules contained in sections 671–79 are commonly known as the grantor trust rules.

When the grantor trust rules apply, section 671 provides in part that:

there shall then be included in computing the taxable income and credits of the grantor or the other person those items of income, deductions, and credits against tax of the trust which are attributable to that portion of the trust to the extent that such items would be taken into account under this chapter in computing taxable income or credits against the tax of an individual.1

Only the income of a trust not subject to the grantor trust rules is governed by the remainder of Subchapter J. Nevertheless, it is possible for a grantor to be taxed under assignment of income

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principles\(^2\) or family partnership rules.\(^3\) The assignment of future trust income by a trust beneficiary may not effectively transfer the tax liability to the assignee unless the assignment is of such a permanent nature that a grantor would be relieved of tax on creation of a similar trust.\(^4\) For example, the assignment of interest accruing on a bond to a non-grantor trust may not transfer the income tax liability to the trust.\(^5\) In addition, the regulations provide that an assignment of income from an employment contract to a non-grantor trust may not relieve the assignor of the tax liability.\(^6\)

In Revenue Ruling 85-13,\(^7\) the Service ruled that all transactions between the grantor and a grantor trust should be disregarded for all income tax purposes and expressly rejected the U.S. Court of Appeals for the Second Circuit’s then-recent decision in \textit{Rothstein v. United States}.\(^8\) The Service re-applied its position in Revenue Ruling 2007-13, which reached a similar conclusion.\(^9\) In the 2007 ruling, the Service held that the income tax transfer-for-value rule of section 101 does not apply when one grantor trust created by the insured purchases an insurance policy from another grantor trust created by the same grantor, and the transfer for value rule does not apply when the purchasing trust is a grantor trust, even though the selling trust is not a grantor trust.\(^10\)

It is possible that a trust is a grantor trust in some tax years and not a grantor trust is other years. This switch from grantor trust status to

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5. Treas. Reg. § 1.671-1(c).

6. \textit{Id.}


9. Rev. Rul. 2007-13, 2007-1 C.B. 684. \textit{See also} IRS INFO 2009-0120, in which the Service determined that the transfer of Series I bonds to a grantor trust does not result in the realization of income and the grantor may continue to defer reporting of interest each year. Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

10. Under I.R.C. § 101(a)(1), life insurance proceeds payable by reason of the death of the insured are not, as a general rule, included in gross income.
non-grantor trust status may occur, for example, when a power that causes a trust to be deemed a grantor trust is released. Sometimes, switching back and forth between grantor trust status and non-grantor trust status is employed to achieve favorable tax results. In Notice 2007-73,\(^{11}\) the Service expressed interest in a transaction that apparently is designed to cause a loss recognition to a taxpayer without a corresponding economic cost or gain recognition to that taxpayer by changes in the status of a trust from grantor trust status to non-grantor trust status and then back to grantor trust status. The Notice does not indicate that the “toggling” of grantor trust status is itself of concern to the Service.

§ 4:1.2 History

The early structure of the income tax did not permit joint income tax returns for married couples and the tax rate structure was very progressive. These aspects encouraged taxpayers to reduce taxes by deflecting income to other taxpayers who were in lower income tax brackets. The advantage of splitting income between spouses was obvious: If income could be spread between two tax returns with two uses of lower income tax brackets and personal exemptions, less overall tax was due. Another method used to deflect income from higher tax brackets to potentially lower tax brackets was to shift income to trusts or beneficiaries of trusts.

Attempts to lower income taxes by deflecting income to other taxpayers have not always been successful. The Supreme Court’s landmark decision in *Lucas v. Earl*\(^ {12}\) is the classic example of courts not permitting income earned by one taxpayer to be taxed to another through a contractual assignment of income.\(^ {13}\)

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\(^{13}\) *Lucas v. Earl* involved a contract assigning income between spouses that predated the 16th Amendment by twelve years. Thus, the contract likely was not tax motivated; however, the Court determined the contract was nevertheless an assignment of income. *See id.* at 114.
Deflecting income from higher tax brackets to potentially lower tax brackets was contested by the Service. The landmark decision *Helvering v. Clifford*\(^{14}\) is an example of an attempted assignment of income between spouses, in the pre-joint return era, with the creation of a short-term trust that did not pass judicial scrutiny to effect a shift of income to a lower bracket.

Motivated by *Clifford*, the Treasury Department adopted regulations under the 1939 Code’s definition of gross income\(^{15}\) that provided guidelines for when trusts would be recognized as taxpayers separate from their grantors and when trust income would be taxed to the grantor. The regulations were commonly known as the “*Clifford*” regulations. These rules taxed the grantor rather than the trust if any one of a number of lines were crossed. In 1954, Congress adopted the “grantor trust” provisions of Internal Revenue Code (Code) sections 671 through 679\(^{16}\) that generally followed the *Clifford* regulations.

The 1948 adoption of joint returns for married couples\(^{17}\) eliminated the income tax incentives to divide income between spouses, but the Code’s highly progressive rate structure continued to motivate income splitting between grantors and trusts created for others and the beneficiaries of those trusts. For example, the pre-1987 “ten-year and a day trusts,” also called “*Clifford* trusts,” were in wide use to shift income to taxpayers in lower marginal brackets.\(^{18}\)

The Tax Reform Act of 1986,\(^{19}\) with much-less-progressive income tax rates, fundamentally changed the incentive to divide income among several taxpayers. Individual tax brackets became relatively flat: the great disparity of tax rates among individuals was eliminated.\(^{20}\) In addition, the 1986 Act all but eliminated lower tax brackets for

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18. Section 673, before amendment in 1986, permitted a trust to avoid grantor trust status as to tax income allocable to the fiduciary income portion of the trust if the grantor’s reversionary interest in principal was delayed more than ten years. *See* I.R.C. § 673 (1954).
20. The “kiddie” tax has de-incentivized diverting income to children. Under Code section 1[g], the unearned income of a minor child may be taxed at the parent’s marginal income tax bracket. In addition, unearned income of dependent students under the age of twenty-four similarly may be taxed under I.R.C. § 1[g][2][A][ii][I].
trusts. For example, in 1987 a trust reached the top income tax bracket at $5,000 of taxable income. Thus, for a separate trust, the use of a trust’s lower brackets saved only $650 in income taxes. In 2009, a trust reaches the top income tax bracket at about $11,150 of taxable income. As a result, the use of a trust’s lower brackets will save something in the neighborhood of $1,000. Neither sum likely would justify the planning and administration expenses of creating a separate trust.

§ 4:1.3 **Intentional Grantor Trusts—The Big Picture**

With no significant income tax savings to be achieved by diverting income from a taxpayer with substantial income to trusts or trust beneficiaries in non-existing lower brackets, some taxpayers switched directions and sought to invoke the grantor rules so that the grantor is treated as owning the trust (or its assets) for income tax purposes—in other words, to make each trust a grantor trust. For a taxpayer-grantor to be obliged to pay taxes on income that belongs to another (that is, income that belongs to the grantor trust or a beneficiary of the grantor trust) generally is desirable from a gift and estate tax perspective. The tax savings goal no longer is achieved by avoiding grantor trust status; rather, it is achieved by obtaining grantor trust status with an “intentional grantor trust,” and that has become a holy grail of tax and estate planning. Taxpayers seek to use the grantor trust rules to their advantage to save estate, gift, and generation-skipping transfer taxes.

The term *defective* was applied first to grantor trusts when the grantor trust rules originally were adopted because, as a general matter, a grantor trust classification prevented income splitting. Avoiding grantor trust status was the typical taxpayer goal. Thus, before 1987 the trust was “defective” from the perspective that the trust income was taxable to the grantor instead of the trust or a trust beneficiary. That label has carried over to today, although now grantor trust status usually is viewed as beneficial. Many planners, however, avoid using the word *defective* when describing the trust because of negative connotations to clients who are unaware of the historical background.

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21. See id. § 1(e). Section 643(f) was enacted in 1984 (Deficit Reduction Act of 1984, Pub. L. No. 98-369, 98 Stat. 494, 599) to treat multiple trusts created by a taxpayer or the taxpayer’s spouse as one trust in some instances if avoidance of income tax was the purpose in creating the trusts.

22. Under section 1(e) for 1987, the tax on the first $5,000 of income was $750. A “straight” 28% tax (the higher bracket in 1987) on $5,000 would be $1,400, with the difference being $650. See I.R.C. § 1(e) (1987).

23. Under section 1(e) for 2009, the tax on the first $11,150 of income is $2,879. A “straight” 35% tax on $11,150 would be $3,903, with the difference being $1,024. See I.R.C. § 1(e) (2009).

24. The income tax status of a grantor trust is the same whether or not achieved intentionally.
In any event, a grantor trust, whether or not it is viewed as defective, has potential planning opportunities presented by that tax status.25

Grantor trusts are used affirmatively to enhance many common estate planning strategies by:

permitting the income earned by the trust to grow free of income tax because the tax burden is imposed upon the grantor, and the payment of the trust’s income tax liability by the grantor is not a gift;26

permitting assets to be sold by the grantor to the trust for fair market value without the imposition of gift tax27 or income tax, even if the assets sold are appreciated;28 and

permitting the purchase or exchange of low basis assets in exchange for higher basis assets, such as cash, by the grantor shortly before death without the imposition of an income tax.29

Grantor trusts have other beneficial uses. For example, a trust is a permissible shareholder of S corporation stock if the trust is a grantor trust [with respect to a taxpayer who is an eligible shareholder of an

27. An individual makes a gift only to the extent the taxpayer receives back consideration in money or money’s worth that is less than the value of what the taxpayer transferred. See I.R.C. § 2512(b); see also Treas. Reg. § 25.2512-8.
28. No capital gain or loss should be recognized on sales between the trust and the grantor. See Rev. Rul. 85-13, 1985-1 C.B. 184 [to the extent grantor is treated as owner of trust, the trust will not be recognized as separate taxpayer capable of entering into a sales transaction with the grantor]. In that ruling, the Service indicated it would not follow Rothstein v. United States, 735 F.2d 704 (2d Cir. 1984), to the extent it would require a different result. In Rothstein, the Second Circuit concluded that a taxpayer could enter into a sales transaction for income tax purposes with a grantor trust because the trust was a separate taxpayer. See id. at 709; see also Rev. Rul. 2007-13, 2007-1 C.B. 684 [ruling in Situation 1 that the sale of a life insurance policy from one “wholly-owned” grantor trust to another “wholly-owned” grantor trust is not a transfer at all for income tax purposes because the grantor is treated as the owner of the assets of both trusts]; Rev. Rul. 92-84, 1992-2 C.B. 216 [gain or loss on sale of asset by Qualified Subchapter S Trust, which is grantor trust as to its S corporation stock, is treated as gain or loss of the grantor or other person treated as owner under the grantor trust rules and not of the trust, even if the gain or loss is allocable to trust corpus rather than to trust income].
29. The subsequent inclusion of the low basis assets in the grantor’s gross estate at death generally will result in a new basis equal to the estate tax values. See I.R.C. § 1014(a).
S corporation) as to income and corpus. In addition, the $250,000 ($500,000 for joint returns) exclusion from income under section 121 for the sale of a principal residence by an individual is available if the residence is owned by a grantor trust with respect to that individual.

The affirmative use of grantor trusts as a tax planning tool has been aided by several published rulings. In Revenue Ruling 85-13, the Service concluded that transactions between a grantor and his or her grantor trust have no income tax effect. This position disagreed with a decision of the Court of Appeals for the Second Circuit, but until revoked the Service is obligated to follow its own published ruling. Moreover, the Service more recently has reaffirmed its Revenue Ruling 85-13 position in Revenue Ruling 2004-64 and Revenue Ruling 2007-13.

For many years, some tax advisors were concerned that a gift might occur if the grantor paid income taxes on income that belonged to another; that is, gross income otherwise received by a trust or its beneficiaries. In a private letter ruling, the Service required the grantor of a grantor trust to be reimbursed for income taxes paid by the grantor on trust income. That ruling raised the issue of whether the failure to reimburse the grantor for income taxes paid might be a gift by the grantor. The Service has since changed its position, however. In

30. See I.R.C. § 1361(c)(2)[A][i]; see, e.g., Priv. Ltr. Rul. 2000-01-015 [Jan. 7, 2000]. For a more extensive discussion, see section 7:3.
32. 1985-1 C.B. 184.
33. See Rothstein v. United States, 735 F.2d 704 (2d Cir. 1984).
37. In Priv. Ltr. Rul. 94-44-033 [Nov. 4, 1994], the Service stated in dicta that the failure of the trust to reimburse the grantor for income taxes paid by the grantor would be considered a gift by the grantor to the remainderpersons. The Service subsequently reissued the ruling without that dicta in Priv. Ltr. Rul. 95-43-049 [Oct. 27, 1995]. Rulings have approved various types of reimbursement provisions. See, e.g., Priv. Ltr. Ruls. 94-15-012 [Apr. 15, 1994]; 94-16-009 [Apr. 22, 1994]; 94-51-056 [Dec. 23, 1994]. The Service’s position created a dichotomy because including an income tax reimbursement provision would seem to create some risk that the trust would be included in the grantor’s estate under Code section 2036 by providing for payment of legal obligations of the grantor. However, because of its prior insistence that trusts provide that the grantor be reimbursed for income taxes, the application of section 2036 on account of such reimbursement was made prospective only in Rev. Rul. 2004-64, 2004-2 C.B. 7. See Treas. Reg. § 20.2036-1(b)[2]. Various Service private rulings previously held no inclusion would be found under Code section 2036(a); see, e.g., Priv. Ltr. Ruls. 2001-20-021 [May 18, 2001]; 1999-22-062 [June 4, 1999]; 1999-19-039 [May 14, 1999]; 97-10-006 [Mar. 7, 1997]; 97-09-001 [Feb. 28, 1997]; 94-13-045 [Apr. 1, 1994].
Revenue Ruling 2004-64,\(^{38}\) the Service concluded that the payment by a grantor of taxes on income earned by a trust is not a gift if the tax reimbursement is not required under the terms of the trust or required by state law.\(^{39}\) In addition, the Service ruled similarly in Revenue Ruling 2004-64, if the reimbursement is in the discretion of an independent trustee.\(^{40}\) If the trust mandates that the grantor be reimbursed for paying the income taxes attributable to the grantor trust, the ruling indicates that there are no gift tax consequences to the grantor or the trust beneficiaries upon the grantor’s initial payment of the tax and the trust’s reimbursement to the grantor (although quite obviously, the benefit of having the trust grow on an income tax-free basis would be lost).\(^{41}\) The ruling also addressed whether either a mandatory or discretionary reimbursement clause would cause inclusion of trust assets in the grantor’s estate under section 2036.\(^{42}\)

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39. See id. (Situation 1).
40. See id. (Situation 3).
41. See id. (Situation 2).
42. If neither state law nor the governing instrument contains any provision requiring or permitting the trustee to reimburse the grantor for paying income taxes attributable to the trust, the grantor’s payment of the tax is not a gift by the grantor, and no portion of the trust is includible in the grantor’s estate under section 2036. See Rev. Rul. 2004-64, 2004-2 C.B. 7 (Situation 1).

If the trust mandates that the grantor be reimbursed for paying the income taxes attributable to the grantor trust, the ruling indicates that there are no gift tax consequences to the grantor or the trust beneficiaries upon the grantor’s initial payment of the tax or the trust’s reimbursement to the grantor, but “the full value of the trust assets” would be included in the grantor’s estate under section 2036. See id. (Situation 2). (The statement that the “full value” would be includible may overstate the issue. Courts might limit the amount includible in the estate to the maximum amount that might possibly be used for the grantor’s benefit at his or her death.) The ruling says that full estate inclusion would also be required if state law requires reimbursement of the grantor’s payment of the income tax and if the instrument did not override that requirement. See id. If state law gives the grantor the right to be reimbursed, language in the trust instrument must negate the reimbursement right to avoid inclusion of the trust’s assets in the grantor’s estate under I.R.C. § 2036. That provision, perhaps, should be included in all trusts, because the drafter does not know if the trust situs might change in the future.

If the trust instrument authorizes the trustee, in the exercise of discretion, to reimburse the grantor for any income taxes of the grantor attributable to the trust, any such reimbursement is not treated as a gift by the beneficiaries, unless, perhaps, a beneficiary is the trustee making the distribution. Giving the trustee the discretion to reimburse the grantor for income taxes attributable to the income of the grantor trust may risk estate inclusion under I.R.C. § 2036 if an understanding or preexisting arrangement between the trustee and the grantor regarding reimbursement existed, or if the grantor could remove the trustee and appoint himself
The “spousal-unity” rule enacted by Congress in 1986 broadens the potential scope of the grantor trust rules.\(^{43}\) Under section 672(e), as amended in 1988,\(^ {44}\) a grantor is “treated as holding any power or interest held by (A) any individual who was the spouse of the grantor at the time of the creation of such power or interest” even if there is a subsequent divorce,\(^ {45}\) “or (B) any individual who [subsequently] became the spouse of the grantor, but only with respect to periods after such individual became the spouse of the grantor.”\(^ {46}\) This spousal-unity rule has its positive side, however, as it makes the creation of a grantor trust possible in situations in which the grantor’s retention of the same power or interest would not be possible without creating estate, gift, or generation-skipping transfer tax problems for the grantor, and it comes into play with a number of the grantor trust rules. Note that grantor trust treatment may continue even following a divorce if the prior spouse retains the grantor-trust power or interest, such as serving as trustee in some circumstances.\(^ {47}\)

Section 671 provides that when a grantor is “treated as the owner of any portion of a trust,” the grantor must include the “income, deductions, and credits against tax” from that portion when computing his or her taxable income.\(^ {48}\) Only the portion of the trust that


\(^{44}\) See Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, sec. 1014, § 672(e), 102 Stat. 3342, 3559.

\(^{45}\) See I.R.C. § 672(e) [the spousal identity rule does not apply if the grantor and his spouse were divorced or legally separated at the time the power or interest was created].

\(^{46}\) Id.

\(^{47}\) Under section 672(e)[1][A], if the grantor and the spouse are married at the time the power is created, divorce does not terminate the grantor being deemed to have all powers the spouse has, and divorce does not terminate grantor trust status.

\(^{48}\) I.R.C. § 671.
remains is subjected to the remaining rules concerning the income taxation of trusts and their benefici-aries.\(^4^9\) This aspect of the grantor trust rules, known as the “portion rule,” means that a trust may be a grantor trust in whole or only in part. Whether a trust is wholly a grantor trust or partially a grantor trust may depend on which section or sections of the Code make the trust a grantor trust and which power or interest is involved. When grantor trust treatment status is sought, it is common for the grantor to want the trust to be wholly a grantor trust. Thus, care must be taken to determine if a trust is entirely a grantor trust or one only for some lesser portion. The application of the portion rule is discussed below in section 4:2.2 and in the context of the various grantor rules.

Making a trust a grantor trust usually is quite easy because the grantor trust rules were written with that goal in mind,\(^5^0\) but grantor trust status raises a minefield of situations that may cause wealth transfer tax problems—that is, gift, estate, and generation-skipping transfer tax problems. A grantor trust does not preclude estate, gift, and generation-skipping transfer tax consequences.\(^5^1\) Extreme caution must be used to avoid adverse wealth transfer tax issues; every transfer to a trust has potential gift, estate, and generation-skipping transfer tax consequences besides the income tax status issues.\(^5^2\)

Discussed below with the analysis of each grantor trust Code are various grantor trust rules that may be used to achieve grantor trust status.

### § 4:2 General Rules

Any discussion of the grantor trust rules must start with the general rules applicable to grantor trusts and the controlling definitions.

#### § 4:2.1 Who Is a Grantor?

The identification of a trust’s grantor was determined under case law until regulations were issued in 2000. The regulations are applicable to transfers to trusts or transfers of interests in trusts made after the 1999 effective date of the regulations.\(^5^3\) Obviously, a person...
who creates a trust and funds it is the grantor. The issue is no less clear if the person who creates a trust is not the same person who transfers property to the trust: the property transferor is the grantor. For example, in *Moore v. Commissioner*, a state court order set up a trust to hold the residue of a decedent’s estate and the residual beneficiaries of the estate consented to the creation of the trust. The Tax Court ruled that each beneficiary was the grantor to the extent of each beneficiary’s interest in the trust. Similarly, in Revenue Ruling 83-25, the Service ruled a minor was the grantor of a trust that was created for the minor by a court order to hold a personal injury award.

In Private Letter Ruling 200620025, a decedent’s disabled son was one of four designated beneficiaries of the decedent’s IRA. Because the disabled son was eligible for Medicaid, his guardian sought permission of a local court to create a special needs trust for the son and to transfer his interest in the IRA to the trust. The Service ruled that the court-created special needs trust was a grantor trust of the decedent’s son under sections 671 and 677(a) and that the transfer of the IRA to the trust was not a taxable disposition under section 691(a)(2). The Service ruled similarly in Private Letter Ruling 200826008, in which an IRA beneficiary was a minor.

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56. *See also* Priv. Ltr. Rul. 95-02-019 [same where parent as guardian for incompetent creates trust for incompetent with court approval]; see, e.g., I.R.C. § 646 [Alaska Native Settlement Trusts]; Priv. Ltr. Rul. 97-13-011 [Alaskan Native Corporation apparently treated as grantor of state-chartered settlement trust created with the approval of its shareholders even though the transfer of cash and other assets, other than Alaska Native Claims Settlement Act land, by the corporation to the trust treated as distribution of an economic benefit by the corporation to the shareholders]; Rev. Proc. 2003-14, 2003-1 C.B. 319 [providing safe harbor for each American Indian tribe, as therein defined, to be treated as the owner of certain trusts under the grantor trust rules for receipt of revenues under the Indian Gaming Regulatory Act; the trust beneficiaries will not be required to include payments received by the trust in gross income until the taxable year the beneficiaries actually or constructively receive the amounts pursuant to the tax accounting principles of I.R.C. § 451]. *See also* Priv. Ltr. Ruls. 200835029 and 200927022. Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.
57. Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.
58. See section 2.3.1 for an explanation of I.R.C. § 691(a)(2).
T rusts created by court orders are distinguishable from trusts created by the government, however. For example, in Revenue Ruling 77-230,\(^\text{60}\) the United States was determined to be the grantor of a trust set up in settlement of a claim against it, because income in excess of expenses were accumulated and corpus reverted to the United States when the trust terminated.\(^\text{61}\)

The 2000 regulations apply to gratuitous transfers and transfers of trust interest made after August 9, 1999.\(^\text{62}\) The regulations provide that “a grantor includes any person to the extent such person either creates a trust, or directly or indirectly makes a gratuitous transfer (within the meaning of . . . [Treasury Regulation section 1.671-2(e)(2)]) of property to a trust.” The regulations provide three applicable examples:

Example 1. A creates and funds a trust, \(T\), for the benefit of her children. B subsequently makes a gratuitous transfer to \(T\). Under [Treasury Regulation section 1.671-2(e)[1]], both A and B are grantors of \(T\).\(^\text{64}\)

Example 7. A, B’s brother, creates a trust, \(T\), for B’s benefit and transfers $50,000 to \(T\). The trustee invests the $50,000 in stock of Company X. C, B’s uncle, purportedly sells property with a fair market value of $1,000,000 to \(T\) in exchange for the stock when it has appreciated to a fair market value of $100,000. Under [Treasury Regulation section 1.671-2[e][2][ii]], the $900,000 excess value is a gratuitous transfer by C. Therefore, under [Treasury Regulation section 1.671-2[e][1]], A is a grantor with respect to the portion of the trust valued at $100,000, and C is a grantor of \(T\) with respect to the portion of the trust valued at $900,000. In addition, A or C or both will be treated as the owners of the respective portions of the trust of which each person is a grantor if A or C or both retain powers over or interests in such portions under sections 673 through 677.\(^\text{65}\)

Example 9. G creates and funds a trust, \(T\), for the benefit of B. G retains a power to revest the assets of \(T\) in \(G\) within the meaning of section 676. Under the trust agreement, B is given a general power

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\(^{61}\) Priv. Ltr. Rul. 89-43-083 [similar as to a county government]. Under I.R.C. § 6110[k][3], neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.
\(^{62}\) Treas. Reg. § 1.671-2[e][7].
\(^{63}\) Treas. Reg. § 1.671-2[e][1].
\(^{64}\) Treas. Reg. § 1.671-2[e][6].
\(^{65}\) Id.
of appointment over the assets of T1. B exercises the general power of appointment with respect to one-half of the corpus of T1 in favor of a trust, T2, that is for the benefit of C, B’s child. Under [Treasury Regulation section 1.671-2(c)(1)], G is the grantor of T1, and under [Treasury Regulation 1.671-2(c)(1) and (5)], B is the grantor of T2.66

Entities such as partnerships and corporations may be trust grantors.67 Nevertheless, if the transfer is not for a business purpose of the entity, but rather is for a personal purpose of a shareholder or a partner, the transfer may be reclassified as a constructive distribution to the shareholder or partner. The regulations provide an example: “if a partnership makes a gratuitous transfer to a trust that is for the benefit of a child of a partner, the gratuitous transfer will be treated as a distribution to the partner under section 731 and a subsequent gratuitous transfer by the partner to the trust.”68

The regulations define a gratuitous transfer as any transfer that is not a transfer for fair market value, whether or not the transfer is a transfer for gift tax purposes.69 Consideration received by the transferor includes services rendered by the trust, property, or the use of property, but only to the extent of the arm’s-length value of the services or property received.70 Consideration does not include an interest in the trust.71 Distributions on property owned by a trust, such as a dividend on stock, are not gratuitous transfers.72

If, however, a person establishes a trust but does not make gratuitous transfers to the trust, that person is not treated as the owner, nor is a person considered an owner even if that person transfers property to the trust if the transferor is reimbursed within a reasonable period of time.73 The regulations provide an example:

Example 3. A, an attorney, creates a foreign trust, FT, on behalf of A’s client, B, and transfers $100 to FT out of A’s funds. A is reimbursed by B for the $100 transferred to FT. The trust instrument states that the trustee has discretion to distribute the income or corpus of FT to B and B’s children. Both A and B are treated as grantors of FT under [Treasury Regulation section 1.671-2(c)(1)]. In addition, B is treated as the owner of the entire trust under section 677. Because A is reimbursed for the $100 transferred to FT on behalf of B, A is not treated as transferring any

66. Id.
68. Id.
71. Id.
73. Treas. Reg. § 1.671-2(c)(1).
property to FT. Therefore, A is not an owner of any portion of FT under sections 671 through 677 regardless of whether A retained any power over or interest in FT described in sections 673 through 677. Furthermore, A is not treated as an owner of any portion of FT under section 679. Both A and B are responsible parties for purposes of the requirements in section 6048.\(^{74}\)

The trust created in the example is a foreign trust, but for the general principle, it should not matter whether the trust is foreign or domestic.

Nevertheless, if a “person creates or funds a trust on behalf of another person, both persons are treated as grantors of the trust.”\(^{75}\) When a grantor’s interest in a trust is acquired by another, the transferee becomes the grantor. The regulations provide an example:

Example 2. A makes an investment in a fixed investment trust, T, that is classified as a trust under [Treasury Regulation section 301.7701-2(c)(1)]. A is a grantor of T. B subsequently acquires A’s entire interest in T. Under [Treasury Regulation section 1.671-2(e)(3)], B is a grantor of T with respect to such interest.\(^{76}\)

Borrowing from a trust will not make the borrower the grantor of the trust if the loan is at arm’s length. The regulations provide:

Example 6. A borrows cash from T, a trust. A has not made any gratuitous transfers to T. Arm’s length interest payments by A to T will not be treated as gratuitous transfers under [Treasury Regulation section 1.671-2(e)(2)(ii)]. Therefore, under [Treasury Regulation section 1.671-2(e)(1)], A is not a grantor of T with respect to the interest payments.\(^{77}\)

However, borrowing by the grantor from the trust may result in grantor trust status if section 675 applies.\(^{78}\)

The regulations distinguish between being the grantor and the owner when a beneficiary of a trust is taxed under the grantor trust rules because of section 678.\(^{79}\) In this circumstance, the beneficiary is the deemed owner, but not the grantor. The regulations provide:

Example 4. A creates and funds a trust, T. A does not retain any power or interest in T that would cause A to be treated as an owner.

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\(^{75}\) Treas. Reg. § 1.671-2(e)(1).

\(^{76}\) Id.

\(^{77}\) Id. Special rules may apply if it is a foreign trust. See section 5:2.

\(^{78}\) See I.R.C. § 675(2)–(3); infra section 4:6.3.

\(^{79}\) I.R.C. § 678 is discussed in section 4:6.5.
of any portion of the trust under sections 671 through 677. B holds an unrestricted power, exercisable solely by B, to withdraw certain amounts contributed to the trust before the end of the calendar year and to vest those amounts in B. B is treated as an owner of the portion of T that is subject to the withdrawal power under section 678(a)(1). However, B is not a grantor of T under Treasury Regulation section 1.671-2(e)(1) because B neither created T nor made a gratuitous transfer to T.\footnote{80}

Thus, the beneficiary of a “Crummey” trust or an irrevocable life insurance trust (ILIT) with annual exclusion withdrawal powers will become the owner of a trust to the extent of the Crummey withdrawal power, but the beneficiary is not deemed the grantor even after the Crummey withdrawal right expires.\footnote{81}

In some cases, a trust may be set up indirectly. For example, a reciprocal trust may be set up in which A creates a trust for B in return for B’s creation of a trust for A.\footnote{82} Estate tax authority on reciprocal trusts is plentiful and would probably apply to income tax cases. Other indirect transfers may occur. For example, A may furnish other consideration to B to create a trust. In such case, A, the indirect grantor of the trust for the grantor or the benefit of the grantor’s family, is still treated as the grantor for purposes of these rules.\footnote{83}

\footnote{80. Treas. Reg. § 1.671-2(e)(6).}
\footnote{81. However, the Service has continuously ruled that such a beneficiary is not deemed the owner if the grantor is treated as the owner. \textit{See} \textit{generally} Jonathan G. Blattmachr & Frederick Sembler, \textit{Crummey Powers and Income Taxation}, \textit{The Chase Rev.} (July 1995); Jonathan G. Blattmachr, Mitchell M. Gans & Alvina H. Lo, \textit{A Beneficiary as Trust Owner: Decoding Section 678}, \textit{35 ACTEC J.} 106 (2009).
\footnote{83. \textit{See} Jackson v. Comm’r, 64 F.2d 359 (4th Cir. 1933); Kraus v. Comm’r, 497 F.2d 1109 (6th Cir. 1974), \textit{aff’d} 57 T.C. 890 (1972); Priv. Ltr. Rul. 8813039; Chief Couns. Adv. 2004-45-025 [individual who created corporation treated as the grantor of trust to which corporation issued stock]. Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.}
The Service has rarely applied the reciprocal trust doctrine, however, when each trust was a grantor trust for its nominal grantor, but it has in at least one letter ruling and argued successful in one case. The nominal grantor should not be treated as the grantor where another provides the consideration. A second person who makes contributions to a trust originally created by another is treated as the grantor of an appropriate portion of the trust.

§ 4:2.2 Portion Rule

Section 671 provides that where the grantor is “treated as the owner of any portion of a trust,” the income, deductions, and credits of “that portion of the trust” are taken into account in computing the taxable income of the owner. This application of the grantor trust rules is carried out in the operative provisions of sections 673 to 679. As a result of the portion rule, it is possible for a grantor to be taxed on some, but not necessarily all, of the income of a trust. The regulations provide that a portion may be ordinary income of a trust, income allocable to corpus, income related to specific trust property, or a fractional share of the income of a trust. The portion rule will tax the grantor on the ordinary income of a trust if the grantor has a sections 674–78 power over only ordinary income portion of a trust. A grantor with a reversionary interest in the principal of a trust under section 673 will be taxed on the gains allocable to principal, even if not taxed on the ordinary income.

86. Krause v. Comm’t, 497 F.2d 1109 (6th Cir. 1974), aff’g 57 T.C. 890 (1972).
88. See Stavroudis v. Comm’t, 27 T.C. 583 (1956). But see Stern v. Comm’t, 747 F.2d 555 (9th Cir. 1984), rev’g 77 T.C. 614 (1981). Field Service Advice 99-52-114 (although concluding that neither trust was a grantor trust with respect to certain trust beneficiaries because they “neither created . . . nor made any gratuitous transfer to the trusts,” it added “[w]here settlors only nominally fund a trust they create, and other persons make large gratuitous transfers to the trust, the subsequent transferors may be considered grantors for purposes of the grantor trust rules”). Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.
89. I.R.C. § 671.
91. Treas. Reg. § 1.671-3(b)(1).
The portion rule is discussed in greater depth with each grantor trust rule below.

The Code provides in detailed sections that, where various powers and controls exist over portions of a trust, the grantor or another person shall be treated “as the owner” of that portion. This is specified to mean that

there shall then be included in computing the taxable income and credits of the grantor or the other person those items of income, deductions, and credits against tax of the trust which are attributable to that portion of the trust to the extent that such items would be taken into account under this chapter in computing taxable income or credits against the tax of an individual.93

Thus, for example, if a revocable trust pays a portion of its income to charity, an individual grantor will include the income in his or her own return and can add the charitable payments with his or her other charitable gifts for purposes of the charitable deduction under section 170.94 This rule [treat like an individual] should not be taken too literally in the case of a revocable trust created by a corporation.95

No such specific rule applies to estates. A grantor’s estate is not deemed taxable on trust income, such as capital gain, currently accumulated for distribution to it even where trust income of this nature was taxable to the grantor during the grantor’s lifetime.96

Similarly, where income from corpus is taxable to the grantor by reason of a power to revoke, the grantor is allowed the same deductions related to corpus as would be allowed had the trust not been created.97 The grantor of such a revocable trust has been allowed to deduct losses on the sale of securities by the trustee.98 The theory of continued ownership in a revocable trust has been extended to

94. Treas. Reg. § 1.671-2(c); H.R. REP. NO. 1337, supra note 3, at 4084; S. REP. NO. 1622, supra note 3, at 4719. The language of these authorities may suggest that it was intended to permit such a deduction even if the charitable payment was not out of income: a situation in which individuals can take deductions but trusts may not.
95. Treas. Reg. § 1.671-2(c); Rev. Rul. 57-390, 1957-2 C.B. 326 [also holding that the grantor’s fiscal year and method of accounting both apply].
97. See Miller v. Comm’r, 12 T.C.M. (CCH) 506 (1953).
preserve the basis of property transferred in trust, even when special rules exist that normally would change the basis.\textsuperscript{99}

The taxable year of the grantor, even in connection with a partial grantor trust, will govern the year in which the grantor must pick up his or her portion of the income.\textsuperscript{100}

The regulations describe in detail the rules on the necessary allocation of the appropriate income, deductions, and credits to be made in the case of a grantor who is treated as owner of only a portion of a trust.\textsuperscript{101} If any part of the income of a trust is taxable to the grantor or to another person under these sections, it should not be reported on the trust’s return, but such income and the applicable deductions and credits should be shown in a separate statement attached to the trust return.\textsuperscript{102}

\textsuperscript{99} Welch v. Bradley, 130 F.2d 109 [1st Cir.], cert. denied, 317 U.S. 685 [1942]; see also I.T. 3207, 1938-2 C.B. 181 [nature of income as fixed or determinable, annual or periodical].

\textsuperscript{100} Scheft v. Comm’r, 59 T.C. 428 [1972].

\textsuperscript{101} Treas. Reg. § 1.671-3; see Treas. Reg. § 1.677(a)-1(g); Rev. Rul. 66-161, 1966-1 C.B. 164 [grantor could demand payment over of capital gains added to corpus, which reverts, and must therefore include income attributable to that portion of corpus]; see also Rev. Rul. 67-241, 1967-2 C.B. 225 [nongrantor “owner” of portion may be taxed less on actual invasion than if she had been ordinary beneficiary]; Schmolka, \textit{Selected Aspects of the Grantor Trust Rules}, 9 INST. ON EST. PLAN. ¶ 1400 (1975). In regard to special problems raised by the presence of annuities or capital gains, see respectively, Louis A. Del Cotto & Kenneth F. Joyce, \textit{Taxation of the Trust Annuity: The Unitrust Under the Constitution and the Internal Revenue Code}, 23 TAX L. REV. 257, 317B59 (1968); John J. Costello, \textit{Capital Gains Realized by Trusts: Taxation to Persons Other than the Trustee}, 22 TAX LAW 495, 503–27 [1969]; see also Note, \textit{Taxation of Capital Gains Realized by Trusts}, 12 TAX L. REV. 99, 103–09 (1956); John R. Howard, \textit{Discretionary Distributions of Current Capital Gains Realized by Trusts}, 116 TR. & EST. 301 (1977). As to determining the portion over which the grantor is the owner, see the estate tax cases of Ne. Pa. Nat’l Bank & Trust Co. v. United States, 387 U.S. 213 [1967] [a “specific portion” qualifying for marital deduction can be computed from a fixed monthly stipend payable to widow] (overruled by Pub. L. No. 102-486, § 1941(a) by adding I.R.C. § 2056(b)(10)); Estate of Tomec v. Comm’r, 40 T.C. 134 [1963] [capitalizes amount needed to produce the first $10,000 of income payable to other beneficiaries, and the rest is for the grantor]; see also Crane v. Comm’t, 368 F.2d 800 [1st Cir. 1966] [reversionary interest sufficient to require grantor’s inclusion of entire income rather than “elaborate calculations”]; see Benson v. Comm’t, 76 T.C. 1040 [1981] [grantor who borrows past and current years’ income of trust treated as owner of entire trust under I.R.C. § 675]; Bennett v. Comm’t, 79 T.C. 470 [1982] [grantor who borrows some of prior years’ income of trust treated as owner under I.R.C. § 675 of that fractional portion of trust whose numerator is amount of loan at beginning of year and whose denominator is all years’ income].

\textsuperscript{102} See infra section 4:8; see also Treas. Reg. § 1.671-4; Rev. Rul. 61-175, 1961-2 C.B. 200 [with several grantors]. See also Rev. Rul. 60-370, 1960-2 C.B. 203, treating a sale of appreciated property as having been made directly by the...
When real property is transferred to a trust with a leaseback option, the transfer to the trust is not sufficient to enable the grantor to deduct the rental payments to the trust.\textsuperscript{103}

\section*{§ 4:2.3 Tax Year}

A trust that is entirely a grantor trust is not required to file returns on a calendar year as required generally for non-charitable trusts by section 644, at least if the grantor is a corporation. Instead, the trust’s tax year and accounting method for a wholly grantor trust must be the same as the grantor.\textsuperscript{104} While it is possible for individuals to be fiscal-year taxpayers, it is not common; thus, grantor trusts with individuals as owners will generally be required to file a calendar-year return.\textsuperscript{105} For corporations filing on a fiscal-year basis, a grantor trust created by the corporation must use the same reporting year as the corporation, if it is a wholly grantor trust.

\section*{§ 4:2.4 Definitions}

As in most areas of the tax law, definitions are key to the application of the grantor trust rules. Each significant term of art is discussed below.

\[ \text{[A] Adverse Party and Non-Adverse Party} \]

Section 672(a) defines adverse party as “any person having a substantial beneficial interest in the trust which would be adversely affected by the exercise or nonexercise of the power which he possesses respecting the trust,” and includes a person who holds a general power

\begin{footnotes}
\footnote{103}{Treas. Reg. § 1.671-1(c); H.R. REP. NO. 1337, supra note 3, at 4084, S. REP. NO. 1622, supra note 3, at 4719.}
\footnote{104}{Rev. Rul. 90-55, 1990-2 C.B. 161.}
\footnote{105}{However, as explained in section 4:8, some grantor trusts need not file income tax returns.}
\end{footnotes}
of appointment over the trust property.\textsuperscript{106} The term is largely a replacement for references in the 1939 Code and regulations to persons not having a “substantial adverse interest,” and the meaning is probably much the same.\textsuperscript{107} The use of the word “beneficial” introduced a requirement that an adverse interest be economic.\textsuperscript{108} Probably, the power is “exercisable” by such persons whenever the conditions as to decision-making give them power to act without the approval or consent of others. This conclusion is specified in other sections in the subpart on grantor trusts.\textsuperscript{109}

A non-adverse party is anyone who is not an adverse party.\textsuperscript{110}

The question of adverse interest is essentially one of fact to be determined by considering in each case the particular interest created by the trust instrument and the relative size of that interest. For example, an interest in income of $X a year may be regarded as substantial in one situation, in another it may not be. The regulations provide that an interest is substantial “if its value in relation to the total value of the property subject to the power is not insignificant.”\textsuperscript{111} In one case, a remainder interest in which the court took to be under 4% was held to be too “slim a restraint” to be adverse as to the entire trust.\textsuperscript{112}

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\textsuperscript{106} I.R.C. § 672(a).

\textsuperscript{107} Gift and estate tax cases are also relevant on adverse interest. In general, on trustee selection, see Steven A. Winkelman, The Trust and the Trustee, 38 Taxes 569 (1960).


\textsuperscript{109} I.R.C. §§ 674(a), 674(d), 675(1), 675(4), 677; see also I.R.C. § 675(3). A special rule is provided for I.R.C. § 674(c); see also 2 A.L.I. FED. INCOME TAX STAT. 454 cmt. 3 [Draft Feb. 1954]. The Code sections in this whole area are largely taken from the American Law Institute provisions. These sections could be avoided if the powers could be exercised, for example, only with the consent of any one out of ten adverse parties.

\textsuperscript{110} I.R.C. § 672[b].

\textsuperscript{111} Treas. Reg. § 1.672[a]-1[a]; see Paxton v. Comm’r, 57 T.C. 627 [1972], aff’d, 520 F.2d 923 [9th Cir. 1975], cert. denied, 423 U.S. 1016 [1976]. As a result of amendments, however, a trustee-son may come to have a substantial adverse interest, so the grantor is not taxed. Estate of Paxton v. Comm’r, T.C. Memo 1982-464, appeal dismissed [9th Cir. 1983] [some amendments were nullities as there was no reservation of power to make them]; Vercio v. Comm’r, 73 T.C. 1246, 1258 [1980] (“Congress effectively ruled out the possibility of a spouse being treated as an adverse party when a provision in the trust allows for the income to be used for that spouse’s benefit.”).

\textsuperscript{112} Paxton v. Comm’r, 520 F.2d 923 [9th Cir. 1975], cert. denied, 423 U.S. 1016 [1976]; see Paxton v. Comm’r, T.C. Memo 1982-464 [reported but unauthorized changes by trustees to create adverse interest ignored; but son found to have adverse interest in another trust]; see also May v. United States, 40-2 U.S. Tax Cas. [CCH] ¶ 9,725, 27 A.F.T.R. [P-H] 1167 (W.D. Pa. 1940) [$350 a year out of several thousand].
of the income or corpus ordinarily possesses a substantial beneficial interest that would be adversely affected by a revocation of the trust because revocation would cut off the rights to the property or income.

A trustee is not considered an adverse party solely because of being in the position of trustee. The right of a trustee to commissions so long as the trust exists does not make the interest substantially adverse to that of the grantor.

Generally, the grantor is treated as holding any power or interest that the grantor’s spouse holds.

If a person, particularly the grantor, has the power to make himself or herself the trustee, or perhaps even merely to be a substitute trustee (other than substituting one independent trustee for another), it is possible that the person could be treated as having all the powers that normally belong to others as trustee. In at least one case, such a contention for taxability was rejected in view of a “savings clause” in the instrument (perhaps more commonly used as administrative “boilerplate”) to the effect that any provisions determined to cause taxability to the grantor would not be operative.

113. Treas. Reg. § 1.672[a]-1[a].
114. Reinecke v. Smith, 289 U.S. 172 (1933); Morton v. Comm’r, 109 F.2d 47 (7th Cir. 1940) (even though the annual fee was about $700); cf. Miller v. Comm’r, 12 T.C.M. (CCH) 506 (1953).
116. Treas. Reg. § 1.674(d)-2[a]; Treas. Reg. § 20.2038-1[a][3] (estate tax); Rev. Rul. 73-21, 1973-1 C.B. 405 (estate tax); Walter v. United States, 295 F.2d 720 (6th Cir. 1961) (estate tax); Van Beuren v. McLoughlin, 262 F.2d 315 (1st Cir. 1950) (estate tax), cert. denied, 359 U.S. 991 (1959); Corning v. Comm’r, 239 F.2d 646 (6th Cir. 1956), aff’g 24 T.C. 907 (1955); Loughridge’s Estate v. Comm’r, 183 F.2d 294, 298–300 (10th Cir.) (estate tax), cert. denied, 340 U.S. 830 (1950); Stockstrom v. Comm’r, 151 F.2d 353 (8th Cir. 1945), aff’g 4 T.C. 5 (1944); cf. United States v. Byrum, 408 U.S. 125 (1972), aff’g 404 F.2d 949 (6th Cir. 1971) (estate tax: may substitute corporate trustee) [but this case was reversed, in part, by the Tax Reform Act of 1976 by amendment of I.R.C. § 2036]; Mathey v. United States, 491 F.2d 481 (3d Cir. 1974) (estate tax); Clark v. United States, 267 F.2d 501 (1st Cir. 1959), on remand, 180 F. Supp. 696 (D. Me. 1960) (estate tax); Ernest E. Monrad, Power of Disposition, 34 TAXES 693, 699 (1956). In Rev. Rul. 79-353, 1979-2 C.B. 325, modified, Rev. Rul. 81-51, 1981-1 C.B. 458, the Service held that for certain estate tax purposes powers held by a corporate trustee are attributable to grantor whose only power or interest in the trust is to substitute another corporate trustee. This position was explicitly rejected in Estate of Wall v. Comm’r, 10 T.C. 300 (1943), and then to a large degree disavowed by the Service in Rev. Rul. 95-58, 1995-2 C.B. 191.
A person may be an adverse party as to one power over the trust, but not as to another power: a person may have a substantial beneficial interest that is adverse to only part of a trust or of its income. For example, an ordinary income beneficiary with a life interest, remainder to the grantor, has an adverse interest as to ordinary income but not as to income allocable to corpus. A remainderman’s interest is normally adverse as to powers over corpus but not as to powers over any income interest preceding the remainder. In such cases, there is excluded from attribution to the grantor only that part of the trust as to which the person’s exercise or nonexercise of a power would adversely affect the person’s own interest. The regulations provide an example:

[I]f A, B, C, and D are equal income beneficiaries of a trust and the grantor can revoke with A’s consent, the grantor is treated as the owner of a portion which represents three-fourths of the trust; and items of income, deduction, and credit attributable to that portion are included in determining the tax of the grantor.

The following are examples of cases in which a substantial adverse interest was held to exist where the grantor, together with the persons indicated, retained a power of revocation:

1. The grantor reserved the power to revoke the trust with the consent of her husband, who was named as a cotrustee. After the wife’s death, the husband was to receive the income and also such amounts of corpus as the trustees deemed necessary for the grantor’s support and maintenance. It was held that although the grantor’s interest was contingent upon the grantor’s spouse predeceasing the grantor, the grantor nevertheless had a substantial adverse interest.

2. The grantor’s spouse was named the life beneficiary of a trust, with a limited power of appointment over the remainder. The spouse was also one of the trustees. The trust agreement required the consent of all the trustees to revest the corpus in the grantor. It was held that the spouse had a substantial adverse interest, and therefore, the capital gains of the trust, which were to be added to corpus, were not taxable to the grantor.

118. Treas. Reg. § 1.672(a)-1.
119. Treas. Reg. § 1.672(a)-1(b).
The trust agreement provided that if the grantor predeceased his or her spouse, the grantor might cancel the agreement, in which event the grantor would be entitled to receive absolutely the corpus of the trust fund and any undistributed income. The husband was held to have a substantial adverse interest.\(^{122}\)

The grantor created a trust primarily for the grantor’s children, reserving a power to revoke with grantor’s spouse. Thereafter the parties were divorced. It was held that the income was not taxable to the grantor because the spouse, being liable for the support of the children, had a substantial adverse interest in the trust.\(^{123}\) Subsequent cases cast doubt on this rule, at least where the income is not actually needed to meet the obligation.\(^{124}\) As a result, it is not clear whether an indirect interest of this type will suffice, even if the interest has some potential economic significance. But it would appear, at least, from the above examples, that a contingent interest can sometimes suffice.

In the following cases, no substantial adverse interest was found to exist:

1. A brother and sister were joint grantors and joint beneficiaries, with equal rights. The trust could be terminated by their joint action as beneficiaries. If either should die without leaving lawful issue, the entire interest would pass to the survivor. There were no children, and there was no indication of any special factors making survival of one beneficiary more likely than the other except for normal actuarial differences.\(^{125}\)


\(^{123}\) Savage v. Comm’r, 82 F.2d 92 (3d Cir. 1936); Fleischmann v. Comm’r, 40 B.T.A. 672 (1939).

\(^{124}\) Comm’r v. Caspersen, 119 F.2d 94 (3d Cir.), cert. denied, 314 U.S. 643 (1941); Loeb v. Comm’r, 113 F.2d 664 (2d Cir.), cert. denied, 311 U.S. 710 (1940); cf. Treas. Reg. § 1.662(a)-4, which provides, in part, that any amount which, pursuant to the terms of the will or trust instrument, is used in full or partial discharge or satisfaction of a legal obligation of any person is included in the gross income of such person under I.R.C. § 662(a)(1) or § 662(a)(2), whichever is applicable, as though directly distributed to him as a beneficiary, except in cases to which I.R.C. § 71 (relating to alimony payments) or I.R.C. § 682 (relating to income of a trust in case of divorce, etc.) applies.

\(^{125}\) De Amodio v. Comm’r, 299 F.2d 623 (3d Cir. 1962) [the distributability of the income to the grantors was a separate ground under I.R.C. § 677]. The sister was five years older than the brother and was not currently married. De Amodio v. Comm’r, 34 T.C. 894, 898, 902 (1960). But cf. Priv. Ltr.
The grantor named the grantor’s mother and a trust company as trustees. By direction of the mother any part, or all, of the corpus could be transferred to the grantor. It was held that the mother did not have a substantial adverse interest, although under local law she could, if destitute, demand support from the grantor; and if the grantor died intestate, she would have an interest in the grantor’s estate. The mother’s right to the property was considered to be too remote.\(^{126}\)

A trust instrument provided that the trust could be revoked by a committee with the consent of the grantor’s spouse. The committee had no interest in the trust. The spouse’s only interest was that the trustees in their discretion might pay to her any part of the principal or accumulated income. It was held that the spouse’s interest was not substantially adverse because the trustees were not required to pay her anything, and even that right could have been destroyed by an exercise of the power to amend, given to the committee by the trust instrument.\(^{127}\)

The grantor’s divorced spouse, with whom the grantor could revoke, had a remainder that would take effect upon the death of either of the spouse’s children before age thirty-five without issue; the children each had one child at the time. The spouse’s interest was deemed to be too remote.\(^{128}\)

The grantor reserved the right to revoke with the consent of any beneficiary having “a substantial adverse interest.” Nevertheless, the income was held taxable to the grantor on the ground that: “In view of the broad powers of the donor, as trustee, and the family relation, we think it may be reasonably assumed that such a consent would be freely given.”\(^{129}\)

\(^{126}\) Cushing v. Comm’r, 38 B.T.A. 948 (1938).
\(^{127}\) Fulham v. Comm’r, 110 F.2d 916 (1st Cir. 1940).
\(^{129}\) Cox v. Comm’r, 110 F.2d 934, 936 (10th Cir.), cert. denied, 311 U.S. 667 (1940).
The latter case may reflect a tendency to presume that beneficiaries of a trust who are members of the grantor’s family are under his domination and control and, consequently, do not have a substantial adverse interest in the trust. Even without a presumption, the cases at least indicate that arrangements under family trusts will be scrutinized carefully to determine whether the beneficial interests of persons who are members of the grantor’s family are, in fact, adverse.

It has been held under case law before the 1954 Code, that a wife’s interest in a trust created by her husband was not substantially adverse, because of “the normal consequences of family solidarity.” But consideration must still be given to the explicit definition in section 672 of nonadverse party enacted by the 1954 Code. On the other hand, it is certainly still a possibility that a wife may have a substantial adverse interest.

[B] Related or Subordinate Party

A related or subordinate party is a nonadverse party who is:

1. the grantor’s spouse if living with the grantor;
2. the grantor’s father, mother, issue, brother or sister;
3. an employee of the grantor;
4. a corporation or any employee of a corporation in which the stock holdings of the grantor and the trust are significant from the viewpoint of voting control; or
5. a subordinate employee of a corporation in which the grantor is an executive.

In addition, for purposes of sections 672[f], 674, and 675, related or subordinate persons are “presumed to be subservient to the grantor in respect of the exercise or nonexercise of the powers

131. Laganas v. Comm’r, 281 F.2d 731, 735 (1st Cir. 1960); Comm’r v. Katz, 139 F.2d 141 (2d Cir. 1943); Camp v. Comm’r, 195 F.2d 999, 1004 (1st Cir. 1952) (gift tax: extraneous factors do not enter, unless there is some advance agreement to acquiesce). But see infra section 4:2.4[D].
132. I.R.C. § 672(c); Treas. Reg. § 1.672(c)-1.
133. I.R.C. § 672(f) concerns foreign trusts. See discussion at section 5:4.
135. I.R.C. § 675 concerns administrative powers. See discussion at section 4:6.3.
conferred on [them] unless such [person] is shown not to be subservient by a preponderance of the evidence."\textsuperscript{136}

\section*{C} \textbf{Powers Subject to a Condition Precedent}

A person is considered to have power that is subject to a condition precedent if the condition is giving notice or the expiration of a period of time.\textsuperscript{137} Nevertheless, a grantor will not be treated as an owner by reason of such a power if the exercise effects only the beneficial enjoyment of income to be received after a period of time expires, but only if the grantor would not be treated as the owner under section 673, if the power is a reversionary interest.\textsuperscript{138} The regulations provide an example:

[I]f a grantor creates a trust for the benefit of his son and retains a power to revoke which takes effect only after the expiration of 2 years from the date of exercise, he is treated as an owner from the inception of the trust. However, if the grantor retains a power to revoke, exercisable at any time, which can only affect the beneficial enjoyment of the ordinary income of a trust received after the expiration of [the period of time necessary to satisfy the 5\% rule of section 673] . . ., the power does not cause him to be treated as an owner with respect to ordinary income during the term [,the period of time necessary to satisfy the 5\% rule of section 673,] has expired.\textsuperscript{139}

\section*{D} \textbf{Powers and Interest of the Grantor’s Spouse}

Section 672(e), added to the Code in the Tax Reform Act of 1986\textsuperscript{140} and expanded by the Technical and Miscellaneous Revenue Act of 1988,\textsuperscript{141} provides that any power or interest in a trust that is held by the grantor’s spouse is considered an interest or power held by the grantor. This rule applies if the grantor was married to the spouse at the time the power or interest was created and is not affected by a subsequent divorce.\textsuperscript{142} However, if the grantor and spouse are legally separated “under a decree of divorce or of separate maintenance,” at the time the power or interest is created, they are not considered married for purposes of the section.\textsuperscript{143} In addition, if a person with a power or

\begin{thebibliography}{99}
\textsuperscript{136.} I.R.C. § 672[c]; see Treas. Reg. § 1.672[c]-1.
\textsuperscript{137.} I.R.C. § 672[d].
\textsuperscript{138.} Treas. Reg. § 1.672[d]-1.
\textsuperscript{139.} Id.
\textsuperscript{140.} Tax Reform Act of 1986 § 1402, 100 Stat. 2085, 2711 [1986].
\textsuperscript{141.} Technical and Miscellaneous Revenue Act of 1988 § 1014, 102 Stat. 3342, 3559 [1988].
\textsuperscript{142.} I.R.C. § 672[e][1][A].
\textsuperscript{143.} I.R.C. § 672[e][2].
\end{thebibliography}
interest in a trust and the grantor of the trust marry after the trust is
created, the grantor is considered to have the interests or powers of the
spouse, but only with respect to periods after the marriage.144 This rule
applies for transfer made to trusts after March 1, 1986.145

No regulations have been promulgated for section 672(e). The
legislative history of the Technical and Miscellaneous Revenue Act
of 1988 provides:

In addition, the grantor is treated as owner of a trust by virtue of
certain powers exercisable by trustees if the grantor’s spouse is a
trustee or more than half of the trustees are related or subordinate
parties subservient to the wishes of the spouse. The grantor also is
treated as the owner where the trust makes certain loans to the
grantor’s spouse.146

[E] Foreign Trust Limitation

Section 672(f) provides a special rule applicable to foreign trusts. It
is discussed in detail in section 5:4.

§ 4:3 Revocable Trusts—Trusts in Which the Grantor Has
Retained a Beneficial Interest or Power—Sections
676 and 673147

Section 676(a) provides the general rule that a grantor of a trust is
considered to be the owner of any portion of a trust if the grantor or a
nonadverse party, or both, or the grantor’s spouse148 have the power to
revest title to the portion.149 Section 676(a) does not apply, however, in
situations where the corpus will revert to the grantor automatically at
the expiration of a term certain.150 In that circumstance, the income
may be taxed to the grantor under section 673. It is possible also that
revocable trusts might fall under section 674,151 dealing with power to
to control beneficial enjoyment. However, perhaps reflecting historical
distinctions, revocable trusts are separately treated under section 676.

144. I.R.C. § 672(e)(1)(B).
145. See supra note 140, § 1401, 100 Stat. 2085, 2711; see supra note 141,
§ 1014, 102 Stat. 3342, 3559.
147. For an additional discussion of the tax consequences of revocable trusts,
see chapter 8, infra.
148. For transfers in trust after March 1, 1986, the grantor is treated as holding
powers that the grantor’s spouse holds, under I.R.C. § 672(e). See section
4:2.4[D], supra, for a discussion of when I.R.C. § 472(e) is not applicable.
149. I.R.C. § 676[a].
151. See Batson v. Comm’r, T.C. Memo 1983-545.
In Private Letter Ruling 200128048, the Service ruled that section 676 was not applicable when trust distributions could be made to the grantor or the grantor’s spouse, among other beneficiaries, but only as instructed by a distribution committee consisting of two beneficiaries, other than the grantor or the grantor’s spouse, eligible to receive distributions, if they both act jointly or if one acts with grantor because distribution committee members were deemed to have substantial adverse interests to distributions to any beneficiary and to accumulation of income when grantor held testamentary power of appointment.  

Section 676 applies if the power to revest exists, even though it is not exercised in the taxable year. The grantor may be taxed under this section, even if the power is not immediately operative and, thus, the revesting can take effect only in a subsequent year.

It does not apply if the exercise of the power to revest affects “the beneficial enjoyment of the income” for the period that correlates in general with the section 673 rule that permits a reversion after a period of time. Thereafter, the grantor may be treated as the owner if the power has not been relinquished.

The regulations state that a power to revest can be present “regardless of whether the power is a power to revoke, terminate, alter or amend, or appoint.” The device or mechanics by which a power to

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153. I.R.C. §§ 672(d), 676(b); Treas. Reg. §§ 1.672(d)-1, 1.676(b)-1.

154. The measurement of this period, when it is not specifically measured by a term of years or when it is subsequently extended or when the income is payable to charity, is discussed infra at section 4:5.1.


156. Treas. Reg. § 1.676(a)-1; see Krag v. Comm’r, 8 T.C. 1091 (1947) [revocable despite state court]; Rev. Rul. 71-548, 1971-2 C.B. 250 [right to cause sale of trust assets, which triggers reversion]. In general, however, the appropriate state law governs the trust relationships. See Helvering v. Stuart, 317 U.S. 154 (1942); Rev. Rul. 62-148, 1962-2 C.B. 143 [savings bank deposit “as trustee,” so-called New York Totten trust, is revocable]; Estate of Stewart v. Comm’r, 436 F.2d 1281 (3d Cir.), cert. denied, 404 U.S. 828 (1971) [estate tax: limitations under state law then applicable did not sufficiently prevent discretionary powers from being power to invade charitable remainder].
revest may be exercised is immaterial in determining the taxability of the income to the grantor. For example, if the grantor reserves the power to purchase the trust corpus for a nominal consideration, the trust is revocable to the extent of the excess of the value of the property that can be reacquired over the amount to be paid.\textsuperscript{157} Similarly, the reservation of broad powers of sale, under which the grantor may buy from or sell to the trust at his own price, is substantially equivalent to a power to revest.\textsuperscript{158} The income is likewise taxable to the grantor if a power to terminate the trust is reserved through the retention of a power to appoint an individual other than the grantor to exercise the right to terminate the trust.\textsuperscript{159}

Nevertheless, a contingent power is not necessarily covered.\textsuperscript{160} Also, a power to substitute securities producing a substantially equal income for securities\textsuperscript{161} that constitute the corpus of the trust is not a power to revest, nor is it a power to purchase trust assets at a fair price.\textsuperscript{162} The grantor is not taxable under section 676 if the only power retained is the right to direct investments.\textsuperscript{163} A power to appoint the remainder by deed or will does not constitute a power to revest.\textsuperscript{164} Similarly, a provision that reserves to the grantor a power to change the beneficiaries or to modify the distributive shares is not a power to revest if power cannot be exercised to revest the corpus in the grantor.\textsuperscript{165} However, depending upon the existence or absence of other material circumstances, the income of such trusts may be included in the grantor’s income under other grantor trust sections of the Code.\textsuperscript{166}

\begin{thebibliography}{9}
\bibitem{157} Fisher v. Comm’r, 28 B.T.A. 1164 (1933); \textit{see also} I.R.C. § 675[1], which treats this as a taxable administrative power.
\bibitem{159} Pulitzer v. Comm’r, 36 B.T.A. 964 (1937).
\bibitem{162} Palmer v. Comm’r, 40 B.T.A. 1002 (1939), \textit{aff’d}, 115 F.2d 368 [2d Cir. 1940].
\bibitem{163} Maloy v. Comm’r, 45 B.T.A. 1104 [1941].
\bibitem{164} Comm’r v. Bateman, 127 F.2d 266 [1st Cir. 1942].
\bibitem{166} This subject is discussed \textit{infra} in section 4:5.
\end{thebibliography}
A so-called Totten trust is a revocable trust taxable to the grantor under section 676.167
Whether a trust is revocable or not is a state law issue. The Uniform Trust Code section 602 creates a basic presumption that a trust is revocable unless the trust expressly provides otherwise.168 This reverses the common law rule that trusts are presumed irrevocable unless a power to revoke was reserved at the time of creation.169

**§ 4:3.1 Grantor Trust Status**

A section 676 power likely will cause estate tax problems for the grantor under sections 2036 and 2038, and thus a section 676 power to revoke held by the grantor is not a choice for creating a grantor trust if there is an intention to exclude the property from the grantor’s gross estate.170 Moreover, if the power is not held by the grantor, but the existence of power subjects the trust assets to claims of the grantor’s creditors, a section 676 power to revoke is not a choice for creating a grantor trust if either excluding the assets from the grantor’s gross estate or avoiding making the subject to claims of the grantor’s creators is a goal. Such a power held by the grantor’s spouse would cause the trust to be a grantor trust—because of the spousal unity rule of section 672(e)—but the power would likely be a general power of appointment and result in the inclusion of the property in the gross estate of the spouse under section 2041 (unless the power is limited by an ascertainable standard, in which event there is uncertainty as to whether section 676 would apply).171

**§ 4:4 Trusts with Income for Benefit of Grantor or Spouse**

Section 676 deals with the possible return to the grantor of the corpus of a trust. On the other hand, section 677 deals with the situation in which the income of a trust may be distributed to or used for the benefit of the grantor or accumulated for the grantor—including distribution, use, or accumulation to or for the grantor’s spouse.172 The two provisions complement each other in that they both attempt

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169. 76 AM. JUR. 2D TRUSTS (2005).
170. See I.R.C. §§ 2036, 2038.
171. See I.R.C. § 2041. As to the impact of an ascertainable standard or distribution, see infra notes 346–50 and accompanying text.
172. The provisions concerning the grantor’s spouse apply to transfers in trust after October 9, 1969. Treas. Reg. § 1.677(a)-1(a)(1). For the definition of income, see note 207, infra, and accompanying text.
to tax to the grantor the income of a trust in which the grantor has not surrendered substantially all interest or control. In their construction, therefore, the two sections are governed “by similar considerations.”

§ 4:4.1 Discretionary Distribution of Income to Grantor or Spouse

Section 677(a) of the Code provides in part that the grantor shall be treated as the owner of any portion of a trust whose income, without the approval or consent of any adverse party, is or may be, in the discretion of the grantor or a nonadverse party or both, either (1) distributed to the grantor or the grantor’s spouse, or (2) held or accumulated for future distribution to the grantor or the grantor’s spouse. Four possibilities are covered, all assuming no approval or consent of an adverse party:

1. income is distributed to the grantor or the grantor’s spouse;
2. in the discretion of the grantor, or nonadverse parties, income may be distributed to the grantor or the grantor’s spouse;
3. income is accumulated for future distribution to the grantor or the grantor’s spouse; and
4. in the discretion of the grantor, or nonadverse parties, income may be accumulated for future distribution to the grantor or the grantor’s spouse.

This analysis suggests, as does a literal reading of the Code, that section 677 would except situations where income is actually distributed or accumulated for future distribution to the grantor or his spouse, provided that the distribution or accumulation has to be,

174. See LaFargue v. Comm’r, 689 F.2d 845 [9th Cir. 1982] [annuitant treated as creditor and not grantor with retained interest for the trust with which taxpayer had exchanged property for lifetime annuity]; cf. Horstmier v. Comm’r, 46 T.C. Memo 1983-409 [taxpayer’s sale to trust for annuity and trust’s creation treated as shams]; Lazarus v. Comm’r, 513 F.2d 824 [9th Cir. 1975]; Bixby v. Comm’r, 58 T.C. 757 [1972]; see Priv. Ltr. Rul. 200407002 [transfer of liquidating trust assets to a trust will be treated for all federal tax purposes as a transfer from the bankruptcy estate to the beneficiaries, who apparently are the creditors, followed by a deemed transfer by the beneficiaries to the trust which will be considered a grantor trust; the beneficiaries will be treated as the owners under I.R.C. § 677 where trust agreement provides that the liquidating trustee will make annual distributions to its beneficiaries]. Under I.R.C. § 6110(k)(3), neither a National Office Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.
and is, with the consent of an adverse party.\footnote{175} However, the Committee Reports do not so specify, and the regulations take the opposite view.\footnote{176}

For post-October 9, 1969 transfer to trusts, the grantor’s spouse cannot be an adverse party.\footnote{177} The regulations provide, however, that section 677’s coverage of income to or for a spouse applies to the income solely during the period of the marriage of that person to the grantor.\footnote{178} Generally, the grantor is treated as holding any power or interest that the grantor’s spouse holds if the individual was grantor’s spouse at the time of the creation of such power or interest or the individual became the grantor’s spouse after the creation of the power or interest [but in this latter case only as to periods after such individual became the grantor’s spouse].\footnote{179}

It appears that the words “may be” have a double function in categories (2) and (4) above. They cover both discretion and contingencies. First, the words appear to cover income that is subject to distribution to the grantor (or accumulation for the grantor)\footnote{180} at the discretion of the grantor or a nonadverse party. Second, in category (2) the words also seem to encompass income that in certain contingencies would have been distributable to the grantor. Similarly, in category (4) they seem to cover income that is (or discretionarily can be) accumulated if accumulated income can in the future be distributed to the grantor either at someone’s discretion or upon the happening of a contingency.

The discretionary aspect is most clearly illustrated for category (2) above, which applies to income that is currently subject to discretion. One court stated in regard to the predecessor section: “Section 167 is not concerned with what is done under a trust agreement but with

\begin{footnotes}
\footnote{175}{1939 I.R.C. § 167(a)(2) failed even to specify that it applied to income that is distributed to the grantor. See H.R. Rep. No. 1337, supra note 3, at 4089, S. Rep. No. 1622, supra note 3, at 4719. The 1954 Code corrected this, at least apart from the adverse party consent situation. Of course, if any actual distribution to a grantor were excepted from the grantor trust rules, presumably the normal rules of taxability of a trust beneficiary would apply to the grantor.}
\footnote{176}{See Treas. Reg. § 1.677(a)-1(b)[1], [2]. However, see supra note 149 and accompanying text.}
\footnote{177}{Treas. Reg. § 1.677(a)-1(b)[2].}
\footnote{178}{Id.}
\footnote{179}{I.R.C. § 672(e) (for transfers in trust after March 1, 1986). For purposes of determining whether the individual is married to the grantor at the time of the creation of the interest or power, the individuals are not considered married if they are legally separated under a decree of divorce or of separate maintenance.}
\footnote{180}{The latter is category (4) above, and led to taxation of grantors in Humphrey v. Comm’r, 39 T.C. 199 (1962).}
\end{footnotes}
what might be done. The controlling statutory consideration is the existence of the described discretion, not the way in which that discretion is actually exercised.

Therefore, if the trustees are persons not having a substantial adverse beneficial interest in the disposition of the income and if the income may, in their discretion, be distributed to the grantor or, alternatively, accumulated for someone else, all of such income is taxable to the grantor. Trust instruments frequently provide that the trustees have power to determine which receipts are capital and which are income. However, the relevant test is whether the item is income in the income tax sense. A grantor who is entitled to the income is taxable on the capital gains of a trust if the gains could have been distributed as income, even though nonadverse trustees, in the exercise of their discretion, determine to treat the gains as an addition to corpus. Similarly, even though the trust instrument directs capital gains to be treated as corpus, the grantor is taxable on such gains if the trustees, in their discretion, can invade corpus for the grantor’s “proper education, care, comfort and support.”

The grantor is taxable even though the discretionary power cannot be exercised except in the contingent event that “accident, sickness, calamity, misfortune, adversity, bereavement or loss, financially or otherwise, shall visit” the grantor. The question of how remote the contingency must be before the grantor can escape tax on income that “may be” distributed to the grantor arises also for income that “may be” accumulated for the grantor. The question is discussed below. As to this income that can be distributed to the grantor upon a nonremote contingency, apparently the fact that the contingency has not occurred will not prevent the grantor from being taxed.

181. Rollins v. Helvering, 92 F.2d 390, 395 (8th Cir.), cert. denied, 302 U.S. 763 (1937); see also Greenough v. Comm’t, 74 F.2d 25 (1st Cir. 1934).


183. Greenough v. Comm’t, 74 F.2d 25 (1st Cir. 1934); Sharp v. Comm’t, 42 B.T.A. 336 (1940); cf. Comm’t v. O’Keefe, 118 F.2d 639 (1st Cir. 1941) [general power to allocate does not give trustees discretion as to ordinary dividends].


Further, similar to the case with revocable trusts, indirect devices by which income may be distributable to the grantor will not overcome the substance. The grantor will be treated as the owner.\textsuperscript{187}

Although section 677[a] provides that a grantor is treated as the owner of any portion of a trust if the income \textit{may} be paid to the grantor or the grantor’s spouse without the consent of an adverse party,\textsuperscript{188} the regulations under section 677[a] provide that such a trust is a grantor trust only as to the income portion if the interest of the grantor or the grantor’s spouse is limited to ordinary (or fiduciary accounting) income.\textsuperscript{189}

Despite the very clear example in the regulations, the Service has issued several private letter rulings holding that both the income and corpus portion of a so-called grantor-retained annuity trust, or GRAT, would be treated as owned by the grantor, that is, the trust would be a grantor trust, because the annuity amount would be payable from principal to the extent that income was insufficient.\textsuperscript{190} However, the Service has taken the position in other private rulings that a retained annuity alone does not confer grantor trust status as to both the income and corpus portion of a GRAT.\textsuperscript{191}

Various rulings indicate that a combination of sections 677 and 674[b][3] can be used to confer grantor trust status as to income and corpus for a GRAT. The authority to make distributions of the annuity payments would result in grantor trust treatment as to the ordinary income under section 677. If the grantor retains a testamentary power of appointment to appoint the trust assets (in the event the grantor dies before the stated termination of the GRAT), this power will result in grantor trust treatment as to the corpus under sections 674[a] and

\begin{itemize}
\item \textsuperscript{187} Rev. Rul. 68-183, 1968-1 C.B. 308 [sale of stock for lifetime private annuity in amount equal to projected income yield]. \textit{See supra} note 174.
\item \textsuperscript{188} \textit{See} I.R.C. § 677[a] (“grantor shall be treated as the owner of any portion of a trust . . . whose income . . . is, or . . . may be” distributed or accumulated for future distribution to the grantor or the grantor’s spouse).
\item \textsuperscript{189} \textit{See} Treas. Reg. § 1.677[a]-1[g], Example 1.
\item \textsuperscript{190} \textit{See} Priv. Ltr. Ruls. 95-04-021 [Jan. 27, 1995]; 94-51-056 [Dec. 23, 1994]; 94-49-012 [Dec. 9, 1994], \textit{modified} by 1999-51-031 [Dec. 24, 1999]; 94-44-033 [Nov. 4, 1994], \textit{modified} by 95-43-049 [Oct. 27, 1995]; 94-15-012 [Apr. 15, 1994]. \textit{See also} Priv. Ltr. Rul. 95-01-004 [Jan. 6, 1995] [CRUT treated as grantor trust as to income and corpus under section 677[a] because of the possibility that income allocable to principal could be used to satisfy the unitrust payment]. Under I.R.C. § 6110[k][3], neither a National Office Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.
\item \textsuperscript{191} \textit{See} Priv. Ltr. Rul. 96-25-021 [June 21, 1996]. For a description of a GRAT, see Treasury Regulation section 25.2502-3. Under I.R.C. § 6110[k][3], neither a National Office Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.
\end{itemize}
674(b)(3). This result is acceptable for a GRAT, assuming the power of appointment ends when the grantor’s retained annuity interest terminates but likely is not acceptable for other grantor trusts where the purpose is to exclude the trust assets from a grantor’s estate, unless some other trust provision causes grantor trust status after the power expires.

In Private Letter Ruling 200842007, the Service ruled that a trust was a grantor trust because the trustees, who were not adverse parties, could distribute income or principal of the trust to the grantor’s spouse. In the ruling, the grantor proposed to use a power to substitute the assets of the trust for other assets of equivalent value. Because the trust was a grantor trust, the exchange of assets was not a taxable exchange to either the grantor or the trust because of the application of Revenue Ruling 85-13.

[A] Grantor Trust Status

A grantor trust may be created under section 677 without significant concerns about the trust being included in the grantor’s gross estate with a trust that includes the grantor’s spouse (but not the grantor) as a discretionary beneficiary of income and principal. The trustee should not be the grantor, the grantor’s spouse, or any adverse party. Possible concerns with this approach are that keeping flexibility to end grantor trust status is difficult and that grantor trust status would end at the spouse’s death, unless some other interest or power results in continuing grantor trust status.

192. See Treas. Reg. §1.674(b)-1(b)(3) (“[I]f a trust instrument provides that the income is payable to another person for his life, but the grantor has a testamentary power of appointment over the remainder, and under the trust instrument and local law capital gains are added to corpus, the grantor is treated as the owner of a portion of the trust and capital gains and losses are included in that portion.”); see also Priv. Ltr. Ruls. 2000-01-013 (Jan. 7, 2000); 2000-01-015 (Jan. 7, 2000) (grantor trust treatment as to income because trustee had discretion to pay all of GRAT’s income—if any is remaining after payment of the annuity payments—to the grantor; grantor trust treatment as to corpus under section 674(a) because capital gains are accumulated and added to corpus and grantor held general testamentary power of appointment over the accumulated amounts); 97-07-005 (Feb. 14, 1997) (GRAT is a grantor trust as to income and corpus under sections 674(a) and 677(a) because grantor will either receive all the trust income or be able to appoint it by will, and qualifies as an S corporation shareholder); 96-25-021 (June 21, 1996). Under I.R.C. § 6110(k)(3), neither a National Office Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

193. If grantor trust status is desirable after the retained interest terminates, the continuing trust will need alternative provisions to make the trust a grantor trust. A continuing power of appointment held by the grantor would cause estate tax problems under Code sections 2036 and 2038.

A section 677 grantor trust might be created by parents engaged in asset transfer planning if one of the parents transfers his or her separate property into a trust that would include the spouse as a discretionary beneficiary. Each spouse should not name the other as beneficiary of trusts each creates for the other, as the reciprocal trust doctrine may apply. By including the spouse as a discretionary beneficiary, the trustee would be able to access the trust for the benefit of the spouse in the event the spouse ever needed distributions from the trust.

If the spouse is included as a beneficiary, shedding grantor trust status may be difficult. If the spouse relinquishes his or her rights as a discretionary beneficiary, a taxable gift by the spouse may result, unless the relinquishment is a qualified disclaimer—one made within nine months of the creation of the interest. Alternately, someone other than the grantor could be given the power to eliminate the spouse as a beneficiary.

As long as the spouse does not make any contribution to the trust, including the spouse as a beneficiary will not cause the trust to be included in the spouse’s gross estate for estate tax purposes, as long as the spouse does not have a general power of appointment under section 2041. Neither section 2036 nor 2038 should apply because the spouse is not a grantor of the trust. This tax result is true even if the split gift election is made because the split gift election under section 2513 applies only for gift tax and generation-skipping transfers (GST) exemption allocation purposes and not for estate tax purposes. Note, however, that the split gift election is not available if the spouse’s interest in the trust cannot be quantified. Even in such a “self-settled trust” state, however, if the trustee actually

196. See Treas. Reg. § 25.2518-2 [requirements for a qualified disclaimer].
199. Compare Outwin v. Comm’r, 76 T.C. 153 [1981] [applying Massachusetts law], with Estate of German v. United States, 7 Cl. Ct. 641 [1985] [applying Maryland law].
makes distributions to the grantor, a concern may arise under section 2036 as to whether there was an implied agreement about distributions to the grantor, which could trigger section 2036 inclusion even apart from creditors’ rights.\(^\text{200}\)

If section 677 is being used to confer grantor trust status by including the grantor’s spouse as a potential beneficiary, the death of the spouse would result in the trust no longer being a grantor trust unless one of the other grantor trust provisions applies.

\section*{§ 4:4.2 Accumulation of Income for Future Distribution to Grantor or Spouse}

Under section 677, the income of a trust is taxable to the grantor if, without the approval or consent of an adverse party, it “is” or, in the discretion of the grantor or of a nonadverse party, “may be” held or accumulated for future distribution to the grantor or his spouse in the case of a post-October 9, 1969, transfer in trust. Thus, if the trust instrument provides for the distribution of accumulated income to the grantor upon the happening of some event in the future, the statute presents the problem of whether the nature or the remoteness of the contingency is to be taken into account, or whether the statutory language referring to income that “is” or “may be . . . held or accumulated for future distribution to the grantor” covers every contingent accumulation, regardless of its nature or however remote.

The regulations take the broad position that the grantor is treated as the owner if “he has retained any interest which might, without the approval or consent of an adverse party, enable the grantor to have the income from that portion distributed to the grantor at some time either actually or constructively.”\(^\text{201}\) The First Circuit has said: “the statute means that if under any circumstances or contingencies any part of the accumulated income might inure to the benefit of the

\footnotesize{\begin{enumerate}
\item \textit{Cf.} Rev. Rul. 2004-64, supra note 35 [estate tax inclusion if the trust may reimburse the grantor for income taxes on trust income imputed to the grantor under the grantor trust rules if there is an understanding that the trustee will reimburse the grantor]. \textit{Cf.} Priv. Ltr. Rul. 2009-44-002 [no estate tax inclusion in gross estate of grantor who is a discretionary beneficiary under “self-settled” Alaska trust because, under Alaska law, creditors of the grantor cannot attach the trust assets and grantor had no other interest or power that would cause estate tax inclusion]. Under I.R.C. § 6110(k)(3), neither a National Office Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.
\item Treas. Reg. § 1.677(a)-1(c). This language is buttressed by I.R.C. § 672(d). The regulation makes exception for little more than the possibility of voluntary return by inheritance; \textit{cf.} Rosenblatt v. Comm’r, 8 T.C. 1245 (1947), \textit{acq.} 1947-2 C.B. 4.
\end{enumerate}}
grantor such portion of the income is taxable to the grantor.”202 The instrument in that case provided that the corpus and any accumulated income was to revert to the grantor if he survived his wife, who was named life beneficiary.

But the Board of Tax Appeals declared that it did not think

that the language of this section covers or was intended to cover the situation where there is no definite provision for such future distribution to the grantor, but only the bare possibility that upon certain contingencies over which the grantor has no control the corpus and accumulations may revert to him.203

In that case the corpus and any accumulated income was to revert to the grantor if the grantor’s son died before the age of thirty and the grantor survived him. Apparently, the rule is that the grantor will be taxable if an eventual distribution to the grantor (personally, during the grantor lifetime) depends upon a contingency but not if the occurrence of the contingency is highly unlikely.204

The regulations imply that an accumulation solely for the grantor’s estate is permissible: a sentence specifies that the grantor may be deemed the owner, in the case of a post-October 9, 1969, trust, on an accumulation for the spouse during grantor’s lifetime, even where the spouse cannot receive it before the grantor’s death.205 No such statement is extended to possible receipt by grantor’s estate. Contrast this with the taxability of a grantor whose estate may enjoy a reversionary interest.206

204. Kent v. Rothensies, 120 F.2d 476 [3d Cir.], cert. denied, 314 U.S. 659 (1941); Moore v. Comm’r, 39 B.T.A. 808 (1939), acq. 1939-2 C.B. 25; May v. Comm’r, 3 T.C.M. (CCH) 733 (1944); Downie v. Comm’r, 46 B.T.A. 937 (1942), aff’d, 133 F.2d 899 [6th Cir. 1943]; Ayer v. Comm’r, 45 B.T.A. 146 (1941); Baker v. Comm’r, 43 B.T.A. 1029, 1035 (1941) [and cases cited]; Ward v. Comm’r, 40 B.T.A. 225 [1939], rev’d on other grounds, 119 F.2d 207 [3d Cir. 1941]; Rev. Rul. 54-306, 1954-2 C.B. 240; Rev. Rul. 77-230, 1977-2 C.B. 214 [United States held owner of trust it created and over which it had possibility of reverter on accumulated income without discussing probabilities of accumulation or reverter]. If eventual distribution will be to the grantor’s appointees or heirs, apparently the grantor is not taxable. Comm’r v. Bateman, 127 F.2d 266 [1st Cir. 1942]; Goodan v. Comm’r, 12 T.C. 817 (1949), aff’d, 195 F.2d 498 [9th Cir. 1952]; cf. I.R.C. § 674(b)[3].
205. Treas. Reg. § 1.677(a)-1(f) [last sentence].
206. See Priv. Ltr. Rul. 2002-34-054 [trust formed by REIT’s limited partnership and partnership’s wholly owned management corporation to avoid value of securities rule for REITs under I.R.C. § 856(c)[4][B][iii][III], where partnership is trustee and corporation is sole beneficiary apparently not a grantor.
The “income” referred to by section 677 is taxable income. Thus, if capital gains are treated as corpus in a particular trust, and if corpus may eventually be distributed to the grantor, the grantor is taxable on the capital gain.\textsuperscript{207}

The regulations indicate that it does not matter when presently accumulated income will be distributed to the grantor or his spouse.\textsuperscript{208} However, it does acknowledge one exception: the Code makes section 677 inapplicable “to a power the exercise of which can only affect the beneficial enjoyment of the income for a period commencing after a period such that” a reversionary interest would be permissible under section 673 (in general, where, as of the inception of the trust, the value of the reversionary interest is not greater than 5% for transfers in trust after March 1, 1986, as discussed below and after ten years, for transfers in trust before March 2, 1986).\textsuperscript{209} Thereafter, the grantor may be taxable unless the power is relinquished. This exception from section 677 means that for transfers in trust after March 1, 1986, if the power cannot be exercised before the initial time period that satisfied the 5% rule to cause the income to be distributed to the grantor or his spouse, or to be accumulated for distribution to the grantor or his spouse, the grantor is not taxable on the income for the time period.\textsuperscript{210} Note that the exception is phrased only as to a power, and not as to a requirement of distribution to or accumulation for a grantor or his spouse after the period.\textsuperscript{211} The exception does not apply where income of the actual year is accumulated and will be distributed to the grantor or his spouse even only after the qualifying term expires.\textsuperscript{212}

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\textsuperscript{208} Treas. Reg. § 1.677[a]-1[c].

\textsuperscript{209} See section 4:6.1.

\textsuperscript{210} Treas. Reg. § 1.677[a]-1[e]; S. REP. NO. 1622, supra note 3, at 4719.

\textsuperscript{211} See Treas. Reg. § 1.677[a]-1[e], Example.

It is questionable whether section 677 should be construed to tax the grantor on current income for transfers in trust that cannot be distributed to or accumulated for the grantor or the grantor’s spouse even though income of some later year may be so distributed or accumulated (for example, when, upon the grantor’s death, after a short life expectancy, income becomes currently distributable to the grantor’s widow). Taxing the grantor may in fact be the regulatory intention of the phrase treating the grantor as owner if the grantor or the grantor’s spouse may get income “for the taxable year or for a period not within the exception” in the regulations. 213 An implication to the same effect may exist in the last sentence of Treasury Regulations section 1.677(a)-1(e). 214

§ 4:4.3 Satisfaction of Legal Obligations of Grantor or Spouse

The income of a trust may be considered distributable to the grantor and may be taxed to the grantor under section 677 if that income is or may be devoted by the grantor or by nonadverse parties to the discharge of an obligation of the grantor or the grantor’s spouse. The Supreme Court applied this rule to income that could be used for the support, education, and maintenance of the grantor’s minor children. 215 To reverse this decision, Congress added a provision that trust income is not taxable to the grantor merely because, in the discretion of another person, the trustee or the grantor acting as trustee or cotrustee, it may be applied or distributed for the support or maintenance of a beneficiary (other than the grantor’s spouse) whom the grantor or the grantor’s spouse is legally obligated to support, except to the extent that such income is actually so applied or distributed. 216 In other words, such undistributed income is not treated as income when it may be indirectly distributed to the grantor.


214. As to the particular textual example of a change becoming effective upon the grantor’s death, compare I.R.C. § 673[e], which excepts short-term reversionary interests taking effect at the death of an income beneficiary.

215. Helvering v. Stuart, 317 U.S. 154, 169–71 (1942). Taxation to the grantor of income that could be used to discharge his obligations also was sustained under 1939 I.R.C. § 22(a), which defined gross income. See Douglas v. Willcuts, 296 U.S. 1 (1935); Helvering v. Schweitzer, 296 U.S. 551 (1935); Helvering v. Blumenthal, 296 U.S. 552 (1935); Anesthesia Serv. Med. Group v. Comm’r, 825 F.2d 241 (9th Cir. 1987) (trust established by corporation to obtain malpractice insurance to pay claims against grantor’s employees is grantor trust and no current deduction for contributions to it).

216. I.R.C. § 677[b]. Or required to be distributed. Treas. Reg. § 1.677[b]-1[f].
It should be noted that this provision applies only if the income, “in the discretion of another person, the trustee, or the grantor acting as trustee or co-trustee, may be applied or distributed for the support or maintenance of a beneficiary (other than grantor’s spouse) whom the grantor is legally obligated to support or maintain.” If the grantor, individually and not as trustee, retains the right to require that income be expended for the interests of his children, he may be taxed upon the entire trust income.\(^{217}\) The exception for support obligations of the spouse is covered in the regulations, perhaps emphasizing that grantor is taxable as to other possible obligations of the spouse.\(^{218}\) If a distribution is made out of

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In considering the effect of “shifting” tax income to a child, it is important to note that under I.R.C. § 1(g), generally, unearned income of a child under age eighteen (and sometimes age twenty-one) is taxed at the higher of the marginal rate of the child or of the child’s parents. Note that gain taxed to a trust, of which a parent is the transferor, under I.R.C. § 644 is added to the parent’s income for this purpose. I.R.C. § 1(g)(3)(c).

\(^{218}\) Treas. Reg. § 1.677(b)-1[a], [d].
other than current income, it may be taxed to the grantor under the rules as to distributions out of other than income by ordinary trusts. The extent of the legal obligations of a grantor is generally determined by local law. The obligation that may be discharged need not be an obligation of support. The income of a trust may be taxable to the grantor if, pursuant to a contract or otherwise, the income may be used, for example, to discharge encumbrances on real estate by paying creditors’ claims, to discharge a debt of the grantor, or to pay gift or estate taxes on the grantor’s estate.

219. Treas. Reg. § 1.677(b)-1[b], [c]; Rev. Rul. 74-94, 1974-1 C.B. 26. Rev. Rul. 61-223, 1961-2 C.B. 125, distinguishes this rule requiring actual distributions for taxability from the rule of I.R.C. § 170(b)(1)(D) [before the 1969 amendments], under which a probability or possibility of such a distribution could be deemed a reversionary interest sufficient to prevent a charitable deduction.


222. Sheaffer v. Comm’r, 313 F.2d 738 (8th Cir.), cert. denied, 375 U.S. 818 (1963); Estate of Sheaffer v. Comm’r, 25 T.C. Memo 1966-126 [related case]; Krause v. Comm’r, 56 T.C. 1242 (1971); Hirst v. Comm’r, 63 T.C. 307 (1974); Downie v. Comm’r, 46 B.T.A. 937, 942–43 (1942), aff’d, 133 F.2d 899 (6th Cir. 1943); Rev. Rul. 57-564, 1957-2 C.B. 328 [gift taxes of grantor on creation of trust itself]. But cf. Comm’r v. Goodan, 195 F.2d 498 (9th Cir. 1952); Estate of Morgan v. Comm’r, 37 T.C. 981, aff’d, 316 F.2d 238 (6th Cir. 1962), cert. denied, 375 U.S. 825 (1963) [trust agreement required trustees to pay gift tax, which is usually donor’s obligation and they had done so by borrowing from a bank; repayment to bank out of income held, with three dissents, not to be payment of grantor’s obligation]; Estate of Davis v. Comm’r, 30 T.C. Memo 1971-318, aff’d per curiam, 469 F.2d 694 (5th Cir. 1973) [not taxable]; Priv. Ltr. Rul. 97-13-011 [neither the Alaskan Native Corporation nor its shareholders treated as owners of a state-chartered settlement trust by the corporation, pursuant to federal law, with the consent of its shareholders, where the assets of the trust are not available to the creditors or to the corporation’s creditors other than those creditors of the corporation before the transfer to the trust where corporation expected that its retained assets would be sufficient to discharge existing liabilities and under federal law trust assets are liable to existing creditors only if the corporation’s other assets are inadequate]. Michael M. Sachs, Assumption of Indebtedness by a Donee: Income Tax Consequences, 17 STAN. L. REV. 98 (1964); Peter Somers,
[A] Grantor Trust Status

Section 677(b) limits the application of section 677(a) in situations in which payment of income or principal are made for support or maintenance obligations of the grantor. This section 677(b) exception does not apply to payments that may be made to support or maintain the grantor’s spouse; thus grantor trust status is possible until the spouse dies. However, for estate tax purposes, any payments for the support of a beneficiary whom the grantor has a legal obligation to support should be prohibited to avoid section 2036.

§ 4:4.4 Insurance Trusts

Section 677(a)(3) specifically provides that the grantor is treated as the owner of any portion of a trust from which 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 upon policies of insurance on the life of the grantor or, in the post-1969 case, his spouse (except policies of insurance irrevocably payable for a purpose specified in section 170(c), defining charitable contributions). The constitutionality of the predecessor provision to section 677(a)(3) was established in Burnet v. Wells. Currently, the Service will not issue rulings or determination letters as to whether the grantor will be considered the owner of any portion of a trust where, among other cases, the trust corpus consists or will consist substantially of insurance policies on the life of the grantor or the grantor’s spouse.

The purpose of section 677 is to prevent the avoidance of income tax by the use of trusts created with income-producing properties to pay the premiums necessary to keep in force insurance policies owned by the same trust. The section makes no distinction between

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223. When such amounts are actually paid, the grantor is taxed on the income under section 662 rather than under the grantor trust rules. See I.R.C. § 677(b) [last sentence].


226. Rev. Proc. 2009-3, 2009-1 I.R.B. 107, § 3.01 (53); see Priv. Ltr. Rul. 90-09-047 [income-only charitable remainder trust described in I.R.C. § 664(d)[3] is not grantor trust where proceeds of insurance on life of first of two life recipients, who is the grantor, will be allocable to corpus]. Under I.R.C. § 6110[k][3], neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

endowment policies and other kinds of policies, such as ordinary life insurance policies, but is equally applicable to all.\textsuperscript{228}

The section refers to any portion of a trust from which income is or may be applied to the payment of premiums for policies of insurance “on the life of the grantor.” Thus, the section has been inapplicable unless the insurance policies in the trust cover the grantor’s life. Because the 1969 amendments to section 677 apply only in respect of property transferred in trust after October 9, 1969, policies on the grantor’s spouse can remain significant in old trusts. The effect of the section has been avoided by arrangements under which the grantor of the trust was not the insured under the policies placed in the trust. For example, the Board of Tax Appeals held that a grantor-wife was not taxable where the trust was set up by her under an agreement that provided that current dividends should be used to pay the premiums on life insurance policies on the life of her husband, when the husband had the policies placed in a separate trust.\textsuperscript{229}

Notwithstanding the technical creation of a pre-1969 trust by the wife, a husband may be taxable on the income if he is found to be the real grantor. Thus, a husband was held taxable on the income of a funded insurance trust holding policies on his life where shortly before the trust was created he transferred to his wife the property used by her in creating the trust.\textsuperscript{230}

Although under section 677(a)(3) the grantor could not be taxed upon trust income used or available for the payment of premiums on policies that did not cover the grantor’s life, the grantor may nevertheless be taxed on such income under other provisions of the Code.

In one case,\textsuperscript{231} a wife created two trusts from which income was to be used by the trustee to pay premiums on life insurance policies on the

\begin{itemize}
\item 228. Heffelfinger v. Comm’r, 32 B.T.A. 1232, aff’d, 87 F.2d 991 (8th Cir. 1935), cert. denied, 302 U.S. 690 (1937).
\item 229. Blumenthal v. Comm’r, 30 B.T.A. 591, rev’d on other grounds, 76 F.2d 507 (2d Cir. 1934), rev’d, 296 U.S. 552 (1935); see also Barbour v. Comm’r, 39 B.T.A. 910 (beneficiary may use income by premiums), rev’d on other grounds, 122 F.2d 165 (2d Cir. 1939), cert. denied, 314 U.S. 691 (1941); Baldwin v. Comm’r, 36 B.T.A. 364 (1937).
\end{itemize}
life of her husband. She was sole beneficiary of eight policies involved in one of the trusts, and she also had the right to change the beneficiary and could exercise for her own benefit the right to their cash surrender or loan value. The proceeds of the policies in the second trust were payable, via the trustee, to the grantor if she survived her husband. Power to terminate the trusts was vested in the husband. Upon termination of the trusts during the grantor’s life, the corpus was to revert to the grantor, and any accumulated income was to go to the husband. The Seventh Circuit held that because the grantor directly or indirectly was the beneficiary under the insurance policies on the life of her husband and was entitled to the cash surrender and loan value of the policies, the income remained, in substance, that of the grantor, being used to purchase property for her, and consequently was taxable to her under section 167(a)(1) and (2) of the 1939 Code, relating generally to income distributed to or accumulated for the grantor.

Somewhat similarly, it has been held that the grantor-wife is taxable upon the income of a funded insurance trust if the insurance policies on her husband’s life are to be used to pay inheritance taxes on her share of her husband’s estate with any balance to be paid to her after her husband’s death.232

Because of the 1969 change in section 677(a)(3) to include the grantor’s spouse in the scope of the section, the cases acknowledging the distinctions discussed above will still be potentially applicable when the grantor of the trust is the insured and not husband and wife. For example, similar situations could arise in parent-child arrangements or with domestic partners who are not married but that have significant personal relationships.

It should also be noted that under section 677(a)(3) the grantor is to be taxed not only if the income “is” but also if it “may be” applied to the payment of premiums on policies of insurance on the life of the grantor. Thus, the trust income need not actually be applied to the payment of premiums. It is sufficient if, in the discretion of the grantor or some person without an adverse interest,233 the income may be applied to the payment of the premiums upon existing policies. However, the policies probably must be in existence during the year.234 And it seems likely that there must be some positive suggestion by the grantor that


233. Rieck v. Comm’r, 41 B.T.A. 457 (1940) (indirectly paid via beneficiaries), aff’d, 118 F.2d 110 (3d Cir. 1941); cf. Todd v. Comm’r, 32 B.T.A. 1067, 1070 (1935), aff’d, 82 F.2d 1020 (2d Cir. 1936).


(Blattmachr, Rel. #3, 10/10) 4-47
income be so used.\textsuperscript{235} However, this is not necessary if income is actually so used.\textsuperscript{236}

However, the Service has not always agreed with the courts. In a ruling involving a foreign trust where it was in the Service’s interest for the trust to be a grantor trust, a Field Attorney Advice Memorandum\textsuperscript{237} took the position that the power to purchase life insurance on a grantor causes grantor trust treatment. It provides: “Article II of B Trust Agreement authorizes the trustee to purchase life insurance on taxpayer. There does not appear to be any limit on the amount the trustee may apply to the payment of premiums. Therefore, pursuant to section 677(a)(3), taxpayer is treated as the owner of B.”\textsuperscript{238}

One private letter ruling held that grantor trust status arises only to the extent of premiums payable by the trust for the current year.\textsuperscript{239} Another private letter ruling provides that a power to pay premiums alone causes the entire trust to be a grantor trust.\textsuperscript{240}

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\item instrument to purchase policies on the life of the grantor and pay premiums from income or corpus, or both, causes I.R.C. § 677(a)(3) to apply. Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.
\item See Corning v. Comm’r, 104 F.2d 329, 333 [6th Cir. 1939]; Foster v. Comm’r, 8 T.C. 197, 205 [1947]; cf. Dunning v. Comm’r, 36 B.T.A. 1222 [1932] (taxable where grantor’s suggestion to beneficiary was not in trust instrument), appeal dismissed, 97 F.2d 999 [4th Cir. 1938]. But cf. Cent. Hanover Bank & Trust Co. v. Hoey, 74 F. Supp. 770 (S.D.N.Y. 1947); Booth v. Comm’r, 3 T.C. 605 [1944] (not taxable where independent act of beneficiary); Rev. Rul. 66-313, 1966-2 C.B. 245 (second trust, whose beneficiaries were the grantor’s children and who agreed to have that trust pay life insurance premiums on policy owned by first trust created by same grantor, was grantor trust under I.R.C. § 677(a)(3) to the extent so paid despite no provision in second trust to so pay); see also Priv. Ltr. Rul. 88-39-008 [taxable “because the insurance premiums paid by . . . Trust . . . exceeds . . . the taxable income of . . . Trust,” despite prohibition that trust accounting income could not be used to pay premiums and corpus did not consist of policies], But cf. Priv. Ltr. Rul. 87-01-007 [not a grantor trust under I.R.C. § 677(a)(3) where trust includes policy on grantor’s life but trust agreement prohibits use of ordinary income or gain for payment of premiums]. Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.
\item Foster v. Comm’r, 8 T.C. 197, 205 [1947]; Rand v. Comm’r, 40 B.T.A. 233 [grantor was trustee], aff’d, 116 F.2d 929 [8th Cir. 1939], cert. denied, 313 U.S. 594 [1941].
\item I.R.S. Field Att’y Advice Mem. 20062701F [July 7, 2006].
\item Id. at 10.
\item See Priv. Ltr. Rul. 88-52-003 [Dec. 30, 1988]; see also Priv. Ltr. Rul. 88-39-008 [Sept. 30, 1988] [actual payment of premium from income causes grantor trust treatment as to income so paid, even though trust instrument
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\end{flushleft}
[A] Grantor Trust Status

The net effect of the cases and letter rulings leaves the power to pay life insurance premiums a not-so-useful tool to assure that a trust will be treated as a grantor trust. However, a drafter may wish to use this power as one of multiple grantor trust triggers by providing in the trust agreement that the trustee may pay insurance premiums from income or principal, so as to build the best possible argument that the trust is a grantor trust as to both income and principal.

§ 4:5 Other Grantor Trusts

Before the enactment of the 1954 Code, the grantor trust statute only contained specific provisions for revocable trusts and retained-income trusts. The 1954 Code added provisions for the taxability of grantors of certain other types of trusts.241

The 1954 Code provisions were taken with relatively little change from the detailed *Clifford* regulations242 under the 1939 Code. The regulations resulted from *Helvering v. Clifford*,243 in which the Supreme Court applied the broad definition of taxable income then contained in section 22(a) of the 1939 Code and taxed to the grantor the income of a five-year trust created for the benefit of his wife, for which he retained broad powers of management and control. On the basis of the grantor’s retained “bundle of rights” and “in the absence of . . . appropriate regulations,” the Court declared that the grantor “retained the substance of full enjoyment of all the rights which previously he had in the property.”244

In *Helvering v. Stuart*,245 the Supreme Court remanded to the Tax Court for a determination, on the facts, whether the grantor was similarly taxable, although it recognized “the impossibility of reversion to the grantors.” Thus, a reversion to the grantor after a short term seemed unessential as a reason to tax the grantor.

Both *Clifford* and *Stuart* indicated that no single factor was to be considered controlling, and the two cases did not set up precise standards. A great number of cases were decided by the lower federal

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241. See section 4:1.2.
244. *Id.* at 335–36.
courts, variously applying the doctrine of the *Clifford* case. The result was confusion and uncertainty.

This uncertainty was considerably reduced by the Treasury’s so-called *Clifford* regulations, which have now largely been incorporated into the Code. There was not much litigation under the *Clifford* regulations, although the U.S. Court of Appeals for the Seventh Circuit in *Commissioner v. Clark* rejected them partly on constitutional grounds, stating that even Congress would be without power to create a conclusive presumption that the short-term trust there involved


247. T.D. 5488, 1946-1 C.B. 19; T.D. 5567, 1947-2 C.B. 9, amending Treas. Reg. 111, §§ 29.22(a)-21, 29.161-1, 29.162-1, 29.166-1, 29.166-2 [1939]; see also Lazarus v. Comm’r, 513 F.2d 824 (9th Cir. 1975) (“sale” for private annuity deemed creation of trust with reserved life interest); Krause v. Comm’r, 497 F.2d 1109 (6th Cir. 1974) [trusts not bona fide family partners], cert. denied, 419 U.S. 1108 (1975); Van Zandt v. Comm’r, 341 F.2d 440, 444 [5th Cir.], cert. denied, 382 U.S. 814 (1965) [trust factors, while permissible, can bear upon business purpose: taxpayer cannot deduct rent on business premises in building he gave to ten-year reversionary trust]; Brooke v. United States, 468 F.2d 1155 (9th Cir. 1972) [holding similar rent deductible]; Iber v. United States, 409 F.2d 1273 (7th Cir. 1969); Mathews v. Comm’r, 520 F.2d 323 [5th Cir. 1975]; Thomas D. Aitkin, *Coping with the Tough New Court Tests for Deductions in Leaseback Situations*, 44 J. TAX N 47 (1976); Quinlivan v. Comm’r, 599 F.2d 269 [8th Cir.], cert. denied, 444 U.S. 996 (1979); Lerner v. Comm’r, 71 T.C. 290 [1978], acq. in result 1984-1 C.B. 1; May v. Comm’r, 76 T.C. 7 [1981], aff’d, 723 F.2d 1434 [9th Cir. 1984]; Rosenfeld v. Comm’r, 43 T.C. Memo 1982-263, aff’d, 706 F.2d 1277 [2d Cir. 1983]; Evans v. United States, 572 F. Supp. 74 [C.D. Ill. 1983]; see Orbach & Reiner, *IRS Approves Third-Party Gift Leasebacks*, TAX HOTLINE, Jan. 1985, at 6 [suggesting that the “IRS has now taken the position that it will no longer litigate gift-leaseback transactions where the lessee is a third party—i.e., a corporation—unless the third party is a partnership or an S corporation,” apparently on the basis of the Service’s acquiescence in the result in *Lerner*]; cf. Gatto v. Comm’r, 1 F.3d 826 [9th Cir. 1993] [taxpayer who created reversionary trust and immediately borrowed trust fund for note could not deduct interest because debt not genuine].

was taxable. Nevertheless, it was clear that the Clifford regulations, and the Code, should be carefully followed by taxpayers’ attorneys. The 1954 Code sections made little change from the regulations, and most of the changes were liberalizations; on the other hand, it should have been noted that it is sometimes possible for the new sections to tax the grantor of a trust on income that was not taxable to the grantor under the regulations. For example, the broad powers over beneficial enjoyment permitted by section 674(c) were not available in some instances that the Clifford regulations would have permitted if the power could not affect the interests of the spouse or a child of the grantor. 249 Moreover, half of the trustees who can exercise such power must be independent, whereas under the Clifford regulations one independent trustee with veto power was apparently sufficient. 250 Under changes made by the Tax Reform Acts of 1969, 1976, and 1986, there are additional circumstances not provided for in the Clifford regulations in which the grantor may be treated as the owner of a portion of the trust.

The Clifford regulations and the 1954 and 1986 Code sections depart from the cases in that they make single factors sufficient for taxation of the grantor. The Code thus sets forth three categories in which trust income will be held taxable to the grantor even if the trust is not revocable and income cannot be distributed to or accumulated for the grantor. These three categories are discussed below.

§ 4:5.1 Reverter to Grantor

Before the enactment of the Tax Reform Act of 1986, section 673 of the Code provided that the grantor was treated as the owner of any portion of a trust, regardless of who the beneficiaries may be, if, as of the inception of that portion of the trust, the corpus or the income therefrom “will or may reasonably be expected” to revert to the grantor within ten years commencing with the date of the transfer of that portion of the trust. 251 This provision continues to apply to transfers in trust made before March 2, 1986. 252

251. See generally, and in particular with regard to a device that the 1969 amendments to section 677 will now restrict, Maurice S. Spanbock & Israel Katz, An Attractive Trust Proposal: The Short-Term Accumulation for a Spouse, 14 J. TAX’N 258 (1961); Harry Yohlin, The Short-Term Trust—A Respectable Tax-Saving Device, 14 TAX L. REV. 109 (1958).
252. Section 1402(a) of the Tax Reform Act of 1986. Apparently, it also continues to apply to any transfer in trust made after March 1, 1986, pursuant to a binding property settlement agreement entered into on or
Under section 673, for transfers in trust made after March 1, 1986, subject to one special rule, the grantor is treated as the owner of any portion of the trust in which he has a reversionary interest in either corpus or income, if, as of the inception of that portion of the trust, the value of the interest exceeds 5% of the value of that portion.\footnote{253} This means, in effect, that regardless of the length of time before property will revert to the grantor, if the value of the grantor’s interest exceeds 5% of the value of the portion, the income, deductions, and credits of the portion will be attributed to the grantor. However, under a special rule, in the case of a beneficiary who is a lineal descendant of the grantor (such as a child) who holds all the “present” interests\footnote{254} in any portion of the trust, the grantor is not treated as the owner solely by reason of a reversion to take effect upon the death of that lineal descendant before that beneficiary attains the age of twenty-one years.\footnote{255} Conforming amendments were made by the 1986 Act to other grantor trust provisions that substitute the 5% valuation and lineal descendant beneficiary rules for the ten-year rule used previously under the grantor trust provision.\footnote{256}

When interest rates are low, section 673 is avoided only if the term of a trust is quite long. For example, if the applicable rate under section 7520\footnote{257} is 4%, the trust must last more than seventy-six years before the reversion may take effect to avoid section 673.\footnote{258} This rule means a trust of a slightly shorter duration will invoke grantor trust status. The 5% rule is based on the value determined at the time the trust is created, and a subsequent decline in value of the reversionary interest as a result of increasing interest rates or an extension of the term does not appear to alter the grantor trust status.\footnote{259}

before March 1, 1986, to the extent it required the taxpayer to establish a grantor trust and for the transfer of a specified sum of money or property to the trust by the taxpayer. Tax Reform Act of 1986 § 1402(c)(2), 100 Stat. 2085 (1986).

\footnote{253}{As a result of changes, discussed above, to I.R.C. § 672 made by the Tax Reform Act of 1986, the grantor generally is treated as the owner of any portion of the trust (contributed after March 1, 1986) in which the value of the grantor’s spouse’s interest in corpus or income exceeds 5% of the value of such portion.}

\footnote{254}{No definition of “present interests” is provided under I.R.C. § 673. It may or may not have the same meaning as for gift tax purposes. See I.R.C. § 2503(b).}

\footnote{255}{I.R.C. § 673(b).}

\footnote{256}{See I.R.C. §§ 674(b)(2), 676(b), 677(a).}

\footnote{257}{See I.R.C. § 7520 (providing the methodology to value term, life, and remainder interests).}

\footnote{258}{Using a 4% interest rate, the actuarial value of a remainder interest is 5.0754% following a term certain of seventy-six years, the actuarial value of a remainder interest is 4.8801% following a term certain of seventy-seven years.}

\footnote{259}{This interpretation is based on a literal reading of the statute. No authority exists to suggest otherwise. See I.R.C. § 673.}
The portion rule when applied to section 673 will make a trust a grantor trust as to income if the grantor retains a reversionary interest after the term interest expires and the value exceeds 5%. Whether section 673 is applicable or not, if a reversionary interest is retained, section 677(a)(2) will invoke grantor trust status as to income allocable to principal because of the reversionary interest.

As to the duration question, the test is: What is the expectation as of the time of transfer of each particular portion of or addition to the trust? In determining if the value of the grantor’s reversionary interest exceeds 5%, it is assumed that any discretionary powers are exercised in such a way as to maximize the value of the reversionary interest. Also, any postponement of the date specified for the reacquisition of possession or enjoyment of the reversionary interest is treated as a new transfer in trust commencing on the date the postponement is effective and ending on the date prescribed by the postponement. However, income for any such period is not to be attributed to the grantor under this postponement-of-date rule if the income would not be attributed to the grantor in the absence of the postponement.

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261. Rev. Rul. 56-601, 1956-2 C.B. 458; see also Bibby v. Comm’r, 44 T.C. 638 (1965) [period does not commence until valid conveyance of the property]. But see Priv. Ltr. Rul. 99-06-015 (minor member of Indian tribe is owner of trust to receive, hold and invest payments for tribal members for gaming proceeds and the tribe is not the owner pursuant to I.R.C. § 673, because, despite the possibility of reverter to the tribe, no reasonable assumption exists that the possibility that the minor having issue who would succeed to interest upon minor’s death may be ignored or discounted]. Under I.R.C. § 6110(k)(3), neither a Private Letter Ruling nor a National Office Technical Advice Memorandum may be cited or used as precedent.
262. I.R.C. § 673(c).
263. I.R.C. § 673(d).
264. Id. See Priv. Ltr. Rul. 91-52-034 [indicating that if total actuarial interests of grantor in trust of which grantor retained right to annuity payments for a term and contingent reversion to take effect only if grantor died during annuity term exceeds 5%, the grantor is the owner of the entire trust]; see also Priv. Ltr. Rul. 89-23-017 (grantor taxed on trust income where payment (1) to trust to prepay cost of funeral would revert if funeral business company ends or (2) is used to pay grantor’s funeral expenses]; cf. Priv. Ltr. Rul. 99-06-015 [minor beneficiary, who is a member of Indian tribe that creates trust, is treated as trust owner under I.R.C. § 677, and not tribe under I.R.C. § 673, because, despite reversionary interest to tribe, no reasonable assumption exists that would permit possibility of minor dying without issue who could take remainder]. Under I.R.C. § 6110(k)(3), neither a Private Letter Ruling nor a National Office Technical Advice Memorandum may be cited or used as precedent.
For transfers in trust before March 2, 1986,\textsuperscript{265} it should be noted that the expiration of a specific term of years is not considered necessary to measure the reverter. Section 673, in effect as to transfers in trust before March 2, 1986, is applicable if the reversion of the trust depends upon contingencies that may reasonably be expected to occur in less than ten years.\textsuperscript{266} But by specific provision a grantor is not taxable on trust income merely because he has a reversionary interest in the corpus which “is not to take effect in possession or enjoyment until the death of the person or persons to whom the income therefrom is payable,” whatever the life expectancy of such person or persons at the time of the creation of the trust.\textsuperscript{267} The rule concerning reversion at the death of the grantor illustrates that the grantor may be taxable even if only the grantor’s estate, and not the grantor, can receive the reversion. The test in such a case is the time at which the estate may reasonably be expected to enjoy the reversion.\textsuperscript{268}

It should be noted that section 673 refers to a reversionary interest in the income itself as well as to a reversionary interest in the corpus. Section 677 specifically covers income that may be accumulated for the grantor, although there is some doubt as to what this means. Likely, the duplication is just a case of overlap between the sections. The term “income” as here used probably should not be taken to mean future income, but it is possible that an attempt will be made to tax the grantor on the income of the first years of the trust if the trust’s income for a later year within the current greater than 5% in value test is to be distributed to the grantor. A different possible view might be that the term “income” means past income, so that if 2009’s income is accumulated to go to the grantor in less than the period applicable to the current greater than 5% in value test, then in 2010 the income earned on the 2009 accumulated income will be taxable to the grantor,\textsuperscript{265, 266, 267, 268}

\textsuperscript{265.} Which applies after 1969 (except generally for transfers in trust after March 1, 1986), even if there is a charitable beneficiary.

\textsuperscript{266.} It seems that similar rules should apply to the not more than 5% reversionary value rule in effect for transfers in trust after March 1, 1986. Note, however, that, in determining if the value exceeds 5%, it is assumed that any discretionary powers are exercised so as to maximize the value of the reversionary interest. I.R.C. § 673(c).

\textsuperscript{267.} I.R.C. § 673(c) as in effect for transfers in trust before March 2, 1986. Where reversion will be at the death of a grantor whose own expectancy is less than ten years, the grantor is taxable. Treas. Reg. § 1.673(a)-1(c); Rev. Rul. 73-251, 1973-1 C.B. 324; Rev. Rul. 75-267, 1975-2 C.B. 255.

\textsuperscript{268.} Rev. Rul. 58-567, 1958-2 C.B. 365; Rev. Rul. 56-601, 1956-2 C.B. 458. Both revenue rulings were modified by Rev. Rul. 73-251, 1973-1 C.B. 324, solely as to the appropriate actuarial table. Cf. Thuet v. Riddell, 104 F. Supp. 521 (S.D. Cal. 1952), which held that an eighty-four-year-old grantor who was entitled to $300 annually from the corpus of a $5,000 trust was not taxable.
even if the 2010 income is not distributed to or accumulated for the grantor.²⁶⁹

[A] **Grantor Trust Status**

A grantor’s reversionary interest causes an estate inclusion for the date of death value of the grantor’s reversionary interest determined at that time under section 2033.²⁷⁰ In addition, section 2702 will treat the entire transfer to the trust for the benefit of a “member of the transferor’s family”²⁷¹ as a gift, unless structured as a Grantor-Retained Annuity Trust (GRAT) or a Grantor-Retained Unitrust (GRUT) as described under section 2702 and applicable regulations.²⁷² Thus, grantor trust status under section 673 is generally not a choice.

§ 4:5.2 **Control Over Beneficial Interests**

Section 674(a) provides broadly that the grantor is treated as the owner of any portion of a trust if the beneficial enjoyment of the corpus or the income is subject to a power of disposition exercisable by the grantor, a nonadverse party, or both, without the approval or consent of any adverse party.²⁷³ For example, if one of two co-trustees

269. *Cf.* Comm’r v. Jergens, 127 F.2d 973 (5th Cir. 1942). *See also supra* text accompanying notes 207–14 (as to the possibility of taxation of the grantor if income of a later year can go to him). *Compare* the different language of I.R.C. § 2037[b] as to reversionary interests under the estate tax.

270. *See* I.R.C. §§ 673(c), 2033.

271. *See* I.R.C. § 2702[a][1]. For the definition of *family member*, see section 2704[c][2].


273. Wysong v. Comm’r, T.C. Memo 1988-344 (grantor who borrows funds from banks, loans same to trust, is taxable on trust’s income under I.R.C. § 674[a], because loan is repayable to grantor upon demand, which court states enables “him to exercise complete control over the beneficial enjoyment of corpus at any time”); Kushner v. Comm’r, T.C. Memo 1991-26 (similar); Batson v. Comm’r, T.C. Memo 1983-545, *aff’d*, 758 F.2d 652 (6th Cir. 1985) (applying I.R.C. § 674[a] to revocable trust nominally for grantor’s daughter); Carson v. Comm’r, 92 T.C. 72 (1989) (grantor taxable where a trustee made unequal distributions to his children when the instrument was silent as to each child’s share, despite grantor’s claim that they had to be equal); *see also* Priv. Ltr. Rul. 91-26-015 (trust will be grantor trust under I.R.C. § 674[a] only after the nonadverse party becomes empowered under trust terms to affect beneficial enjoyment of trust property without consent of any adverse party, and not before); Priv. Ltr. Rul. 93-15-010 (direction that trustee, who will later have power to control beneficial enjoyment, must be subservient, related or subordinate party will make a trust a grantor trust at that time). Under I.R.C. § 6110[k][3], neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.
is a beneficiary who would be adverse to the exercise of the power and if the co-trustees must act by unanimous agreement, thus requiring the consent of both trustees, section 674(a) would not apply. Many trusts will initially fall under the general rule of section 674(a), although various exceptions in sections 674(b), 674(c), and 674(d) can negate grantor trust treatment. To rely on a trustee’s general power of disposition to trigger grantor trust status requires very careful navigation through all of the many exceptions. Application of the portion rule to section 674(a) varies depending on the nature of the power. Some powers may affect only income or only principal, but others affect both and will result in grantor trust status for the entire trust.

The broad exceptions to this sweeping provision determine its real substance. The existence of certain powers will not cause the trust income to be taxed to the grantor. These powers are divisible generally into three groups—those permitted to be held by anyone, those that may be held solely by trustees not including the grantor or the grantor’s spouse, and those broadest powers permitted to be held only by certain people.

[A] Powers Permitted to Be Held by Anyone

The powers permitted to be held by anyone, whether or not as trustee, are:

(1) a power exercisable only by will, except where the income is accumulated for the grantor to appoint or may be accumulated by nonadverse parties for the grantor to appoint; for example, where the trust provides for income to be accumulated during the life of the grantor, then to go to the grantor’s appointees by will, the grantor is taxable on the income;
(2) a power to determine the recipients of the corpus or income, if the corpus or income is irrevocably payable to charitable beneficiaries, as specified in section 170(c);\(^{276}\)

(3) a power to pay out corpus to or for any current-income beneficiary, provided the payment is chargeable against the beneficiary's share held in trust as if it constituted a separate trust or to or for any beneficiary (whether or not an income beneficiary), provided that the power is limited by "a reasonably definite standard," which must be set forth in the trust instrument;\(^{277}\)

(4) a power to distribute or apply income to or for any current income beneficiary, or alternatively, to accumulate the income for the beneficiary, provided the beneficiary (or the beneficiary's estate, or appointees) must ultimately get the income accumulated or provided that it must ultimately be payable in fixed shares to current-income beneficiaries, under rules specified in the Code and regulations;\(^{278}\)

(5) a power to distribute or apply income to or for a beneficiary, or alternatively, to accumulate and add the income to the corpus, provided the power is exercisable only during (a) the existence of a legal disability of any current-income beneficiary or (b) the period in which the beneficiary is under the age of twenty-one.\(^{279}\)

The general rule of section 674(b) provides that certain powers may be held by anyone as a trustee or not as a trustee, without creating a grantor trust.\(^{280}\) Nevertheless, the relevant Treasury regulation provides that the exception under section 674(b)(1) is available for the grantor—and the grantor’s spouse because of section 672(e)—only when the power is held as a trustee.\(^{281}\)


277. I.R.C. § 674[b][5][A]. The Code does not contain the Clifford regulations requirement that the standard "must consist of needs and circumstances of the beneficiaries." Treas. Reg. 118, § 39.22[a]-21[d][2][iv][b][1] (1939); see Treas. Reg. § 1.674[b]-1[b][5] [contains examples of what is deemed a reasonably definite standard].

278. I.R.C. § 674[b][6]. See Treas. Reg. § 1.674[b]-1[b][6].

279. I.R.C. § 674[b][7].

280. See I.R.C. § 674[b][1]–[8].

Section 677(b)(1) provides that a trust is not a grantor trust as to income merely because some other person, the trustee, or the grantor acting as a trustee or co-trustee may apply or distribute income for the support or maintenance of a beneficiary (other than the grantor’s spouse) whom the grantor is legally obligated to support or maintain, except to the extent that income is so applied or distributed. \(^{282}\) Section 674(b)(1) also provides that section 677(b) preempts the general rule of section 674(a) when a trustee has discretion to use income of a trust to support someone the grantor has an obligation to support. \(^{283}\) In other words, when section 677(b) applies, section 674 is not applicable. \(^{284}\) A section 674(b)(1) power might cause an estate tax problem for a grantor and should be avoided because of section 2036(a)(2) and section 2038 \(^{285}\) if distributions are mandatory or are subject to an ascertainable standard. \(^{286}\)

Section 674(b)(2) provides a rule similar to section 673, so that powers are not within section 674(a) if the exercise is so far in the future that the 5% rule of section 673 would not apply to a retained interest. \(^{287}\) Because this rule is a time limit on powers that otherwise must trigger the grantor trust rules, section 674(b)(2) offers no real alternative to the other grantor powers, unless avoiding grantor trust status is actually desirable. Moreover, any such power retained by the grantor likely will be a section 2036 power because of the retained interest or power, and section 2036 ignores conditions precedent. \(^{288}\) Section 674(b)(3) excepts a testamentary power of disposition over a trust from section 674(a) grantor trust status. \(^{289}\) Excepted from the section 674(b)(3) exception is a power held by the grantor to appoint the income of a trust. \(^{290}\) Thus, retention by the grantor of a testamentary power to appoint accumulated trust income would create a grantor trust (assuming the power is not just to appoint accumulated income among charitable beneficiaries, in which event, the exception in section 674(b)(4) would apply). The “exception to the exception” for

\(^{282}\) See I.R.C. § 674(b)(1).

\(^{283}\) See id.

\(^{284}\) See supra section 4:4 for a detailed discussion of Code section 677.


\(^{286}\) A mandatory requirement to pay support obligations would be a section 2036 problem; discretion to pay support obligations is less clear unless under state law, but if the trustee could be required to make payments to someone because of an ascertainable standard, section 2036 will apply. See Estate of Gokey v. Comm’r, 72 T.C. 721 (1979) (holding irrevocable inter vivos trusts for children were support trusts and included in decedent’s gross estate).

\(^{287}\) See I.R.C. § 674(b)(2).

\(^{288}\) See Treas. Reg. § 20.2036-1(b)(3).

\(^{289}\) See I.R.C. § 674(b)(3). Note that a power exercisable by a writing other than a will does not come under the section 674(b)(3) exception.

\(^{290}\) See id.
a grantor testamentary power, thereby triggering grantor trust status, applies only if the power to accumulate income must be in the discretion of the grantor or a nonadverse party or is mandatory and does not require the consent of an adverse party.291 However, such an inter vivos power for the grantor to accumulate income will cause section 2036 and section 2038 to apply, and the gift may be incomplete in part or whole depending on the terms of the trust.292 But to create a grantor trust, the power to accumulate income could be mandatory or could be held by anyone else who is not adverse to the accumulation of income.293 An income beneficiary of the trust should not be given the power to accumulate income because such a power might cause the powerholder to be treated as making a gift of income that is accumulated, and the trust will not be a grantor trust because the beneficiary would be adverse within the scope of section 674(a).294

A grantor-retained power to appoint accumulated income also is not a wise choice for grantor trust status, however, if it is desired that the trust property not be included in the grantor’s gross estate, section 2036 would apply, causing an estate inclusion for the grantor’s gross estate, regardless of who held the power to accumulate income.295 Nevertheless, a special power of appointment held by the grantor’s spouse to appoint accumulated income would create a grantor trust because of the spousal-unity rule and would not result in an estate inclusion problem for the grantor or the spouse.296 The portion rule

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291. See id.
292. A gift is incomplete to the extent the donor does not release dominion and control. See Treas. Reg. § 25.2511-2(c). In addition, section 2702 may apply if the gift is complete in part, and incomplete in part, and the completed gift portion is to a family member. See I.R.C. § 2702.
293. Section 674(a) is not applicable to any power that requires the consent or approval of any adverse party.
294. See Treas. Reg. § 25.2511-1(g)[2] (a trustee with a beneficial interest in trust property does not make a gift if he distributes trust property to another beneficiary under a fiduciary power that is limited by a “reasonably fixed or ascertainable standard”; a possible implication is that if a beneficiary is also the trustee and makes a distribution to another beneficiary under a standard that is not an ascertainable standard, a gift would result]. No cases or rulings have interpreted that regulation in this context; however, commentators have advised planners of the potential issue. See, e.g., Jerold I. Horn, Whom Do You Trust: Planning, Drafting and Administering Self and Beneficiary-Trusteed Trusts, 20 ANN. HECKERLING INST. ON EST. PLAN. ¶ 500, ¶ 503.2 (1986).
295. See I.R.C. § 2036.
296. See I.R.C. § 672(c). But see I.R.C. § 2041(a)(3) (treating a special power of appointment as a general power of appointment for estate tax purposes, in some cases, by the manner in which the special power is exercised). See infra text accompanying note 299 regarding a power limited to allocating income among charitable beneficiaries.
limits the grantor trust status under section 674(b)(3) to the income portion of the trust, however. 297 If grantor trust status is sought for the entire trust, another grantor trust provision would need to be applicable for the principal portion.

A testamentary power to appoint the remainder interest in a trust held by the grantor or the grantor’s spouse will cause the principal portion of a trust to be a grantor trust. 298 The grantor retaining such a power will result in an estate inclusion for the grantor under section 2036(a)(2) and section 2038. 299 This result is acceptable for some trusts—such as grantor-retained annuity trusts and grantor-retained unitrusts—as they will be included anyway, in whole or in part, in the grantor’s gross estate by section 2036, if the grantor dies during the annuity or unitrust term 300 but is likely not acceptable with many other types of trusts a grantor might create for estate planning purposes. A special testamentary power over the remainder held by the grantor’s spouse avoids the estate tax issues, 301 however, and will create a grantor trust as to principal while both the grantor and the spouse are living. Thus, a testamentary special power held by the grantor’s spouse over both accumulated income and trust principal will create a wholly grantor trust.

Section 674(b)(4) permits a power to “sprinkle” income or principal (that is, to distribute, on a discretionary basis, the income or principal) among charities that are described in section 170 without causing grantor trust status. 302 Thus, such a power will not cause the trust to be a grantor trust.

Section 674(b)(5) is an exception from grantor trust treatment under section 674(a) as to corpus if a “reasonably definite standard” for distributions of corpus exists, 303 or if separate shares are created for the respective beneficiaries and distributions are charged against the beneficiary’s share. 304 Therefore, to establish a grantor trust by not

297. See Treas. Reg. § 1.671-3(b)(1).
298. See I.R.C. § 674(a); Treas. Reg. § 1.674(b)-1(b)(3).
299. See I.R.C. §§ 2038(a), 2036(a)(2).
300. See Treas. Reg. § 20.2036-1(c).
301. See id. § 20.2038(a)(3) [sections 2036 and 2038 applicable only to the transferor].
302. See I.R.C. § 674(b)(4).
303. I.R.C. § 674(b)(5)[A]. Note that in Code section 674(b)(5)[A] the test is whether there is a “reasonably definite standard” without the requirement that it be “external,” as required by section 674(d). Treasury Regulation section 1.674(d)-1 references the definition of reasonably definite standard in Treasury Regulation section 1.674(b)-5[i], which suggests that the terms may mean the same thing.
304. See I.R.C. § 674(b)(5)[B]. It seems relatively certain that if there is only one trust beneficiary, the entire trust is that beneficiary’s “share” for purposes of section 674(b)(5)[B].
complying with section 674(b)(5), no “reasonably definite standard” for principal distributions should be included in the trust and the trustee should have a “spray” or “sprinkle” power—any principal distributions cannot be required to be charged against the beneficiary’s proportionate share of corpus. Nevertheless, unless the grantor or the grantor’s spouse is a trustee, section 674(c) may prevent it from being a grantor trust.\footnote{The exception under section 674(b)(5) does not apply if anyone has the power to add beneficiaries to the trust, excepting after-born or after-adopted children.}

Section 674(b)(6) provides an exception from grantor trust treatment as to income if any of the following apply: (1) income accumulated for a beneficiary ultimately must be payable to that beneficiary, to the beneficiary’s estate, or to the beneficiary’s appointees, which may only exclude the beneficiary’s estate, the beneficiary’s creditors, or the creditors of the beneficiary’s estate;\footnote{See I.R.C. § 674(b)(6)(A). The “other than” exception seems to mean it could be a power that includes the beneficiary’s estate, creditors, or creditors of the beneficiary’s estate and still come under the section 674(b)(6) exception, although that would make the power a general power of appointment under section 2041 and thus cause inclusion in the powerholder’s gross estate. See I.R.C. § 2041[b][1].} (2) income accumulated for a beneficiary ultimately must be payable on termination of the trust, or in conjunction with a distribution of corpus that includes accumulated income, to the current income beneficiaries in shares that have been irrevocably specified in the trust instrument;\footnote{See I.R.C. § 674(b)(6)(B).} or (3) income accumulated for a beneficiary must be payable to the beneficiary’s appointees or to “one or more designated alternate takers (other than the grantor or grantor’s estate)” if the beneficiary dies before a distribution date that could “reasonably have been expected to occur within the beneficiary’s lifetime.”\footnote{See I.R.C. § 674(b)(6) (last paragraph). It should be noted that, under the section 674(b)(6)[A] exception to create a grantor trust, the power would have to be exercisable in favor of the grantor or the grantor’s estate, raising the question of whether such a power triggers section 677[a]. The prohibitions in the second paragraph of section 674(b)(6) on appointment to the grantor or the grantor’s estate does not by its terms apply to an appointment to the grantor’s spouse or the spouse’s estate, but it may so apply on account of the spousal unity rule of section 672[e].}

The regulations generally provide that the section 674(b)(6) exception from grantor trust treatment will not apply “if the power is in
substance one to shift ordinary income from one beneficiary to another.” Nevertheless, an exception to this general statement applies (meaning that the section 674(b)(6) exception applies to avoid grantor trust treatment) if the grantor or a nonadverse party has the power to shift income from one beneficiary to another by accumulating income with a provision that at a later distribution date, accumulated income will be distributed to the current income beneficiaries in shares that are irrevocably specified. For example, a trust instrument might provide for payment of income in equal shares to two of the grantor’s children but permit withholding the distribution from either. When the youngest child reaches age thirty, the remaining trust would be distributed equally between the two. If income is withheld from one, this provision has the effect of ultimately shifting one-half of the accumulated income from one child to the other. However, the power to effect this shift would not negate the exception from grantor trust treatment.

Accordingly, a provision that would prevent the section 674(b)(6) exception from applying includes the following: Permit totally discretionary distributions of current and accumulated income to be “sprayed” among beneficiaries. Alternatively, if the grantor wishes to provide for “separate shares” for each beneficiary as to accumulated income, the trust will be a grantor trust if it is to last for the lifetime of the beneficiary and the trust does not require that accumulated income be distributed to the beneficiary’s estate or give the beneficiary a broad testamentary power of appointment. The exception under section 674(b)(6) does not apply if anyone has the power to add beneficiaries to the trust excepting after-born or after-adopted children.

The section 674(b)(7) exception from grantor trust treatment under section 674(a) is very similar to section 674(b)(6) as it permits the accumulation of income, but only in situations when the beneficiary is under the age of twenty-one or when the beneficiary is disabled. However, there is no requirement that the accumulated income ultimately be payable to the beneficiary, the beneficiary’s estate, or the beneficiary’s appointees. Thus, if grantor trust status is

311. See id.
312. See id. § 1.674(b)-1(b)(6)(ii), Example 1.
313. See id. Example 2.
314. See id. Example 3.
315. See I.R.C. §§ 674(b)(5) (last sentence); 674(b)(6) (last sentence); 674(b)(7) (last sentence). For a discussion of the power to add beneficiaries, see infra section 4:5.2[E].
316. See I.R.C. § 674(b)(7).
317. See Treas. Reg. § 1.674(b)-1(b)(7).
desirable, a power to accumulate income should not be limited to periods when the beneficiary is under the age of twenty-one or legally disabled. The exception under section 674(b)(7) does not apply if anyone has the power to add beneficiaries to the trust, excepting after-born or after-adopted children.318

Finally, under section 674(b)(8), a broad power to allocate trust receipts between income and principal for fiduciary accounting purposes will not result in grantor trust status.319 This exception is consistent with a similar rule for estate tax purposes.320

[B] Powers of Independent Trustee

The section 674(c) exception to grantor trust status permits the trustee or trustees to have discretion to distribute income or principal without being limited by a standard for invasion if neither the grantor nor the grantor’s spouse is a trustee, and if not more than half of the trustees are related or subordinate parties who are “subservient to the wishes of the grantor.”321 Requiring the consent of a person other than the trustees to exercise a discretionary power over income or principal will negate the exception from grantor trust status.322 “Person” is not defined for this purpose.323 A beneficiary who must consent likely would be treated as an adverse party and should not be a “person” for this purpose, but being adverse negates the general rule of section 674(a) without regard to the section 674(c) exception.324 Who else’s consent might cause grantor trust status is not set forth in the statute or the regulations. Nevertheless, it likely means that requiring the consent of anyone who is not required to act in a

318. See I.R.C. §§ 674(b)(5) [last sentence]; 674(b)(6) [last sentence]; 674(b)(7) [last sentence]. For a discussion of the power to add beneficiaries, see infra section 4:5.2[E].
319. See I.R.C. § 674(b)(8).
320. See Old Colony Trust Co. v. United States, 423 F.2d 601, 603 [1st Cir. 1970].
321. I.R.C. § 674(c).
322. Thus, a discretionary trust will be a grantor trust if not falling under another exception if someone other than a trustee may participate in the exercise of that discretion. Nonetheless, it might be contended such a person is a “de facto” trustee. See, e.g., Priv. Ltr. Rul. 2007-31-019 [Aug. 3, 2007] [whether a power to substitute property of equivalent value under section 675(4)(C) is held in a fiduciary capacity is a question of fact]; see also infra notes 417–20 and accompanying text.
323. See I.R.C. § 672. However, section 7701(a)(1) defines person “to mean and include an individual, a trust, estate, partnership, association, company, or corporation.”
324. Code section 674(a) is not applicable to any power that requires the consent or approval of any adverse party.
fiduciary capacity and who is not adverse will negate the section 674(c) exception.325

The exception under section 674(c) can be avoided by making the grantor or the grantor’s spouse a trustee or a co-trustee who holds (or may participate in) the discretionary decision to distribute income and principal.326 A grantor with this power likely will have the assets included in his or her gross estate under section 2036 or section 2038; however, to create a grantor trust, the grantor’s spouse may hold this power without the estate inclusion issue.327 Subsection [c] does not require the spouse to be living with the grantor,328 as is required in section 674(d).329 Grantor trust status will end, however, when the spouse dies if grantor trust status was a result only of the grantor’s spouse being a trustee.330

Thus, one possible method to cause grantor trust status is to give the grantor’s spouse as trustee the discretionary power to distribute income or corpus to beneficiaries, not including the spouse, without including a “reasonably definite external standard.”331 The spouse should not have any obligation to support the trust beneficiaries, or the spouse will be adverse and the general rule of section 674[a] will not apply.332

325. The conclusion that person means anyone acting in a nonfiduciary capacity is based on the context of the requirement. The surrounding provisions deal with who may be a trustee and who may not for purposes of the section, and it may be assumed that trustees must act as fiduciaries when exercising discretion. See infra note 373 and accompanying text about the use of powers of appointment to create grantor trust status.
326. See I.R.C. § 674(c).
327. See I.R.C. §§ 2038[a], 2036[a][2].
328. See id. § 674[c] (citing id. § 672[e][2]).
329. Section 674[d] applies for trustees “none of whom is the grantor or spouse living with the grantor...” Id. § 674[d].
330. Obviously, a deceased spouse cannot be a trustee to cause grantor trust status.
331. I.R.C. § 674[b][5][A]. If there is a “reasonably definite standard,” the section 674[b][5][A] exception would apply, and the trust would not be a grantor trust as to corpus. See supra notes 303–05 and accompanying text. The trustee must have the power to “spray” distributions among multiple beneficiaries, or else the section 674[b][6] exception may apply as to trust income. See supra notes 313–14 and accompanying text. For a discussion of the “reasonably definite standard” exception under section 674[d], see infra notes 345–50. See also, e.g., Priv. Ltr. Rul. 2008-46-001 (Nov. 14, 2008) [example of situation where grantor’s spouse as trustee with discretionary power of distribution made grantor trust]. Under I.R.C. § 6110[k][3], neither a National Office Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.
332. If the spouse has an obligation to support all trust beneficiaries, including remainder beneficiaries, the spouse would not seem to be an adverse party as the spouse is not adverse to anyone; however, if the spouse is obligated to support the trust’s beneficiaries, the spouse’s power to distribute is likely a general power of appointment within the meaning of estate tax section 2041.
If the spouse did not make any contributions to the trust, this power should not result in estate inclusion for the spouse, so long as the spouse cannot distribute to himself or herself or in satisfaction of his or her legal obligations.

Alternatively, grantor status is achieved by making more than half the trustees persons who are “related or subordinate parties who are subservient to the wishes of the grantor” and giving the trustee the discretionary power to distribute income or corpus to beneficiaries without including a reason-ably definite external standard. The term “related or subordinate party” is defined in section 672(c), and includes the grantor’s spouse if living with the grantor, “father, mother, issue, brother, sister, [as well as] an employee of the grantor, a corporation or any employee of a corporation in which the stock holdings of the grantor and the trust are significant from the viewpoint of voting control, [and] a subordinate employee of a corporation in which the grantor is an executive.”

Section 672(c) creates a presumption that a related or subordinate party is subservient to the grantor. This presumption is difficult to overcome and would require a finding that the trustee is not acting in “accordance with the grantor’s wishes.”

The requirement that the trustee be “subservient to the wishes of the grantor” to cause grantor trust treatment raises an interesting estate tax question. If the person who holds the power to make distributions without a standard is in fact subservient to the wishes of the grantor, does a potential estate inclusion issue arise under section 2036 and section 2038? Estate of Goodwyn v. Commissioner answers the question with a “no,” holding that de facto control of a trustee was insufficient to cause inclusion in grantor’s estate under section 2036. Nevertheless, whether or not someone is subservient is a question of fact, and whether that determination

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333. I.R.C. § 674(c). Note that whether a party is subservient is a factual determination. See I.R.C. § 672(c)(1), last paragraph. Because of section 672(e), this likely means subservient to the grantor’s spouse as well. See I.R.C. § 672(e). With regard to the discretionary “spray” power without a standard, see supra note 331.

334. I.R.C. § 672(c). This provision is in addition to the rule of section 672(e). As discussed infra note 354 and accompanying text, the specific inclusion of a reference to section 672(e)(2) likely negates any requirement that the grantor’s spouse be living with the grantor.

335. I.R.C. § 672(c).


337. See I.R.C. §§ 2036, 2038.

338. 32 T.C.M. (CCH) 740 (1973), see also United States v. Byrum, 408 U.S. 125 (1972).

339. See Goodwyn, 32 T.C.M. (CCH) at 740.
would in turn cause estate inclusion under section 2036 and section 2038 has some inherent uncertainty. Accordingly, some cautious planners are unwilling to rely on this exception to create or avoid grantor trust status.

Finally, the section 674(c) exception can be avoided by requiring the consent of the grantor’s spouse to discretionary distributions if the spouse is not adverse, whether or not the spouse is a trustee.\textsuperscript{340}

The portion rule will apply to limit grantor trust status to trust income if the section 674(c) power is solely over income.\textsuperscript{341} A power over principal may create a wholly grantor trust rather than just a grantor trust as to principal if the power over principal may affect income.\textsuperscript{342}

Because no standard for distributions need be involved with a trust that fails to satisfy the section 674(c) and section 674(b)(5)(A) exceptions, a grantor who is a trustee and who is relying on section 674 to cause grantor trust treatment likely will have an estate inclusion under section 2036 and section 2038. In addition, care must be taken to prevent creating a tax problem for any other trustee who has any obligation to support any trust beneficiary. Such a power might be construed as a general power of appointment and, therefore, gift or estate taxable under section 2041 or section 2514,\textsuperscript{343} and such a person may be deemed adverse so that section 674(a) is inapplicable.

The exception under section 674(c) does not apply if anyone has the power to add beneficiaries to the trust, except in providing for after-born or after-adopted children, as discussed in greater detail \textit{infra}.\textsuperscript{344}

\section*{[C] Reasonably Definite External Standard Sprinkle Powers}

Section 674(d) provides that the general rule triggering grantor trust treatment as to income, but not principal, under section 674(a) will not apply when trustees—other than the grantor or grantor’s spouse, who is living with the grantor—have the power to make or withhold distributions of income if the power is limited by a reasonably definite external standard.\textsuperscript{345}

\begin{footnotesize}
\begin{enumerate}
\item See I.R.C. § 672(e). \textit{See supra} notes 44–47 and accompanying text.
\item See Treas. Reg. § 1.671-3(b)(1).
\item See id. § 1.671-3(b)(2).
\item See I.R.C. §§ 2041, 2514.
\item See I.R.C. § 674(c) [next to last sentence]. \textit{See infra} section 4:5.2[E] for a discussion of the power to add beneficiaries.
\item See I.R.C. § 674[d]. Note that in section 674(b)(5)(A) the test is whether there is a “reasonably definite standard” without the requirement that it be “external,” as required by section 674[d]. Treasury Regulation section 1.674[d]-1 references the definition of \textit{reasonably definite standard} in Treasury Regulation section 1.674(b)-5, which suggests that the terms may mean the same thing. Treasury Regulation section 1.674(b)-5[i] provides:
\end{enumerate}
\end{footnotesize}
Section 674(d) refers to a power over disposition of income and should preclude grantor status under section 674(a) as to income but on its face it is not applicable to a power over principal, and the regulations do not make clear that the exception does not apply to a power over principal. Nevertheless, if a dispositive power is subject to a “reasonably definite standard,” the exception in section 674(b)(5)(A) likely will prevent grantor trust status as to principal.

A trust that potentially satisfies the exception in this subsection—that is, a trust that is not a grantor trust—will provide that the trustee has discretion to distribute income among a class of beneficiaries or withhold distributions of income based on a “reasonably definite external standard.” If a grantor is willing to limit who may serve as the trustees, section 674(c) is potentially applicable instead to prevent grantor trust status when no external standard for distributions is required by the terms of the trust instrument.

The standard under section 674(d) is a “reasonably definite external standard.” Note that this standard is not necessarily the same as an “ascertainable standard” under section 2041 and section 2514. For example, an “emergency” standard appears to be a reasonably definite external standard, but it may not be an ascertainable standard under section 2041 and section 2514. Also, the “reasonably definite

It is not required that the standard consist of the needs and circumstances of the beneficiary. A clearly measurable standard under which the holder of a power is legally accountable is deemed a reasonably definite standard for this purpose. However, a power to distribute corpus for the pleasure, desire, or happiness of a beneficiary is not limited by a reasonably definite standard. The entire context of a provision of a trust instrument granting a power must be considered in determining whether the power is limited by a reasonably definite standard. However, the fact that the governing instrument is phrased in discretionary terms is not in itself an indication that no reasonably definite standard exists.

Id.

346. I.R.C. § 674(d).

347. See id. §§ 2041, 2514.

348. See, e.g., Estate of Jones v. Comm’r, 56 T.C. 35 (1971) (“in cases of emergency, or in situations affecting her care, maintenance, health, welfare and well-being,” court says that words “comfort” and “well-being” (citing Miller v. United States, 387 F.2d 866 [3d Cir. 1968]) and “comfort, welfare, or happiness” (citing Treas. Reg. § 20.2041-1) are not ascertainable); Tech. Adv. Mem. 86-06-002 (Oct. 31, 1985) (provision for distributions for ascertainable standard, coupled with power to distribute for “emergency needs,” does not constitute an ascertainable standard); Tech. Adv. Mem. 83-04-009 (Oct. 25, 1982) (“any great emergencies which may arise in the lives and affairs . . . such as extra needed medical services or hospitalization” not an ascertainable standard); Priv. Ltr. Rul. 78-41-006 (June 19, 1978) (power to invade corpus for “emergency” without “qualifying
external standard” may be different from the amorphous standard that courts have found will avoid estate inclusion under section 2036 and section 2038 for powers held by grantors as trustees. Thus, a grantor who is a trustee could have an estate inclusion under section 2036 and section 2038 because of the difference. Moreover, it is not clear if a power retained by a grantor limited by a reasonably definite external standard is a complete gift. In addition, care must be taken to prevent creating a tax problem for any other trustee who has any

language” created general power of appointment for section 2041]. However, various other cases and private letter rulings have concluded that “emergency” is an ascertainable standard. See, e.g., Martin v. United States, 780 F.2d 1147, 1150 [4th Cir. 1986] (“[i]n the event of the illness of [life tenant], or other emergency,” court said clear that Service argument that language created general power “was a loser,” and if argument was not “irivolous” before, it became so after Sowell decision of the Tenth Circuit was issued); Estate of Sowell v. Comm’r, 708 F.2d 1564, 1565 [10th Cir. 1983] (“in case of emergency or illness” ascertainable and measurable); Hunter v. United States, 597 F. Supp. 1293 [W.D. Pa. 1984] (“should any emergency arise” ascertainable standard within section 2041[b]); I.R.S. Priv. Ltr. Ruls. 2000-28-008 [Apr. 10, 2000] [construing reference to “other emergency” following an ascertainable standard as limited to the type of emergency covered by that standard]; 90-12-053 [Dec. 27, 1989] (“to relieve emergencies affecting” beneficiaries; power to invoke for emergencies is generally not ascertainable, but ruled that this standard was ascertainable in light of Martin decision). Under I.R.C. § 6110(k)[3], neither a National Office Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.


350. The regulations clarify that a power to change beneficial interests will not cause a transfer to be incomplete for gift tax purposes if the power is held in a fiduciary capacity and is subject to a “fixed or ascertainable standard.” Treas. Reg. § 25.2511-2(e), (g). If there is a fixed or ascertainable standard, the beneficiaries would have legal rights to force distributions according to the standard, thus divesting the donor of dominion and control over the transferred property. The regulations cited above do not give examples of what constitutes an ascertainable standard, but an analogous regulation [Treas. Reg. § 25.2511-1(g)(2), addressing powers by a trustee who has a beneficial interest in trust property] does provide details, including the requirement that the standard be such that the trustee is “legally accountable” for exercise of the power. The analogous regulation states that a power to distribute for the “education, support, maintenance, or health of the beneficiary; for his reasonable support and comfort; to enable him to maintain his accustomed standard of living, or to meet an emergency, would be such a standard.” Treas. Reg. § 25.2511-1[g](2).

Only a few cases have addressed the ascertainable standard exception in connection with whether retained powers to change beneficial interests preclude treating a transfer as a completed gift. See McHugh v. United States, 142 F. Supp. 927, 929 [Ct. Cl. 1956] (“to provide properly ‘for the
obligation to support any trust beneficiary. Such a power might be construed as a general power of appointment and thus taxable under section 2514 or section 2041, unless there is an “ascertainable standard” for distributions or the powerholder might be deemed adverse so that the general rule of section 674(a) does not apply.

The portion rule will limit grantor trust status under section 674(d) to the income. However, section 674(b)(5) prevents grantor trust status if there is a similar power over principal. Thus, the trust will be a grantor trust if the grantor or the grantor’s spouse, if living with the grantor, has a power of distribution over income and principal, even though limited by the requisite standard, as long as the consent of an adverse person is not required. The exception under section 674(d) does not apply if anyone has the power to add beneficiaries to the trust excepting after-born or after-adopted children, as discussed infra.

[C][1] Grantor Trust Status

One way of avoiding the exception in section 674(d), even if there is a reasonably definite external standard, so that grantor trust status can be achieved as to income, but not as to principal—if none of the other exceptions apply—is by making the grantor or the grantor’s spouse, as long as the spouse lives with the grantor, the trustee or a co-trustee. Because section 672(e) generally treats a spouse the same as a grantor, a question exists whether the specific section 674(d) requirement that the spouse must live with the grantor is a limitation. The section 674(d) “living with the grantor” requirement pre-dates section 672(e), but it may have been trumped by the more expansive rule of section 672(e)(2). The confusion is compounded by the fact that section 674(c) specifically mentions section 672(e), while section 674(d) does not. Grantor trust status will end, however, when the spouse dies; grantor trust status may also end if the grantor and the spouse divorce or if the spouse is no longer living with the grantor if the specific rule of section 674(d) overrides section 672(e).

essential needs—such as food, clothing, shelter and illness expenses” constituted ascertainable standard; transfer subject to such standard was a completed gift; Pyle v. United States, 766 F.2d 1141, 1143 [7th Cir. 1985] (“necessary for her health, support, comfort and maintenance requirements” constituted ascertainable standard, based on an Illinois Supreme Court case holding that the word “comfort” created an ascertainable standard; transfer subject to such standard was a completed gift), rev’d 581 F. Supp. 252 (C.D. Ill. 1984).

351. See I.R.C. § 674(b)(5).
352. See I.R.C. § 674(b)(7)(B). See infra section 4:5.2[D] for a discussion of the power to add beneficiaries.
353. See I.R.C. § 672(e)(2).
354. See I.R.C. § 674(c), [d].

(Blattmachr, Rel. #3, 10/10) 4–69
Section 672(e) does not include within its rule a spouse who is legally separated from the grantor at the time the power was created, but the spousal rule of section 674(d) might apply if the spouses still lived together, although legally separated. If the grantor’s spouse is a beneficiary of the trust, the spouse would be an adverse party; the spouse’s power of disposition as trustee then would not cause the general rule of section 674(a) to apply, but the trust will be a grantor trust under section 677 and possibly under section 676.

[D] Power to Add Beneficiaries—Grantor Trust Status

The general rule of section 674(a) causes grantor trust status if the grantor or a nonadverse party holds a power of disposition, but exceptions are provided in section 674(b), 674(c), and 674(d), as discussed above. A limitation to the section 674(b)(5)–(7), 674(c), and 674(d) exceptions applies (meaning that the general rule of section 674(a) applies, thereby causing grantor trust status) if “any person has a power to add to the beneficiary or beneficiaries or to a class of beneficiaries designated to receive the income or corpus, except where such action is to provide for after-born or after-adopted children.” Thus, permitting the grantor, the grantor’s spouse, or another party to add beneficiaries to a trust otherwise described in sections 674(b)(5)–(7), 674(c), or 674(d) will not prevent grantor trust status if the person or persons that may be added is a potential beneficiary of both income and principal.

The power to add beneficiaries will likely trigger grantor trust status even if held by a beneficiary who would be adverse to adding additional beneficiaries as long as a nonadverse party holds a power over dispositions to invoke the general rule of section 674(a). However,

355. See id. §§ 672(e)(1)(A); 674(d).
356. For a discussion of section 676, see supra section 4:3 and accompanying text; see supra notes 188–200 and accompanying text as to section 677.
357. I.R.C. §§ 674(b)(5) [last sentence]; 674(b)(6) [last sentence]; 674(b)(7) [last sentence]; 674(c) [next-to-last sentence]; 674(d) [last sentence].
358. Code sections 674(b)(5)–(7), 674(c), and 674(d) deal essentially with distributions that may be made or withheld. In other words, they do not deal with mandatory distributions. Thus, it seems relatively certain that the person or persons added as beneficiaries need not have mandatory rights to distributions to cause the limitations to these grantor trust rule exceptions to apply.
359. The power to add beneficiaries exception in I.R.C. §§ 674(b)(5)–(7), 674(c), and 674(d) does not require that the person holding the power to add beneficiaries be a nonadverse party. A power to add beneficiaries merely keeps those exceptions from applying (presumably even if held by an adverse party), and as long as a nonadverse party holds a power over dispositions, the general rule of section 674(a) would apply.
a beneficiary with such a power to add beneficiaries might be deemed to have a taxable general power of appointment under section 2514 if actually exercised.\footnote{360. The power to add someone else if the powerholder is a beneficiary or has the obligation to support an existing beneficiary arguably could result in a taxable gift. \textit{See} Treas. Reg. § 25.2511-1(g)(2); \textit{see also} Regester \textit{v. Comm’r}, 83 T.C. 1 \{1984\} (exercise of limited power of appointment by beneficiary with mandatory income interest resulted in a taxable gift).} Similarly, a powerholder who is able to add himself or herself as a beneficiary may have section 2514 and section 2041 power of appointment issues, depending on the terms of the trust. However, if a third party, other than the powerholder, has discretion to decide whether to make distributions to any added beneficiary, it is likely that the mere power to add oneself as a potential discretionary beneficiary is not within the scope of sections 2514 or 2041.

The grantor should not hold the power to add beneficiaries because that retained power would cause the transfer to be an incomplete gift, unless that result is being sought.\footnote{361. \textit{See} Treas. Reg. § 25.2511-2(c), (f); \textit{see also} Estate of Sanford \textit{v. Comm’r}, 308 U.S. 39 \{1939\}.} In addition, this power, if held by the grantor, may cause trust assets to be included in the grantor’s estate under section 2036 and section 2038. The grantor’s spouse could hold the power and thereby make the trust a grantor trust so long as the spouse is not an adverse party.\footnote{362. A spouse who is adverse negates the application of section 674(a).} The power of the spouse to add himself or herself would not in and of itself make the spouse adverse, except that such a power might make the spouse adverse as to adding other beneficiaries and might be a taxable power of appointment, depending on the terms of the trust.

The power to add beneficiaries might be granted to the trustee of a trust.\footnote{363. \textit{See} Priv. Ltr. Ruls. 1999-36-031 \{Sept. 10, 1999\} \{trustee who was a nonadverse party held power to add one or more charitable organizations to the class of beneficiaries eligible to receive distributions from a CLAT upon the termination date\}; 97-09-001 \{Feb. 28, 1996\}; 90-10-065 \{Mar. 9, 1990\} \{independent trustee holding power to add charities as beneficiaries makes grantor trust\}. Under I.R.C. § 6110(k)(3), neither a National Office Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.} However, fiduciary duties possibly limit a trustee’s exercise of a power to add beneficiaries. A trustee of a trust has a fiduciary duty to act in the best interests of the trust’s beneficiaries,\footnote{364. \textit{See}, \textit{e.g.}, 1 SCOTT AND ASCHER ON TRUSTS § 2.1.5 \{Mark L. Ascher et al. eds., 5th ed. 2006\}.} and it is difficult to argue that adding more beneficiaries to a trust will benefit the current beneficiaries. As a result, it may be preferable to give the power to a nontrustee to avoid the issue or, at a minimum, to provide that the

\footnote{360. The power to add someone else if the powerholder is a beneficiary or has the obligation to support an existing beneficiary arguably could result in a taxable gift. \textit{See} Treas. Reg. § 25.2511-1(g)(2); \textit{see also} Regester \textit{v. Comm’r}, 83 T.C. 1 \{1984\} (exercise of limited power of appointment by beneficiary with mandatory income interest resulted in a taxable gift).

361. \textit{See} Treas. Reg. § 25.2511-2(c), (f); \textit{see also} Estate of Sanford \textit{v. Comm’r}, 308 U.S. 39 \{1939\}.

362. A spouse who is adverse negates the application of section 674(a).

363. \textit{See} Priv. Ltr. Ruls. 1999-36-031 \{Sept. 10, 1999\} \{trustee who was a nonadverse party held power to add one or more charitable organizations to the class of beneficiaries eligible to receive distributions from a CLAT upon the termination date\}; 97-09-001 \{Feb. 28, 1996\}; 90-10-065 \{Mar. 9, 1990\} \{independent trustee holding power to add charities as beneficiaries makes grantor trust\}. Under I.R.C. § 6110(k)(3), neither a National Office Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

364. \textit{See}, \textit{e.g.}, 1 SCOTT AND ASCHER ON TRUSTS § 2.1.5 \{Mark L. Ascher et al. eds., 5th ed. 2006\}.}
power is exercisable by the trustee in a nonfiduciary capacity. But can a trustee ever do anything with respect to a trust in a nonfiduciary capacity? It might be wiser, therefore, to provide that the person who is acting as the trustee, holds the power in his or her or its individual capacity not in the capacity as trustee or any other fiduciary capacity.

The power to add beneficiaries could be so broadly stated as to permit adding any person as a permissible additional beneficiary, other than the powerholder or someone the powerholder is obligated to support. Nevertheless, many grantors may be uncomfortable granting anyone discretion that broad. The permissible classes of additional beneficiaries, however, could be limited in any manner acceptable to the grantor so long as it is clearly a larger group than the beneficiaries or a class of beneficiaries designated in the trust agreement “to receive income or corpus” or who are not after-born or after-adopted children.

The statute and applicable regulations specifically provide that a power to add after-born or after-adopted children does not trigger the exceptions to the section 674(a) exceptions, but do not specify whose children may be added, however.\(^{365}\) One view might be that the power refers only to the grantor’s children. A second, more expansive, view would allow the addition of children of a beneficiary or of any other described persons (for example, after-born children of a sibling, whether or not the sibling is a beneficiary). Because neither the Code nor any regulation clarifies the point, the safer view, if grantor status is not intended, is to assume that only after-born and after-adopted children of the grantor may be added without losing the protection of sections 674(b)(5)-(7) and 674(c)-(d).

If grantor trust status is sought, the power to add beneficiaries should be broader than after-born and after-adopted children or other after-born or after-adopted lineal descendants of the grantor and other trust beneficiaries. For example, the power might permit the addition of members of a specific group, such as nieces and nephews, spouses of children, lineal descendants who have already been born, or more remote relatives. However, it is not clear that a power to “add” persons who are already contingent remote beneficiaries would be treated as a power to add beneficiaries that would trigger grantor trust treatment. “Adding” beneficiaries in that situation arguably just elevates their beneficiary status but literally does not add them as beneficiaries.

Some commentators have questioned whether a trust is a grantor trust if the persons who may be added are not living or in existence at a specific moment in time.\(^{366}\) For example, if the power is to add spouses

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365. See Treas. Reg. § 1.674(d)-2(b).
of beneficiaries but none of the beneficiaries is married, is the trust a grantor trust? This situation is avoided by providing that the power includes the ability to add charitable beneficiaries generally or specifically identified charities currently in existence. Some cases and rulings have recognized grantor trust status where there is a power to add charities as beneficiaries.\textsuperscript{367} For a grantor who is uncomfortable with a broad power to add charities, the list of permissive charities may be short and the power to add charitable beneficiaries might be shared by several persons, so long as none of the powerholders is an adverse party; that is, a beneficiary of the trust or a person who is obligated to support a beneficiary should not have this power.\textsuperscript{368} Alternatively, the power to add charities might be limited to when there are no other potential beneficiaries that may be added at a specific point in time.

Also, commentators have suggested several provisions that “fine-tune” the power to add beneficiaries.\textsuperscript{369} These provisions include giving the powerholder the right to remove any beneficiary that is added.\textsuperscript{370} Also suggested is the right to provide that the person may be added for a limited amount of time, such as for the current year or for a limited number of years.\textsuperscript{371}

There is no reason, at least for grantor trust purposes, to let the power to add beneficiaries continue after the grantor dies. However, permitting the addition of beneficiaries after the grantor’s death could add opportunities to “split” the trust income among a broader class of persons.

To “toggle off” grantor trust status, the powerholder should have specific authority to release the power to add beneficiaries. To “toggle

\begin{thebibliography}{9}
\bibitem{367} See Madorin v. Comm’r, 84 T.C. 667 [1985]; see also Priv. Ltr. Ruls. 1999-36-031 [Sept. 10, 1999]; 97-10-006 [Mar. 7, 1997]; 97-09-001 [Feb. 28, 1997]; 93-04-017 [Jan. 29, 1993]. The reason why the power to add charities to the class of beneficiaries that triggers grantor trust status with respect to a discretionary trust is not prevented by section 674[b][4] is because the latter rule applies only if the corpus or income is irrevocable and payable for charitable purposes (or an employee stock ownership plan [ESOP]). Presumably, if discretionary payments of corpus or income could be made to persons other than charities, the section 674[b][4] exception could not apply. Under I.R.C. § 6110[k][3], neither a National Office Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.
\bibitem{368} Section 674[a] is not applicable to any power that requires the consent or approval of any adverse party.
\bibitem{370} See id.
\bibitem{371} See id.
\end{thebibliography}
on” the grantor trust status, a special trustee or trust protector might be given the power to grant a third person the power to add beneficiaries. In other words, it seems that the power to add to the class of beneficiaries applies only for a year in which such a power may be exercised.\footnote{372}

A special power of appointment granted to an individual to appoint trust assets to non-beneficiaries should constitute a power to add beneficiaries that would confer grantor trust status though it will not be effective to cause the trust to be a grantor trust if held by an adverse party.\footnote{373} Thus, giving a third party (who is not a trustee and who is not a beneficiary or otherwise an adverse party) a presently exercisable power of appointment is a way to cause grantor trust status. Because the person is not a trustee, the exceptions in section 674(c) and (d) should not apply. The testamentary power of appointment exception in section 674(b)(3) would not apply (because the power of appointment is presently exercisable). None of the other exceptions in section 674 would apply, so the general rule of section 674(a) would treat the trust as a grantor trust because the third party who is not an adverse party would have a power of disposition over the trust assets.

\[E\] Summary of “Viable” Choices for Causing Grantor Trust Status Under Section 674

A grantor trust may be created with one or more of the following powers, which should be used only if they do not create other problems (such as estate inclusion for the grantor or another person):

1. Grant a nonadverse person who is not a trustee a presently exercisable special power of appointment over both principal and income of the trust, whether an external standard exists or not.\footnote{374}

2. Designate a nonadverse person as trustee with discretion over distributions of income and principal and give a different nonadverse person the power to add beneficiaries to the trust who are not after-born or after-adopted children, and—to further reinforce grantor trust status—the power to

\footnote{372.} Toggling is discussed in greater detail in section 4-6, infra.
\footnote{373.} See Priv. Ltr. Rul. 96-43-013 (Oct. 25, 1996) [trustee for one trust and grantor’s spouse for another trust held special power of appointment currently exercisable in favor of spouses and former spouses of the grantor’s descendants; held that the power of appointment was the equivalent of the power to add beneficiaries, which meant that the section 674(c) exception did not apply]. Under I.R.C. § 6110(k)(3), neither a National Office Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.
\footnote{374.} See I.R.C. § 674(a). See also supra text accompanying note 373.
add beneficiaries who are not after-born or after-adopted children of a named beneficiary. The persons who may be added should be living or in existence (such as a named charity), and may include, but should not be limited to, additional persons who may not currently exist, such as a spouse of a person who is not yet married.\footnote{375}  

3. Name the grantor’s spouse as trustee of a trust so long as the spouse does not have a legal obligation to support any beneficiary and the spouse is not a beneficiary. The terms of the trust must permit discretionary distributions of both income and principal (without a reasonably definite standard) that are charged against the trust as a whole, not against a beneficiary’s share.\footnote{376} The trust instrument should carefully plan who the successor trustees would be in the event the spouse ceases to serve, to ensure that more than half of the trustees would be related or subordinate parties so as to continue grant trust status after the spouse ceases to serve.  

4. Name “related or subordinate trustees” who outnumber the trustees who are not. These trustees must be nonadverse, that is, trustees who do not have a legal obligation to support any beneficiary,\footnote{377} and who are not themselves beneficiaries. The terms of the trust must permit discretionary distributions of both income and principal that are charged against the trust as a whole and not against a beneficiary’s share.\footnote{378} However, it must be certain that it cannot be proved that they are not subservient to the wishes of the grantor or the grantor’s spouse.\footnote{379}  

In nearly all cases, it is unwise for the grantor to retain any of the suggested powers. In most circumstances, it is safe to give the power to the grantor’s spouse, so long as the spouse is not a beneficiary of the trust and does not have a legal obligation to support a trust beneficiary.

\footnote{375}{Section 674[a] and the exceptions in section 674[b][5]–[7], [c], [d] do not apply. See supra section 4:5.2.}  
\footnote{376}{See supra notes 303–05 and accompanying text as to avoiding the section 674[b][5] exception for powers over principal. As to avoiding the section 674[b][6] exception for powers over income, see supra notes 310–15 and accompanying text. The exception in section 674[c] does not apply.}  
\footnote{377}{If the trustee has a legal obligation to support all beneficiaries, the trustee may not be adverse. See supra note 332.}  
\footnote{378}{The exceptions in sections 674[b]–[d] do not apply. See supra notes 303–52 and accompanying text.}  
\footnote{379}{Some cautious planners avoid this approach because of possible uncertainty over whether giving the power to someone who is subservient to the wishes of the grantor might risk estate inclusion in the grantor’s estate. See supra notes 333–39 and accompanying text.}
However, if the grantor’s spouse has the power, grantor trust status will terminate when the spouse dies and may terminate sooner in the event of divorce. Thus, succession of powerholders should be planned if grantor trust status is to continue under section 674(a).

§ 4:5.3 Administrative Control for Benefit of Grantor

Section 675 provides that the grantor is treated as the owner of any portion of a trust over which the grantor has certain administrative powers or controls. The following are the situations covered:

1. Where there is a power in the grantor, nonadverse party, or both, whereby the grantor or anyone else can “purchase, exchange, or otherwise deal with or dispose of” the corpus or income for less than an adequate consideration in money or money’s worth.

2. Where there is a power in the grantor, nonadverse party, or both, that enables the grantor to borrow corpus or income without adequate interest or security. But if a trustee (other than the grantor) has a general power to make loans without interest or security to persons other than the grantor, the trustee’s power to make unsecured loans to the grantor on the same terms and conditions will not cause the trust income to be taxable to the grantor. Apart from this broad exception, both this and first power, are “disapproved” even if held by trustee.380

3. Where the grantor has directly or indirectly borrowed the trust corpus or income and has not completely repaid the loan, including any interest, before the beginning of the taxable year. This rule does not apply to a loan with adequate interest and security made by a trustee other than a related or subordinate party, as defined in the statute. Because it is a grantor trust—and therefore under Rev. Rul. 85-13 the interest isn’t treated as paid.382

380. See Treas. Reg. § 1.675-1(c). In general, H.R. Rep. No. 1337, supra note 3, at 4089, and S. Rep. No. 1622, supra note 3, at 366, state that, except where otherwise provided, the fact that a power is held in the capacity of trustee is not material.

381. The grantor is generally treated as holding any interest or power of his or her spouse as defined, and for the periods, specified in I.R.C. § 672(e). For any periods during which an individual is treated [under I.R.C. § 672(e)(2)] as the spouse of the grantor, any reference in I.R.C. § 675(3) to the grantor includes a reference to such person so treated as the grantor’s spouse.

382. Cf. I.R.C. § 267; Mau v. United States, 355 F. Supp. 909, 912 [D. Haw. 1973] [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

4–76
Where any one of the following powers of administration is exercisable in a nonfiduciary capacity by any person without the approval or consent of anyone in a fiduciary capacity:

(a) a power to vote or direct the voting of stock or other securities of a corporation in which the holdings of the grantor and of the trust are significant from the viewpoint of voting control;\(^{383}\)

(b) a power to control investment of trust funds either by directing or vetoing proposed investments or reinvestments to the extent that the trust consists of securities of corporations in which the holdings of the grantor and of the trust are significant from the viewpoint of voting control (apparently broad powers over other types of investments being permissible);\(^{384}\)

(c) a power to reacquire trust corpus by substituting other property of equivalent value.

The portion rule applies to section 675; thus, to create a wholly grantor trust (that is, one that is a grantor trust in its entirety) by on the income of that year. It seems that this provides an opportunity to change “retroactively” the tax effect of a transaction that has already occurred during the year, such as attributing the trust’s income, gains, losses, or credits to the grantor. See Benson v. Comm’r, 76 T.C. 1040 (1981); see also Bennett v. Comm’r, 79 T.C. 470 (1982) (grantor trust, in part, as a result of indirect borrowing through partnership of which grantor is partner but not as to loan to corporation); Rothstein v. United States, 735 F.2d 704 (2d Cir. 1984) (indirect borrowing, resulting in grantor trust status, arising on sale to grantor from trust for his inadequately secured note). The Service will not follow Rothstein. Rev. Rul. 85-13, 1985-1 C.B. 184. In many, but certainly not all, sections of the Code there are explicit provisions dealing with the effect under those sections of grantor trusts—e.g., I.R.C. § 318(a)(2)[B][ii][B][ii][B][ii]. See I.R.C. § 163 for restrictions and limits on the deductibility of interest payments. See also National Office Tech. Adv. Mem. 88-02-004 [I.R.C. § 675(3) (applies when grantor-trustee fails to enforce or pay interest or corpus on note to partnership from grantor that is later transferred to the trust). Neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent. I.R.C. § 6110[k][3].

383. Compare the inclusion in the gross estate for estate tax purposes of retained voting rights of I.R.C. § 2036[b].

384. S. REP. No. 1622, supra note 3, at 4719 (1954); see United States v. Byrum, 408 U.S. 125 (1972) [estate tax: veto of transfer permitted, even with power to vote]; Holdeen v. United States, 297 F.2d 886 (2d Cir. 1962) [for year 1946: investment advice permitted]; Estate of Gilman v. Comm’r, 65 T.C. 296 (1976), aff’d, 547 F.2d 32 (2d Cir. 1977). But see supra note 383; I.R.C. § 2036[e].
“violating” section 675, the power must affect both income and principal in their entireties.\textsuperscript{385}

[A] Section 675(1)—Power to Deal with Trust Assets for Less Than Full and Adequate Consideration

Section 675(1) provides that a power in the grantor or the grantor’s spouse\textsuperscript{386} or any nonadverse party, or both, to deal with the trust assets for less than full and adequate consideration results in grantor trust status.\textsuperscript{387} Creating a grantor trust in such a manner may be unwise, however, because that power likely will cause estate tax problems for the powerholder.\textsuperscript{388}

[B] Section 675(2)—Specific Power of Grantor to Borrow Trust Assets Without Adequate Security or Adequate Interest—Grantor Trust Status

Section 675(2) provides that a power in the grantor or the grantor’s spouse\textsuperscript{389} to borrow trust income or corpus without adequate security or without adequate interest being charged will result in grantor trust status.\textsuperscript{390} Excepted from this provision is a power in the trustee to make similar loans to others (besides the grantor or the grantor’s spouse).\textsuperscript{391} The mere existence of the “general lending power” is sufficient to cause grantor trust status regardless as to whether the power is actually exercised. (Contrast this provision with section 675(3), discussed below,\textsuperscript{392} which requires an actual borrowing of trust funds by the grantor to cause grantor trust status.) As long as the power extends to borrowing corpus or income from the trust, grantor trust status will result as to the entire trust.\textsuperscript{393}

While the statute refers to permitting the grantor to borrow, the inclusion of a power of a nonadverse party to enable the grantor or the grantor’s spouse to borrow trust income or corpus without adequate security or without adequate interest being charged may trigger

\textsuperscript{385} See I.R.C. § 671; see also Treas. Reg. § 1.675-1[a] (referring to Treas. Reg. §§ 1.671-2 and 1.671-3).

\textsuperscript{386} The grantor’s spouse is included as a result of section 672(e).

\textsuperscript{387} See I.R.C. § 675(1).

\textsuperscript{388} Such problems likely will arise under sections 2036 and 2038 if the power is held by the grantor, and under section 2041 if held by anyone else.

\textsuperscript{389} Or the grantor’s spouse as a result of section 672(e).

\textsuperscript{390} See I.R.C. § 675(2).

\textsuperscript{391} The grantor’s spouse, as a result of section 672(e).

\textsuperscript{392} See infra section 4:5.3[C].

\textsuperscript{393} See I.R.C. §§ 675, 671; see also Treas. Reg. § 1.675-1[a] (referring to Treas. Reg. §§ 1.671-2 and 1.671-3).
section 675(2) even if the grantor cannot compel the loan. As discussed below, a power of a nonadverse party to lend or to force the trustee to lend to the grantor seems preferable to giving the grantor the explicit power to borrow in a manner that invokes this section.

If the grantor or the grantor’s spouse has the power to borrow, alone or with the consent of a nonadverse party, or a nonadverse party has the power to lend funds, either without adequate security or without adequate interest, the trust is a grantor trust. Grantor trust status, therefore, may be achieved if the trustee has the express power to lend unsecured to the grantor, even if the loan must provide for adequate interest. To help avoid an argument that the grantor has retained a discretionary beneficial interest in the trust that would cause estate inclusion, the lending power should be limited to the authority to make loans without security and should not include the authority to make loans to the grantor without adequate interest. Furthermore, to assure the adequacy requirement is satisfied, the power should be drafted in a manner that explicitly permits making loans without any security to the grantor or without adequate security within the meaning of section 675(2). If a trustee makes the decision to lend funds to the grantor without adequate collateral, the trustee may require a


395. See Priv. Ltr. Ruls. 1999-42-017 [Oct. 22, 1999] (grantor who has authority to borrow all or any of the corpus or income “without adequate security” is treated as owner of trust; that is, it is a grantor trust); 96-45-013 [Nov. 8, 1996]; 95-25-032 [June 23, 1995]. Under I.R.C. § 6110(k)(3), neither a National Office Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

396. See Priv. Ltr. Ruls. 96-45-013 [Nov. 8, 1996] (nonadverse party authorized to lend to the grantor without security causes grantor to be treated as owner of trust); 95-25-032 [June 23, 1995] (grantor’s power to borrow without security causes GRAT, described in section 2702(b), to be grantor trust). However, in Priv. Ltr. Rul. 1999-42-017 [Oct. 22, 1999], the Service issued a ruling that a trust would be a grantor trust when the grantor retained the power to borrow all or any portion of the corpus or income of the trust “without adequate security.” (Presumably, the result would be the same if the trustee merely had the power to lend without adequate security, as opposed to the grantor having the power to borrow without adequate security.) It is interesting to note that in that ruling the S corporation and the grantor who were seeking the grantor trust ruling represented that their intention was “that this section allows Settlor to exercise this power unconditionally, without the approval of the trustees, or any other party.” Id. Under I.R.C. § 6110(k)(3), neither a National Office Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.
higher interest rate to carry out the trustee’s fiduciary duty to act in the best interests of the trust.

A provision permitting the grantor as trustee to make loans to himself or herself without adequate security would cause grantor trust treatment under section 675(2) but could risk estate inclusion for estate tax purposes if the power gives the grantor the authority to obtain trust assets for less than full and adequate consideration. To minimize this estate inclusion risk, the power to lend to the grantor should be held by the grantor’s spouse or a nonadverse party other than the grantor or the grantor’s spouse. Revenue Ruling 95-58,397 an estate tax revenue ruling that permits a grantor to remove a trustee without risking estate inclusion under section 2036 or 2038 as long as the replacement trustee is required to be someone who is not a related or subordinate party within the meaning of section 672(c), seems consistent with this conclusion.398

[C] Section 675(3)—Actual Borrowing of the Trust Assets by the Grantor—Grantor Trust Status

Section 675(3) provides that if the grantor borrows the trust corpus or income, and has not entirely repaid the loan, including interest, before the beginning of a tax year, the trust is a grantor trust for that year.399 Grantor trust treatment will not arise if the loan provides for adequate interest and security, and if the loan is made by a trustee other than the grantor, the grantor’s spouse, or a trustee who is a related or subordinate party subservient to the grantor.400 If the borrower is the grantor’s spouse, the same rule would apply as a result of section 672(e), so long as section 672(e) applies.401

Grantor trust status under section 675(2) and section 675(3) overlap to some degree, as both deal with borrowing by the grantor or the grantor’s spouse. However, in some situations section 675(3) will apply when section 675(2) does not. For example, actual borrowing from the trust with adequate security and adequate interest by the grantor or the grantor’s spouse causes it to be a grantor trust under section 675(3) if the loan is made by a trustee who is a related or subordinate party within the meaning of section 672(c) and who is subservient to the wishes of the grantor,402 regardless of the

398. See id.
399. See I.R.C. § 675(3).
400. “Related or subordinate party” is defined in section 672(c). “Subservient” is defined in Treas. Reg. § 1.672(c)-1.
401. See supra notes 43–47 and accompanying text.
402. See I.R.C. § 675(3).
ability to make similar loans, but such a loan is not described in section 675(2). Alternatively, if the trust document is silent about loans to the grantor or the grantor’s spouse so that section 675(2) is not applicable, section 675(3) will apply if a trustee who is the grantor, the grantor spouse, or a related or subordinate party makes a loan to the grantor or the grantor’s spouse with or without adequate security and with or without adequate interest. Thus, a loan to the grantor or the grantor’s spouse with or without adequate security and with or without adequate interest made by the grantor or the grantor’s spouse as the trustee will cause grantor trust status under section 675(3). Less certain would be a loan by a related or subordinate trustee, because the determination of whether a related or subordinate party is subservient to the wishes of the grantor is a question of fact that is less than a certainty.

The section 675(3) statutory language provides that grantor trust status depends upon a loan being outstanding at the beginning of a taxable year and not repaid in full before the end of the year. Thus, if borrowing occurs during a tax year and the loan is repaid by the end of the year, grantor trust status would not seem to exist for that year. However, the courts and the Service interpret section 675(3) to create grantor trust status if the loan to the grantor is outstanding at any time during the year. For example, if a loan is outstanding at the end of one tax year and repaid early in the next tax year, the grantor would be treated as owning the trust for all of both years. Thus, it is possible to make a loan to the grantor on December 30 of a year, and the trust will be a grantor trust for that entire year. Hypothetically, this strategy could be used in year-end planning to create a grantor trust retroactively for the year. In response to such a plan, the Service might take the position at some point that this strategy is an abusive one, despite

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403. Section 675(2) applies if the grantor or the grantor’s spouse can borrow from the trust without adequate security and adequate interest. Similarly, section 675(2) applies if the trustee is authorized to make loans to the grantor or the grantor’s spouse without adequate security or adequate interest. Actually borrowing is not necessary. This rule is not applicable if loans can be made to others over, unless the grantor or spouse is trustee. See id.

404. And who is subservient to the wishes of the grantor. See id. § 675(3).

405. Of course, the trustee must evaluate his or her fiduciary duties as trustee to determine if such a loan is prudent, if not authorized by the terms of the trust.

406. See supra notes 377–79 and accompanying text discussing the meaning of “related and subordinate trustees.”

407. “The grantor has . . . borrowed . . . and has not completely repaid . . . before the beginning of the taxable year.” I.R.C. § 675(3).

the outstanding case and its own Revenue Ruling that it is obligated to follow.\textsuperscript{409}

Whether grantor trust status relates only to amounts actually borrowed and not repaid before the end of the taxable year, or whether it applies to all income or corpus that could have been borrowed if some borrowing occurs is unclear.\textsuperscript{410} Thus, unless the grantor borrows all of the trust’s assets, no assurance can exist that the grantor will be treated as the owner of the entire income and corpus of the trust for income tax purposes.

Because grantor trust status under section 675[3] is predicated on actual borrowing, toggling grantor trust status “on” and “off“ seems possible.\textsuperscript{411} If the grantor wanted to achieve grantor trust status in any particular year, the grantor could borrow all of the trust funds for some period of time during the year. If the trustee is not a related or subordinate party, the borrowing should not provide for adequate security.\textsuperscript{412} However, if the trustee is a related or subordinate party, subservient to the grantor, the borrowing may provide for adequate interest and security and still result in grantor trust status.\textsuperscript{413} The grantor would need to repay the entire amount of the loan, including interest, by the end of the taxable year so that the grantor could make an independent decision in the following year whether the grantor trust status was desired in that year.

Section 675[3] may be used to convert a nongrantor trust into a grantor trust by having the grantor buy back all of the trust assets for a note, if the note is unsecured but with adequate interest, and grantor trust treatment is effective for that sale.\textsuperscript{414}

\begin{footnotes}
\footnotetext[409]{But see Rauenhorst v. Comm’r, 119 T.C. 157 (2002) (holding Commissioner cannot “litigate against officially published rulings without first withdrawing or modifying them”).}
\footnotetext[410]{Compare Bennett v. Comm’r, 79 T.C. 470 (1982) (grantor borrowed less than all of the income; grantor was taxable on portion of current year’s income that the principal of the loan at the beginning of the year bears to the total trust income from the trust inception), with Benson v. Comm’r, 76 T.C. 1040 (1981) (grantor borrowed all income of trust owning real estate; grantor should be treated as the owner of the entire trust for taxable years loan unpaid).}
\footnotetext[411]{See I.R.C. § 675[3].}
\footnotetext[412]{The loan should provide for adequate interest to avoid issues of whether the trustee might be breaching fiduciary duties and possible estate inclusion issues for the grantor. For a discussion of section 675[1], see supra notes 386–88 and accompanying text.}
\footnotetext[413]{A loan made to the grantor with adequate interest and adequate security by a related or subordinate trustee should not be an estate tax problem for the grantor because of the adequate interest and adequate security.}
\footnotetext[414]{See Rev. Rul. 85-13, 1985-1 C.B. 184 (no gain is recognized because grantor owns “purported consideration both before and after the transaction.”).}
\end{footnotes}
**[D] Section 675(4)—Administrative Powers**

The powers under section 675(4) commonly are considered when grantor trust status is sought. Section 675(4) triggers grantor trust status when someone in a nonfiduciary capacity has a power to vote closely held stock or to control trust investments related to closely held stock if the trust’s holdings of the closely held stock are “significant from the viewpoint of voting control.” In addition, a nonfiduciary power to reacquire trust corpus and replace with property of equivalent value will result in grantor trust status. Excepted from these rules are powers that require the consent of someone who must act in a fiduciary capacity.

All powers under subsection (4) must be exercisable in a nonfiduciary capacity to make a trust a grantor trust for income tax purposes. A power exercisable by a trustee will be presumed to be exercisable in a fiduciary capacity primarily in the interests of the beneficiaries.

Under the regulations, if a power is not exercised by a person as

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417. See Treas. Reg. § 1.675-1[b][4]; see also Wheeling Dollar Sav. & Trust Co. v. Yoke, 204 F.2d 410 (4th Cir. 1953) [income of trusts taxable to grantor; involving other powers also], cert. denied, 346 U.S. 898 (1953); cf. Friedman v. Comm’r, 7 T.C. 54 (1946) [where the major factor leading to taxability of the grantor was his retention, as trustee, of broad powers of administration]. In the case of an oral trust, it is difficult to show that the powers are suitably limited. See Reizenstein v. Comm’r, 22 T.C. 843 (1954). As to the standards for creation of an oral trust, see Del Drago v. Comm’r, 214 F.2d 478 (2d Cir. 1954). For cases of nontaxability where administrative powers were retained as trustee, see, e.g., Cushman v. Comm’r, 153 F.2d 510 (2d Cir. 1946) [some powers held as grantor considered “negligible”]; Fruehauf v. Comm’r, 12 T.C. 681 (1949); Welch v. Comm’r, 8 T.C. 1139 (1947); Smith v. Comm’r, 4 T.C. 573 (1945); and Weisman v. Comm’r, 3 T.C.M. [CCH] 723 (1944). See also Priv. Ltr. Ruls. 96-42-039 [Oct. 18, 1996] [see 675(4)(C) applied when power of substitution held by person other than grantor]; 92-47-024 [Nov. 20, 1992] [grantor who is not trustee but retains power to substitute property of trust is taxed on income of so-called charitable lead unitrust; does not discuss that the exercise of such a power may be subject to an excise tax under section 4941 for self-dealing]; 89-30-021 [July 28, 1989] [section 675(4)(C) applied when trustee, who was also the beneficiary, given the power by modification of the trust and held in nonfiduciary capacity]. Under I.R.C. § 6110[k][3], neither a National Office Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.
trustee, the “determination of whether the power is exercisable in a fiduciary or nonfiduciary capacity depends on all the terms of the trust and the circumstances surrounding its creation and administration.” In general, the regulations indicate that the presence of administrative powers will be judged not only by the provisions of the trust instrument but also by the actual facts of administration. In private rulings the Service generally has ruled that the application of section 675(4) is a question of fact that may only be resolved in an examination after returns have been filed. This position seems questionable when the power is made exercisable only in a nonfiduciary capacity within the meaning of section 675(4).


419. See Treas. Reg. § 1.675-1(a); see also Goemans v. Comm’r, 279 F.2d 12 [7th Cir. 1960] [under prior regulations].

Section 675(4)(A) and (B)—Powers Over Closely Held Stock—Grantor Trust Status

The first two powers under section 675(4)—the power of any person acting in a nonfiduciary capacity to control voting of or investments in closely held stock—may have some utility but are limited to situations in which the trust is funded with closely held stock. This limited use of controlling the voting of closely held stock is restricted by the potential estate tax problem under section 2036(b) if the grantor has the power. However, the right to veto a sale of the closely held stock covered in section 675(4)(B) should not cause estate inclusion under section 2036(b) as long as it is held by someone other than the grantor. But, of course, grantor trust status presumably would end when the stock is sold, assuming the trust is not a grantor trust for some other reason. Grantor trust status may be achieved safely under this subsection, and the estate tax problem avoided, if a married grantor gives the power to vote closely held stock to his or her spouse in a nonfiduciary capacity, but grantor status would end upon the death of the spouse unless there is a successor powerholder or the trust is a grantor trust for some other reason.

The portion rule will limit grantor trust status under section 675(4)(A)–(B) to the closely held stock and, if the trust owns other assets, it will not be a grantor trust in its entirety, unless it is a grantor trust for some reason other than section 675(4)(A)–(B). One circumstance when such grantor trust status under section 675(4)(A) and (B) might be used is where the stock is in an S corporation; a grantor

421. See I.R.C. § 675(4)(A)–(B). Closely held stock for purposes of section 675(4) means “stock or other securities of a corporation in which the holdings of the grantor and the trust are significant from the viewpoint of voting control.” Id. Conceivably, this stock could be a small block of stock if there are relatively few shareholders and if the block could constitute a “swing vote.”


423. See I.R.C. § 2036(b). Under section 2036(b), shares of stock in a corporation transferred by the decedent during his or her lifetime for less than full and adequate consideration in money or money’s worth are included in the transferor’s estate if the transferor retained the power directly or indirectly to vote the stock and held that power at death or relinquished it within three years of death and the block represents at least 20% of the voting rights of all classes of stock. See id.


trust is an “eligible” shareholder of an S corporation if the grantor would be eligible.

Section 675(4)[A]–[B] does not seem to apply to control over a limited liability company (LLC). LLCs did not exist when section 675(4) was enacted in 1954.426 It does not apply to a partnership.

[F] Section 675(4)(C)—Power Exercisable in a Nonfiduciary Capacity to Reacquire Assets by Substituting Assets of Equivalent Value—Grantor Trust Status

Section 675(4)(C) provides that “a power to reacquire the trust corpus by substituting other property of an equivalent value,” held in a nonfiduciary capacity by any person who can exercise it without the approval or consent of any person in a fiduciary capacity, will cause grantor trust treatment.427 Even though section 675(4)(C) refers to a power to reacquire “trust corpus,” this power causes the grantor to be treated as the owner of trust corpus and income, including ordinary income not allocable to corpus.428

The regulations provide that “the determination of whether the power [of substitution] is exercisable in a fiduciary or nonfiduciary capacity depends on all the terms of the trust and the circumstances surrounding its creation and administration.”429 Because grantor trust status depends upon the power being held in a “nonfiduciary” capacity, the power of substitution should not be held by the trustee (or else the requirement in the initial sentence of section 675(4) will not be satisfied).430 Similarly, a trustee’s approval or consent should not be required. The regulations provide that if a power is exercisable by a person “as trustee,” a rebuttable presumption exists that the power is exercisable in a fiduciary capacity primarily in the interests of the beneficiaries.431

The power should not be held by an adverse party if grantor trust status is sought by reason of the power. Even though several other

426. See Robert B. Keatinge et al., The Limited Liability Company: A Study of the Emerging Entity, 47 BUS. LAW. 375 (1992). What may be less clear, however, is whether a LLC or a partnership that elects to be income taxed as an association (corporation) might be deemed a corporation for this purpose.
428. See Treas. Reg. § 1.671-3(b)(3).
430. The initial sentence of section 675(4) provides that the nonfiduciary power must be exercisable without the approval or consent of anyone acting in a fiduciary capacity.
431. See Treas. Reg. § 1.675-1[b](4).
clauses of section 675 require that a power be exercisable by a nonadverse party to cause the trust to be a grantor trust, \textsuperscript{432} subsection 675(4) merely refers to powers held “by any person.”\textsuperscript{433} No requirement exists that the power be held by a nonadverse party. However, the regulations refer to powers of administration held in a nonfiduciary capacity “by any nonadverse party.”\textsuperscript{434} Despite the clear contradiction of the statute and regulations, the regulation possibly might be upheld under the broad deference standard announced in \textit{Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc.}\textsuperscript{435} Even so, it is difficult to understand how someone’s power to substitute assets for equivalent value could be adverse as to that person, thus creating a disincentive to exercise the power. To be safe, however, in making the trust a grantor trust by means of the substitution power, the power should not be held by a trust beneficiary or anyone else who might be considered an adverse party.

Whether the grantor’s retention of a nonfiduciary power to substitute assets of equivalent value causes an inclusion in the grantor’s estate for estate tax purposes has a relatively long history. A power of the grantor to substitute assets of equivalent value does not cause section 2036 or section 2038 to apply when it is held in a fiduciary capacity. In \textit{State Street Trust Co. v. United States},\textsuperscript{436} the court concluded in a “very close”\textsuperscript{437} case that broad management powers retained by the grantor, including the power to exchange trust property for other property without regard to the values of the properties, among other broad powers, caused the predecessor to section 2036 to apply.\textsuperscript{438} After the \textit{State Street} decision, the Service argued in \textit{Estate of Jordahl v. Commissioner}\textsuperscript{439} that a substitution power for equal value held by the grantor-trustee constituted a power to alter, amend, or revoke the instrument. The Tax Court disagreed, reasoning that because any property substituted should be “of equal value” to the property replaced, the grantor was thereby prohibited from depleting the trust corpus.\textsuperscript{440} The court viewed that situation as being no different from a case in which a settlor retains the power to direct

\begin{itemize}
  \item \textsuperscript{432} See I.R.C. § 675(1), [2].
  \item \textsuperscript{433} I.R.C. § 675[4].
  \item \textsuperscript{434} Treas. Reg. § 1.675-1[b](4).
  \item \textsuperscript{436} State St. Trust Co. v. United States, 263 F.2d 635 (1st Cir. 1959) [Magruder, C.J., dissenting].
  \item \textsuperscript{437} \textit{Id.} at 638.
  \item \textsuperscript{438} \textit{See id.} at 638–40.
  \item \textsuperscript{439} 65 T.C. 92 (1975), \textit{acq. in result} 1977-2 C.B. 1.
  \item \textsuperscript{440} \textit{Id.} at 96.
\end{itemize}
investments.\footnote{441} The Service subsequently acquiesced in the \textit{Jordahl} decision.\footnote{442}

Private Letter Ruling 2006-03-040 concerned a trust with a substitution power where "[t]he instrument provides that Grantor’s power to acquire Trust property under this section may only be exercised in a fiduciary capacity."\footnote{443} The ruling concluded that the substitution power would not cause estate inclusion under sections 2033, 2036(a), 2036(b), 2038, or 2039.\footnote{444} The ruling focused on the fact that the instrument said that the substitution power could be exercised only in a fiduciary capacity.\footnote{445} In \textit{Jordahl}, the decedent was a co-trustee,\footnote{446} so one might infer that all powers held by the grantor-trustee in that case were held in a fiduciary capacity. However, the letter ruling interpreted \textit{Jordahl} somewhat differently:

Rather, the court concluded that the requirement that the substituted property be equal in value to the assets replaced indicated that the substitution power was held in trust and, thus, was exercisable only in good faith and subject to fiduciary standards. Accordingly, the decedent could not exercise the power to deplete the trust or to shift trust benefits among the beneficiaries.\footnote{447}

According to the Service’s analysis in the ruling, the reasoning of the court suggests that any substitution power may be exercisable only in a fiduciary capacity to not cause estate tax inclusion. That interpretation might explain why the Service refuses to rule whether a substitution power is held in a nonfiduciary capacity so as to be a grantor trust trigger under section 675(4), even though the instrument specifically says the power is not held in a fiduciary capacity.

Similarly, in Private Letter Ruling 2006-06-006, the Service held that section 2036 would not apply to a situation in which the substitution power was held by the grantor in a fiduciary capacity.\footnote{448}

\footnote{441}{See id. at 96–97.}
\footnote{442}{1977-2 C.B. 1.}
\footnote{443}{Priv. Ltr. Rul. 2006-03-040 (Jan. 20, 2006). Under I.R.C. § 6110(k)[3], neither a National Office Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.}
\footnote{444}{See id.}
\footnote{445}{See id.}
\footnote{446}{See Estate of Jordahl v. Comm’, 65 T.C. 92, 93 (1976), acq. in result 1977-2 C.B. 1.}
\footnote{447}{Priv. Ltr. Rul. 2006-03-040. Under I.R.C. § 6110(k)[3], neither a National Office Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.}
\footnote{448}{See Priv. Ltr. Rul. 2006-06-006 (Feb. 10, 2006). Under I.R.C. § 6110(k)[3], neither a National Office Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.}
Without changing the trust under state law so that the trustee would hold the substitution power in a fiduciary capacity, the Service would not give a favorable ruling on section 2036.449

*Jordahl* is often cited for the proposition that a substitution power does not trigger section 2036, but under the facts of *Jordahl*, the grantor held the power in a fiduciary capacity.450 The issue is a bit different, however, if the grantor retains a substitution power in a nonfiduciary capacity, so as to cause the trust to be a grantor trust under section 675(4)(C).451 Nevertheless, the *Jordahl* court’s reasoning suggests the same result would have been reached if the substitution power had been held in a nonfiduciary capacity:

> Even if decedent were not a trustee, he would have been accountable to the succeeding income beneficiary and remaindermen, in equity, especially since the requirement of “equal value” indicates that the power was held in trust. . . . We do not believe that decedent could have used his power to shift benefits in [a manner to deprive the remaindermen of benefits or to deprive an income beneficiary of property]. Substitutions resulting in shifted benefits would not be substitutions of property “of equal value.”452

The regulations and other authority under estate tax sections 2036 and 2038 say that how the power is held makes no difference.453 If the power exists, holding the power in a fiduciary capacity does not help. So if the substitution power were taxable in *Jordahl*, holding it in a fiduciary capacity would not have helped. Stated differently, if holding a power in a fiduciary capacity does not help to cure a section 2036 or section 2038 problem, then holding a power in a nonfiduciary capacity should not trigger a section 2036 or section 2038 situation when

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449. In the facts of this ruling, other grantor trust triggers were present; the trust was a grantor trust even without a nonfiduciary substitution power. The substitution power was important to the grantor in the ruling because the grantor planned to transfer closely held business interests to the trusts, and the grantor wanted a substitution power to be able to substitute cash for those interests. See id. Under I.R.C. § 6110[k][3], neither a National Office Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

450. See *Jordahl*, 65 T.C. at 97.


452. *Jordahl*, 65 T.C. at 97 [internal citations omitted].

453. See Treas. Reg. §§ 20.2036-1[b][3] (“It is immaterial . . . in what capacity the power was exercisable by the decedent or by another person or persons in conjunction with the decedent.”); 20.2038-1[a] (“It is immaterial in what capacity the power was exercisable by the decedent or by another person or persons in conjunction with the decedent.”).
holding it in a fiduciary capacity would not, or vice versa. Therefore, Jordahl does seem to provide protection from section 2036 inclusion. Commentators generally have concurred that the Jordahl result should apply even when the substitution power is held in a nonfiduciary capacity. In addition, several private letter rulings have ruled that a substitution power held in a nonfiduciary capacity would not cause estate inclusion.

Revenue Ruling 2008-22 provides very helpful guidance on the estate tax issue. It says that a grantor-held nonfiduciary substitution power generally will not trigger estate inclusion under section 2036 or section 2038. The ruling cites Jordahl, but says that section 2038 did not apply because the decedent was bound by fiduciary standards. Even if the grantor is not bound by fiduciary standards, the ruling observes that the trustee has the duty to ensure that equivalent value is substituted. Indeed, if the trustee concludes the substituted assets have a lower value than the assets being reacquired, “the trustee has a fiduciary duty to prevent the exercise of the power.” The ruling reasons the trustee “has a fiduciary obligation to ensure that the assets exchanged are of equivalent value,” and the trustee must prevent any


455. See Priv. Ltr. Ruls. 2000-01-015 (Jan. 7, 2000); 2000-01-013 (Jan. 7, 2000) (holding if grantor survives term of GRAT, the value of property in the trust will not be includible in the grantor’s gross estate under section 2036(a); but without specifically addressing grantor’s nonfiduciary substitution power in the analysis); 1999-22-007 (June 4, 1999) (holding where charitable lead unitrust contained substitution clause, trust assets not includible in estate, but without specifically addressing the effect of nonfiduciary substitution clause on estate inclusion issue); 96-42-039 (Oct. 18, 1996) (holding substitution clause in charitable lead trust causes trust to be a grantor trust for income tax purposes, but does not cause estate inclusion under sections 2033, 2035–38, or 2041); 95-48-013 (Dec. 1, 1995) (holding powers of substitution made grantor trust holding S corporation stock but does not trigger inclusion under section 2038(a)); 94-13-045 (Apr. 1, 1994) (holding no estate inclusion in life insurance trust under sections 2036, 2038, or 2042, with discussion of Jordahl); 92-27-013 (June 3, 1992); 90-37-011 (Sept. 14, 1990). But see Priv. Ltr. Rul. 93-18-019 (May 7, 1993) (declining to rule on whether amending GST “grandfathered” trust to give grantor power to exchange assets of equal value would cause loss of GST grandfathered status, or whether it would create estate tax exposure to the grantor). Under I.R.C. § 6110(k)(3), neither a National Office Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.


457. See id. at 797.

458. See id.

459. See id.

460. Id. at 798.
shifting of benefits among beneficiaries that might otherwise result from the substitution, in view of the trustee’s power to reinvest assets and the trustee’s duty of impartiality regarding the beneficiaries.\footnote{461}

Drafting approaches differ as to how to assure that the trustees must satisfy themselves that assets of equivalent value are substituted and that the substitution power cannot be exercised in a manner that can shift benefits among trust beneficiaries. Some commentators recommend relying on state law and general fiduciary principles; others have suggested drafting those requirements into the trust instrument.\footnote{462}

\footnote{461}{\textit{Id.}} The precise holding of the ruling states:

A grantor’s retained power, exercisable in a nonfiduciary capacity, to acquire property held in trust by substituting property of equivalent value 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. [The ruling does not suggest how that might occur but does provide some safe harbors against the possible shifting of benefits in the next sentence.] A substitution power cannot be exercised in a manner that can shift benefits if: (a) the trustee has both the power (under local law or the trust instrument) to reinvest the trust corpus and a duty of impartiality with respect to the trust beneficiaries [observe: state law would generally impose both of these duties unless the trust instrument negates these duties]; or (b) the nature of the trust’s investments or the level of income produced by any or all of the trust’s investments does not impact the respective interests of the beneficiaries, such as when the trust is administered as a unitrust (under local law or the trust instrument) or when distributions from the trust are limited to discretionary distributions of principal and income.

\footnote{462}In an early response to the ruling, Jonathan G. Blattmachr and Michael Graham suggested the following sample provision to be included in a trust instrument:

Without reducing or eliminating the fiduciary duties imposed upon the Trustee acting hereunder under the terms of this instrument or applicable law, the Trustee shall ensure the Substitutor’s compliance with the terms of this power by being satisfied that the properties acquired and substituted by the Substitutor are in fact of equivalent value within the meaning of Rev. Rul. 2008-22; further, this power to substitute property shall not be exercised in a manner that may shift benefits among the trust beneficiaries within the meaning of Rev. Rul. 2008-22; without limiting the foregoing prohibition upon shifting benefits among trust beneficiaries, the Trustee shall have the power to reinvest the trust

(Blattmachr, Rel. #3, 10/10)
Opinions also differ as to whether the trust instrument should give the trustee the power to prevent the substitution if the trustee thinks the value is not equivalent, or if the trustee can sue only after the fact if the substituted assets have a lower value than the assets being reacquired. The rationale for the position that the trustee cannot prevent the exchange if the value is too low is that section 675 refers to corpus and a duty of impartiality with respect to the trust beneficiaries at all times while this power of substitution is in effect, within the meaning of Rev. Rul. 2008-22.

Quoted in Akers & Zeydel, supra note 369, at R-52. A somewhat more detailed example form clause is provided by Diana S.C. Zeydel and Jonathan G. Blattmachr:

During the settlor’s lifetime, the settlor 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 the trust estate (other than any direct or indirect interest in stock described in section 2036(b) of the Internal Revenue Code or any policy insuring the life of the settlor) by substituting other property of an equivalent value, determined as of the date of such substitution.

This power to substitute property is not assignable, and any attempted assignment will render this power void. Without reducing or eliminating the fiduciary duties imposed on the trustees under this agreement or applicable law, the settlor shall exercise this power to substitute property 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 settlor’s compliance with the terms of this power to substitute property by being satisfied in advance of completing the substitution that the properties acquired and substituted are in fact of equivalent value, within the meaning of Revenue Ruling 2008-22.

This power to substitute property shall not be exercised in a manner that can shift benefits among the trust beneficiaries within the meaning of Revenue Ruling 2008-22. Without limiting the foregoing prohibition upon shifting benefits among trust beneficiaries, the trustees shall have the power to reinvest the principal of the trust and, except in the case of a Marital Trust, the duty of impartiality with respect to trust beneficiaries at all times while this power of substitution is in effect, unless the trustees shall have 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 power of substitution potentially causing a shift of benefits among trust beneficiaries, all within the meaning of Revenue Ruling 2008-22.

(on file with authors).
a “power of administration . . . exercisable in a nonfiduciary capacity by any person without the approval or consent of any person in a fiduciary capacity.” On the other hand, Revenue Ruling 2008-22 specifically says that if a trustee believes that the substituted assets have a lower value, “the trustee has a fiduciary duty to prevent the exercise of the power.”

One approach is to provide that if the trustee believes the property sought to be substituted is not, in fact, property of equivalent value, the trustee should seek a judicial determination to assure that the equivalent value requirement of the substitution provision is satisfied. Treasury and Service officials expressed their personal views at the American Bar Association Section of Real Property Trust & Estate Law Section 2008 Spring Meeting, stating that the trustee would exercise his, her or its fiduciary duty to question the value issue before the transfer if the trustee believes that the value being substituted was not equivalent, which is different from requiring “approval or consent” of the trustee.

Some commentators are concerned that the substitution power should not be applicable over any life insurance policies on the grantor’s life, despite the holding to the contrary in Jordahl. The issue is whether the power to acquire a life insurance policy by exchanging property of equivalent value is a power that would cause inclusion of the life insurance proceeds under section 2042. A power of substitution held by an insured should not constitute an incident of ownership over a policy owned by an irrevocable life insurance trust. The acquiescence in Jordahl seems to evidence the Service’s acknowledgement that a substitution power held in a fiduciary capacity should not constitute an incident of ownership for purposes of section 2042. In an Action on Decision (AOD), the Service’s attorney specifically recommended acquiescence on the section 2042 holding in Jordahl, as well as on the section 2038(a) holding, and those recommendations were adopted. The AOD provides:

463. I.R.C. § 675(4) [emphasis added].
465. See Akers & Zeydel, supra note 369, at R-52.
Applying the Second Circuit’s rational in Estate of Hector R. Skifter v. Commissioner . . . that it was Congresses 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, it is clear from the court’s discussion of the limited rights retained by the decedent over the insurance trust that the proceeds of the policy should not be included in his gross estate. 469

The reasoning of the Jordahl AOD leads to the conclusion that if the right to substitute assets does not cause estate inclusion under sections 2036, 2038, and 2041, it should not cause estate inclusion under section 2042. However, a 1979 Revenue Ruling suggests that the Service’s position is that a power to purchase the policy does create an incident of ownership. 470 The ruling takes the position that an employee has an incident of ownership if the insured’s employment contract gives the insured the right to buy the policy at any time for its cash surrender value. 471 The ruling reasons that the right to buy the policy amounted to a power to veto the policy’s cancellation and that constituted an incident of ownership. 472 The Service lost that argument in Estate of Smith v. Commissioner. 473 The Service acquiesced in result only in Estate of Smith, as it disagreed with the Tax Court’s reasoning as to what constitutes an incident of ownership. 474 The 1979 Revenue Ruling has not been withdrawn. A subsequent private letter ruling stated that “the right to substitute assets of equal value is not by itself considered an incident of ownership under section 2042(2) where it can be exercised to acquire the insurance policy directly.” 475

To avoid the issue, cautious taxpayers likely will provide that a grantor’s nonfiduciary substitution power will not apply to life insurance policies on the grantor’s life, and that some other grantor trust triggering power will be needed as to life insurance policies or the power needs to be given to someone other than the grantor.

Similarly, some commentators suggest providing that the power of substitution could not be exercised to acquire any voting stock of a

469. Id. [internal citations omitted].
471. See id.
472. See id.
474. See id.
“controlled corporation” for purposes of section 2036(b).\textsuperscript{476} A controlled corporation is, generally speaking for section 2036(b) purposes, a corporation in which the decedent held, at any time after a transfer of stock and within three years of the decedent’s death, the right to vote stock possessing at least 20% of the combined voting power of all classes of stock, after applying the attribution rules of section 318 and including a right to vote held in conjunction with another person.\textsuperscript{477} The three-year rule under section 2036 triggers estate tax inclusion even if the voting rights are relinquished or ended within three years of the date of death, separate from the general three-year rule under section 2035.\textsuperscript{478}

A substitution power might be treated indirectly as the power to control the voting of the stock under section 2036(b). The section 2036(b) issue is whether the power to reacquire stock is a “retention of the right to vote [directly or indirectly] shares of stock of a controlled corporation” within the meaning of section 2036(b).\textsuperscript{479} Extending the concept of an indirect power to vote stock to the power to repurchase stock by paying full value for the stock seems to be an extension of the plain meaning of the section, however. In any event, excepting out partnerships or LLCs from substitution powers should not be necessary, as section 2036(b) only applies to corporations, not partnerships or LLCs, except, perhaps, if the LLC has elected to be income taxed as an corporation.\textsuperscript{480}

The Tax Court decided in Jordahl that the right to buy an asset for its fair market value is not a retained right or interest for purposes of section 2038 or section 2042, and the Service acquiesced in the result of the case.\textsuperscript{481} If a right to purchase assets constitutes a retained right under section 2038, questions could be raised about the application of section 2038 to a buy-sell agreement that gives a donor of stock a right of first refusal if a donee elects to sell the stock or a right to buy back the stock if a donee predeceases the donor. Also, questions might be raised about the impact under the charitable “split-interest rules” of a

\begin{itemize}
\item \textsuperscript{476} See Zaritsky, \textit{supra} note 25, ¶ 301.2[B].
\item \textsuperscript{477} See I.R.C. § 2036(b)(2).
\item \textsuperscript{478} See I.R.C. §§ 2036(b)(3); 2035(a)(1).
\item \textsuperscript{479} I.R.C. § 2036(b)(1). \textit{Cf.} Priv. Ltr. Rul. 2005-14-002 (Apr. 8, 2005) (involving a trust agreement providing that the grantor’s substitution power did not extend to stock of a controlled corporation). However, the explicit holding of Rev. Rul. 2008-22 is a grantor’s nonfiduciary substitution power by itself will not cause inclusion under section 2036 or 2038 (which obviously includes section 2036(b)], even though the ruling does not address the reasoning of the potential application of section 2036(b) specifically. \textit{See} Rev. Rul. 2008-22, 2008-1 C.B. 796.
\item \textsuperscript{480} See \textit{supra} note 426 and accompanying text.
\end{itemize}
contribution of voting stock [or other asset] to a charity that is subject to such buy-sell provisions, exercisable either by the donor or by other persons.\(^{482}\)

Giving a third party a substitution power may be a desirable alternative because it might be sufficient to cause grantor trust treatment for income tax purposes (as to the grantor, not the third party who holds the substitution power), but should not be treated as giving the donor any power that would risk estate inclusion for estate tax purposes.\(^{483}\) Read literally, the statute and regulations would both suggest that the power of substitution can be held by a third party. The statute refers to a power held by “any person.” The regulations refer to a power held “by any nonadverse party.”\(^{484}\)

A concern with third-party substitution powers is that subsection 675(4)(C) applies if “a power to reacquire the trust corpus” is present.\(^{486}\) A literal reading might suggest that only the grantor (or a third party who at one time owned the property in the trust) could hold the power to reacquire the property. Several private letter rulings conclude that a power to substitute assets given to a third party in a nonfiduciary capacity for a charitable lead trust was sufficient to cause grantor trust treatment for income tax purposes.\(^{487}\)

Additional authority provides some insight into using third-party substitution powers. The Service issued Revenue Procedure 2007-45 to provide sample forms for inter vivos charitable lead annuity trusts (CLATs).\(^{488}\) One of the sample forms is for a CLAT that is a grantor

\(^{482}\) See I.R.C. § 494(a).

\(^{483}\) See, e.g., Priv. Ltr. Rul. 1999-08-002 [Feb. 26, 1999] [grantor’s brother held nonfiduciary substitution power over CLAT and CLUT; no inclusion of trust assets in gross estate]. Under I.R.C. § 6110(k)(3), neither a National Office Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

\(^{484}\) I.R.C. § 675(4) [power “exercisable in a nonfiduciary capacity by any person”] [emphasis added].

\(^{485}\) Treas. Reg. § 1.675-1(b)(4) [referring to “existence of powers of administration exercisable in a nonfiduciary capacity by any nonadverse party”].

\(^{486}\) I.R.C. § 675(4) [emphasis added].

\(^{487}\) See Priv. Ltr. Ruls. 1999-08-002 [Feb. 26, 1999]; 98-10-019 [Mar. 6, 1998]; 97-13-017 [Mar. 28, 1997] [if the grantor of a charitable lead trust held the power of substitution, any exercise of that power would be a prohibited transaction under section 4941]. In Priv. Ltr. Rul. 90-37-011 [Sept. 14, 1990], the trust instrument gave one of the trustees a power to “acquire any property then held in Trust . . . by substituting property of equivalent value.” The Service held that power caused grantor trust status. See id. These rulings did not address the statutory requirement of a power to “reacquire” trust assets. Under I.R.C. § 6110(k)(3), neither a National Office Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

trust CLAT, which uses a third-party substitution power to cause grantor trust status. Similarly, Revenue Procedure 2008-45 uses the same approach for the sample form of inter vivos CLUT that is a grantor trust.

The sample forms are annotated and contain warnings about the power of substitution:

The donor to a CLAT may claim an income tax charitable deduction under § 170(a) if the donor is treated as the owner of the entire CLAT under the provisions of subpart E, part I, subchapter J, chapter 1, subtitle A of the Code. Paragraph 11, Retained Powers and Interests, of the sample trust in section 7 creates a grantor CLAT through the use of a power to substitute trust assets under § 675(4) that is held by a person other than the donor, the trustee, or a disqualified person as defined in § 4946(a)(1), and is exercisable only in a nonfiduciary capacity. The circumstances surrounding the administration of a CLAT will determine whether a § 675(4) substitution power is exercised in a fiduciary or nonfiduciary capacity. This is a question of fact. Note, that the exercise of a § 675(4) power may result in an act of self-dealing under § 4941.

Notwithstanding the warning contained in the annotations, the CLAT Revenue Procedure provides that “a grantor CLAT will qualify for the safe harbor created under this revenue procedure if the trust satisfies all of the requirements set forth in the preceding sentence . . .”

If there is concern that a nonfiduciary grantor substitution power may cause estate inclusion, despite Revenue Ruling 2008-22, a third-party power could be used to avoid estate inclusion issues. Thus, if a taxpayer is concerned about the potential application of section 2036(b) or section 2042 [as discussed above], a third-party substitution power might be used with respect to life insurance on the grantor’s life.

489. The Revenue Procedure provides the following in a sample form:

Retained Powers and Interests. During the Donor’s life, [individual other than the donor, the trustee, or a disqualified person as defined in § 4946(a)(1)] shall have the right, exercisable only in a nonfiduciary capacity and without the consent or approval of any person acting in a fiduciary capacity, to acquire any property held in the trust by substituting other property of equivalent value.

Id., sec. 7, para. 11 [brackets and emphasis in original].


492. Id. § 3, 2007-2 C.B. 89.

or stock of a controlled corporation. In addition, allowing a third party to hold the substitution power could create additional flexibility to “turn off” or to “toggle on” grantor trust status, as discussed below.\footnote{494}

If grantor trust status is sought under section 675(4) by having someone other than the grantor hold the substitution power, the grantor’s spouse could be given the substitution power. Moreover, any concern that the “reacquire” term suggests the power of substitution generates grantor trust status only if held by the grantor should be alleviated if the grantor’s spouse holds the substitution power, because any power or interest held by the grantor’s spouse is deemed to be held by the grantor for purposes of the grantor trust rules.\footnote{495} For example, a spousal substitution power might be used for life insurance on the grantor’s life (assuming the insurance is not also on the spouse’s life) or voting stock of a controlled corporation as well. However, if toggling grantor trust status on and off is planned, the spouse should not be given the power to both relinquish and reacquire the substitution power, or the grantor would be treated as having the substitution power continuously under section 672(e), making it impossible to turn off grantor trust status while spouses are living.

Section 675(4)(C) is not a certain path to grantor trust status, however. The Service’s consistent position is that whether or not the power is held in a nonfiduciary capacity is a question of fact that cannot be resolved without a trial (or a concession by the Service) after the fact.\footnote{496} As a result, caution suggests that section 675(4)(C) alone should not be relied upon to cause grantor trust status.\footnote{497}

Although a section 675(4)(C) power may be a less-than-certain avenue to cause grantor trust status, it provides few, if any, risks and offers significant flexibility. Thus, including such a provision to attempt to achieve grantor trust status probably is advisable.

Any of the section 675(4) powers might be triggered by substituting the grantor’s spouse for the grantor. This factor should have the advantage of avoiding estate tax issues unique to interests or powers retained by a grantor. But grantor trust status based solely on the spouse’s interest would end with the spouse’s death, and that outcome may or may not be a desirable income tax result.

\footnote{494. See \textit{infra} section 4:6.}
\footnote{495. See I.R.C. § 672(e).}
\footnote{496. In a thorough analysis, two commentators trace the history of section 675(4)(C) and whether a power of substitution fits within the rule. Their conclusion suggests uncertainty when section 675(4)(C) applies because of the Service’s position that it is a question of fact. See Craig L. Janes & Bernadette M. Kelly, \textit{When Using a Power of Substitution—Take Nothing for Granted,} \textit{EST PLAN.}, Aug. 2007, at 3.}
\footnote{497. See id. Other commentators have similarly cautioned against sole reliance on section 675(4)(C). See, e.g., Coleman, \textit{supra} note 366, ¶ 803.1.}
One advantage that a section 675(4)(C) grantor substitution power offers is the flexibility of swapping low basis assets held by a grantor trust with higher basis assets owned by a grantor individually, without income or gain recognition.\textsuperscript{498} The low basis assets returned to the grantor will be given a new basis when the grantor dies.

If the grantor or a third party exercises the substitution power over marketable securities, the question is at what exact value. Should values at the close of the day be used, or should the mean between the high and low on the day of substitution be used (for valuing both the assets acquired from the trust as well as the substitution assets)? Because the “mean between the high and the low” is the general valuation approach for estate and gift tax purposes, this method—which may require a small adjustment on the following day if the exact high and low prices are not known on the day of the substitution—may be preferable.\textsuperscript{499}

**[G] Summary of Powers to Cause Grantor Trust Status Under Section 675**

A grantor trust may be created under section 675 with one or more powers without likely causing the trust to be included in the grantor’s gross estate:

1. Grantor trust status can be achieved under section 675(2) if the trustee has the power to make an unsecured loan to the grantor or the grantor’s spouse with adequate interest. To minimize estate inclusion risks, the power should be held by the grantor’s spouse or a nonadverse party other than the grantor. An even safer choice is for the trustee who holds such a lending power to be someone who is not a “related or subordinate party” to the grantor. Because of section 672(e), a power held to make loans to the grantor’s spouse without adequate collateral would similarly result in grantor trust status so long as the conditions for section 672(e) to apply are met.

2. Under section 675(3), if the grantor or the grantor’s spouse borrows the entire corpus of a trust with adequate interest and adequate security, the grantor will be treated as the owner of

\textsuperscript{498} See Rev. Rul. 85-13, 1985-1 C.B. 184, discussed supra note 32 and accompanying text.


(Blattmachr, Rel. #3, 10/10) 4–99
the entire income and corpus of the trust if the trustee is the grantor, the grantor’s spouse, or a related and subordinate person who is, in fact, subservient to the grantor. For greater certainty on account of the requirement of “subservience to the grantor” for grantor trust status without estate tax inclusion issues, the trustee should be the grantor’s spouse. If the trustee is related or subordinate, there is possible uncertainty as to whether the trustee is subservient to the grantor, although in most instances subservience will be presumed.\footnote{For example, a child of the grantor will always be the grantor’s child and thus related and subordinate.} A loan by a trustee other than the grantor, the grantor’s spouse, or a related and subordinate person can still trigger grantor trust status if the loan requires adequate interest but is unsecured.

3. Under section 675(4)(C), a nonfiduciary power of substitution held by the grantor’s spouse should create a grantor trust. If it is desirable to continue grantor trust status after the spouse dies, a successor powerholder should be named who is not an adverse party. Following the issuance of Revenue Ruling 2008-22,\footnote{2008-1 C.B. 796. See supra notes 454–81 and accompanying text.} planners may be comfortable using grantor substitution powers. The trust instrument should specifically state that the substitution power is exercisable in a nonfiduciary capacity, and it may be wise to exclude the grantor from exercising the power over insurance on his life or her life or closely held stock described in section 2036(b); someone else could be granted the power over the insurance and stock.\footnote{See id. If insurance covers the life of the grantor’s spouse, the spouse probably should not have the power of substitution as to the life insurance.}

In all three of these avenues, the powerholder should not be the trustee and should not be an adverse party.

\section*{§ 4:5.4 Foreign Trust with U.S. Beneficiary}

Section 679 provides that a foreign trust is a grantor trust if the trust was created by a U.S. person and any beneficiary of the trust is a U.S. taxpayer.\footnote{See I.R.C. § 679.} As to such a trust, the trust income is attributable to the U.S. person who is the grantor.\footnote{See id.} Grantor trust rules for a U.S. person who directly or indirectly transfers property to a foreign trust are discussed in detail in chapter 5.
[A] Generally

A trust is a foreign trust unless both of the following tests are satisfied: (1) a U.S. court is able to exercise primary supervision over the trust; and (2) one or more U.S. persons have the authority to control all substantial trust decisions. A U.S. person is defined in section 7701(a)(30) as a citizen or resident of the United States, a domestic partnership or corporation, a non-foreign estate, or a non-foreign trust.

When a foreign person has control over at least one substantial decision, foreign trust status results. Substantial decisions are defined in the regulations to mean “those decisions . . . that are not ministerial.” The regulation includes very expansive examples: the power to determine the timing and amount of distributions from income or corpus, and the selection of beneficiaries, as well as other administrative actions such as making income and principal allocations, investment decisions, and compromising claims, are all substantial decisions. The definition even includes the power to appoint a successor trustee (unless it is restricted so that it cannot change the trust’s residency) and the power to remove, add, or replace a trustee. Thus, a domestic trust becomes a foreign trust if a non-U.S. person or persons come into control of a substantial decision. With multiple trustees, the non-U.S. person or persons must hold a minority vote to make any substantial decision of the trust for the trust to remain a U.S. trust.

Upon termination of grantor trust status—for example, when the grantor dies or when no foreign person or persons any longer controls any substantial decision, or when there are no longer any U.S. beneficiaries—section 684 will impose a tax on the unrealized appreciation in effect (assuming the trust is not a grantor trust with respect to another under section 671). However, if that occurs

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505. See I.R.C. § 7701(a)(30)(E), (31)(B). It is interesting to note that this statutory definition is, in effect, a negative definition and, therefore, somewhat difficult to understand. For example, the requirement that a trust is a foreign trust unless one or more U.S. persons have authority to control all substantial decisions of a trust might be more readily understood by defining a foreign trust as a trust in which one or more foreign persons have control over at least one substantial decision. For a detailed discussion of foreign trusts, see section 5:3.1.

506. See I.R.C. § 7701(a)(30).


508. Treas. Reg. § 301.7701-7(d)(1)(i).

509. See id. § 301.7701-7(d)(1)(ii)(A)–(J).


511. See id. § 301.7701-7(d)(1)(ii)(A)–(J).

512. See I.R.C. § 684.
because of the death of the grantor, the step-up in basis under section 1014, if applicable, should avoid having any gain under section 684.  

Section 672(f) provides that the grantor trust rules will not apply if they would cause someone other than a U.S. citizen, resident, or domestic corporation to be treated as the owner of the income.  

Thus, if a foreign person is the grantor of a trust, the grantor trust rules will not apply as to that person.  

Broad dispositive powers could be granted in the trust agreement without fear of causing the foreign person to be treated as the owner of the trust under the grantor trust rules. For example, section 679 would not apply if a foreign person creates a trust for a U.S. beneficiary, who might be treated as the owner of the income of the trust under section 678 because the beneficiary is the sole trustee or the beneficiary has a Crummey withdrawal power over all contributions to the trust.

Foreign trusts are subject to additional rules not generally applicable to domestic trusts. U.S. beneficiaries (including a grantor) who receive, directly or indirectly, any distribution from a foreign trust must report information to the Service on Form 3520. Additional required information is described in Notices 97-34 and 2003-75. A U.S. person who makes a gift to a foreign trust must file a notice of the gift on Form 3520, with penalties of up to 35% of the amount transferred if the report is not made. In addition, the foreign trust must file an annual return, and if it does not, the U.S. person (if any) who is treated as the owner of the trust may be liable for a 5% penalty of the value of the trust assets that are treated as owned by that person. If a U.S. trust becomes a foreign trust during the lifetime of a U.S. grantor, the U.S.

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513. See I.R.C. § 1014. For example, section 1014[c] denies a stepped basis for section 691 items of income in respect of a decedent. See id. Note, however, that under I.R.C. § 1012, I.R.C. § 1014[a] does not apply with respect to persons who die in 2010. Because I.R.C. § 1014[a] would not apply, it appears that termination of grantor trust status by the U.S. grantor of a foreign trust would mean I.R.C. § 684 would be “triggered.”

514. See I.R.C. § 672[f].

515. See Crummey v. Comm’r, 397 F.2d 82 (9th Cir. 1968).

516. The grantor trust rules will apply to any portion of the trust with a foreign grantor where amounts attributable to that portion are distributable only to the grantor and/or the grantor’s spouse during the grantor’s lifetime, or to satisfy either of their legal obligations. See I.R.C. § 672[f][2][A]; Treas. Reg. § 1.672[f]-3[b][2].

517. See I.R.C. § 6048[c][ii].


519. See I.R.C. § 6677[a].

520. See I.R.C. § 6677[b].
grantor must report the transfer.\(^{521}\) When a grantor foreign trust converts to nongrantor status, such as when the grantor dies and the trust continues as a foreign trust, the U.S. beneficiaries of the foreign nongrantor trusts are subject to several special rules.

The distributable net income (DNI) of a foreign nongrantor trust is determined under section 643(a) in a somewhat different way than for a domestic trust. A primary distinction is that all capital gains are included in DNI for the foreign trust, whether allocated to income or corpus and whether distributed to a trust beneficiary or not.\(^{522}\) When all DNI of a foreign nongrantor trust is not distributed each year, accumulation distributions determined under rules in section 665(b) in subsequent years are subject to the “throwback” rules.\(^{523}\) In addition, the tax under the throwback rule is increased by an interest charge.\(^{524}\) Some loans made by foreign trusts are deemed distributions and indirect distributions may be reclassified as direct distributions to a U.S. person.\(^{525}\) Section 1441 requires withholding at the source on distributions to foreign trusts.\(^{526}\)

A foreign trust is not an eligible S corporation shareholder.\(^{527}\) This rule negates one reason why grantor trust status might be attractive if the grantor is a U.S. individual who is a permissible S corporation shareholder.\(^{528}\)

**[B] Grantor Trust Under Section 679**

A grantor trust may be created under section 679 by making a foreign person the trustee. Alternatively, to create a foreign trust the foreign person may be a co-trustee of a trust so long as the foreign person or persons are a majority of the trustees or some substantial decision is delegated to the foreign trustee. It is not necessary to name the grantor or the grantor’s spouse as a trustee or as a beneficiary to create a grantor trust under section 679. However, the trust must comply with the additional complex rules that are applicable to foreign trusts and be subject to the additional taxes that apply to foreign trusts.

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\(^{521}\) See I.R.C. § 679(a)(5).


\(^{523}\) See I.R.C. § 665(d)(2). These are known as the “throwback” rules because previously accumulated and undistributed DNI is taxed in effect to the beneficiary who later receives it by throwing it back to the year in which the trust received it. See id.

\(^{524}\) See I.R.C. §§ 667(a)(3), 668.

\(^{525}\) For a comprehensive discussion of these issues, see section 5:10, supra note 30, § 5.

\(^{526}\) See I.R.C. § 1441. For a comprehensive discussion of these issues, see section 5:12.

\(^{527}\) See I.R.C. § 1361(c)(2) (last sentence).

\(^{528}\) See notes 48–49 and accompanying text infra chapter 7.
trusts. Certainly, knowledge of the foreign trust rules and experience with them is critical for the planner who suggests this route to grantor trust status.

§ 4:5.5 Taxability of Income to Person Other Than the Grantor—Section 678

Although the grantor trust rules generally address the taxability of trust income to the grantor, in some situations the _Clifford_ trust doctrine has been extended to tax the income of a trust to someone other than the grantor. This happens when the powers granted enable a beneficiary to vest the corpus or income in the beneficiary. The seminal case of Mallinckrodt v. Nunan, held that income of a trust was taxable to a beneficiary because the beneficiary had the right to demand the distribution of the trust's income, although any income not demanded during the year was added to corpus at the end of the year.

The 1954 Code adoption of the grantor trust rules included section 678, which adopted the _Mallinckrodt_ line of cases and pre-existing regulations. This section provides that a person other than the


530. Hirschmann v. United States, 309 F.2d 104 (2d Cir. 1962), aff'd 202 F. Supp. 722 (S.D.N.Y. 1962), Jergens v. Comm'r, 136 F.2d 497 (5th Cir.), cert. denied, 320 U.S. 784 (1943); Bunting v. Comm'r, 164 F.2d 443 (6th Cir. 1947); Emery v. Comm'r, 156 F.2d 728 (1st Cir. 1946); Grant v. Comm'r, 11 T.C. 178 (1948); Conant v. Comm'r, 7 T.C. 453 (1946); Stix v. Comm'r, 4 T.C. 1140 (1945); Oppenheimer v. Comm'r, 16 T.C. 515 (1951) [portions of income and corpus]; Mallinckrodt v. Nunan, 2 T.C. 1128, aff'd, 146 F.2d 1 (8th Cir.), cert. denied, 324 U.S. 871 (1945); Russell v. Comm'r, 45 B.T.A. 397 (1941); Richardson v. Comm'r, 42 B.T.A. 830 (1940), aff'd, 121 F.2d 1 (2d Cir.), cert. denied, 314 U.S. 684 (1941). As to the relationship between the ordinary trust sections and a power of a beneficiary to demand income or corpus, see Treas. Reg. §§ 1.641(b)-2, 1.643(c)-1(e). See also Treas. Reg. § 1.662(a)-4.


532. Treas. Reg. 118, § 39.22(a)-22 (1939); Priv. Ltr. Rul. 90-26-036 ("[L]egislative history of section 678 indicates Congress' interest to implement the principles of Mallinckrodt v. Nunan."). See also Senate Finance Committee Report for 1954 Code that provides:

A person other than the grantor may be treated as the substantial owner of a trust if he has an unrestricted power to take the trust principal or income, or if he has modified this power (by release or otherwise) but has retained powers of the type which would make the grantor taxable, unless the grantor himself is deemed taxable.

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grantor is treated as the owner of any portion of a trust over which the person has the sole power to vest the corpus or the income in the powerholder. This rule applies even if the power is not exercised.

A trust beneficiary’s right to demand from a trust the greater of $5,000 or 5% of the trust assets (commonly called a “five or five power”) is an example of a section 678 power. Similarly, the typical Crummey trust withdrawal power is another common example of a section 678 power.

Only the portion of the trust’s income, deductions, and credits not subject to section 678 (or other grantor trust rules) are subject to the non-grantor portion of subchapter J. Revenue Ruling 67-241 illustrates how the portion rule applies in the section 678 context. In the ruling, a trust beneficiary had the non-cumulative, annual right to vest in herself the greater of $5,000 or 5% of the principal of a trust. The

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because of such a power. Similar rules are contained in the regulations under existing law (commonly known as the Mallinckrodt Regulations).


535. Under I.R.C. §§ 2041(b)[2] and 2514(e), the lapse of a general power of appointment (including a power of withdrawal) constitutes a transfer for estate and gift tax purposes only to the extent that the lapse each calendar year exceeds the greater of $5,000 or 5% of the value of the property subject to the power.

536. See Crummey v. Comm’r, 397 F.2d 82 [9th Cir. 1968].


538. Treas. Reg. § 1.678(a)-1(b). For a discussion of the portion rule, see section 4:2.2, supra.

(Blattmachr, Rel. #3, 10/10)
trust income was payable to the beneficiary’s two children. The Service ruled that section 678 applied to treat the trust beneficiary as the grantor of the portion of the trust corpus that the power covered, and as a result the trust beneficiary’s income tax liability was to be computed by taking into account the income, deductions, and credits attributable to that portion.

“Five or five” and similar withdrawal powers raise unanswered questions of whether gain or loss might be realized by the trust if the amount demanded is satisfied in-kind with a transfer of property. In some respects the trust is satisfying a specific amount due the beneficiary with an appreciated asset, and that invokes the Kenan rule discussed above in section 3:5.6. Alternatively, the satisfaction of the amount demanded might be viewed as mere segregation of the portion of the trust the beneficiary owns because of the demand right, and thus the distribution is not a taxable event. Avoiding income realization by applying this second theory may be dependent on either a pro rata distribution of trust assets or the trust instrument or state law permitting non-pro rata distributions.

The Service has ruled that the distribution of an amount demanded by the beneficiary does not consist of any DNI. This view of the DNI rules may suggest that the Service considers the distribution within the scope of the specific gift rule of section 663(a)(1) or that the Service accepts the ownership theory, but the basis for its position is not enunciated.

In Revenue Ruling 81-6, the Service ruled that section 678 applied to a withdrawal power held by a minor, although the minor could not exercise the power under state law and no guardian had been appointed for the minor. The Service held that the existence of the power, and not the legal ability of the powerholder to exercise the power, was determinative. The power in the ruling appeared to be a

539. I.R.C. § 267 (disallowing loss recognition on sales and exchanges between certain related taxpayers) would be applicable to any possible recognition of loss.

540. For a discussion of the issue, see Adams, supra note 533, at 1900.

541. See note 618, at section 3:5.6, supra, and accompanying text for a discussion of triggering gain on non-pro rata distributions. The recognition might depend on whether the non-cash distribution was in satisfaction of the $5,000 threshold (a fixed sum) or 5% (a fractional share) and state law. Cf. Rev. Rul. 69-486, 1969-2 C.B. 159.


543. It may also take the application of the Service’s position in Rev. Rul. 85-13, 1985-1 C.B. 184, discussed in note 382, supra, and accompanying text, to avoid recognition of gain if appreciated assets are distributed by a grantor trust to the trust’s grantor.

“garden-variety” Crummey power of withdrawal.\textsuperscript{545} Other conditions precedent may, however, prevent the application of section 678.\textsuperscript{546}

### § 4:5.6 Section 678(a) and Ascertaintable Standards

Section 678(a)(1) provides that “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.” The question is to what extent section 678(a)(1) applies if the person’s withdrawal power is subject to limitations such as an ascertainable standard.

Courts have held that section 678 may not apply where the power is subject to a reasonable standard, although neither section 678 nor its regulations address this issue.\textsuperscript{547} Note that the courts do not use the term “ascertainable standards” as is found in the estate and gift tax rules,\textsuperscript{548} but they apparently mean about the same thing. The regulations under section 674 provide guidance on the meaning of the term “reasonably definite standard,” but section 674 uses that term and

\begin{itemize}
\item \textsuperscript{545} See Crummey v. Comm’r, 397 F.2d 82 [9th Cir. 1968].
\item \textsuperscript{546} Another example of a condition precedent is a power that is not exercisable before the powerholder reaches a specified age, such as twenty-five. Other sections of the grantor trust rules specifically provide that conditions precedent are ignored when applying the rules. See, e.g., §§ 674(b), 676(b), and 677(a), all of which ignore conditions precedent that exceed the 5% reversionary interest rule of section 673. The failure of section 678 to provide a similar rule might be interpreted to support the conclusion that a condition precedent will prevent the application of section 678.
\item \textsuperscript{547} De Bonchamps v. United States, 278 F.2d 127 [9th Cir. 1960]; Smither v. United States, 108 F. Supp. 772 [S.D. Tex. 1952], aff’d, 205 F.2d 518 [5th Cir. 1953] [support, maintenance, comfort, and enjoyment]; see May v. Comm’r, 8 T.C. 860 [1947] [nontaxable on portion allocable to education of taxpayer’s minor children; the taxpayer, whose husband had a salary income, probably had no support obligation]; C.E. Brehm Trust No. 3 v. Comm’r, 33 T.C. 734 [minors could terminate only through a guardian, and none had been appointed, thus no “unfettered command”], rev’d, 285 F.2d 102 [7th Cir. 1960] [on ground such appointment is a routine matter]. But see Rev. Rul. 81-6, 1981-1 C.B. 385; Priv. Ltr. Rul. 8211057 [power limited to “welfare” taxable]; cf. Crummey v. Comm’r, 397 F.2d 82 [9th Cir. 1968] [minor’s annual power to withdraw $4,000 from trust makes transfers to trust constitute gift of present interest under I.R.C. § 2503, because power to withdraw is equivalent to right to immediate use, possession, or enjoyment, although no guardian was appointed to exercise the power for the minor]; cf. also I.R.C. § 2652(c) [any income or corpus of a trust that may be used to satisfy a support obligation under state law is ignored for generation-skipping transfer tax purposes if such use is discretionary or is substantially equivalent to Uniform Gifts to Minors Act, even apparently if so used].
\item \textsuperscript{548} For discussions of “ascertainable standards,” see Treas. Reg. §§ 20.2041-1(c)(2), 25.2514-1(c)(2).
\end{itemize}
The type of control that a court may exercise over a discretionary act undertaken by a trustee or beneficiary can be critical. There are, in essence, five categories of cases. First, the governing instrument of the trust may give the beneficiary the right to withdraw assets from the trust for certain purposes but make the judgment of the beneficiary conclusive. Where the instrument takes this form, the court is precluded from exercising any supervisory control regarding withdrawals. Second, while the instrument may give the trustee extraordinarily broad discretion without imposing any standard to guide the trustee’s decision making, it may nonetheless have the effect of giving the court the authority to review any exercise of discretion to make sure that it does not violate any type of mandatory fiduciary duty that may not be waived in the trust instrument, such as the duty to act in good faith. Third, the instrument may impose a standard designed to constrain the trustee’s discretion. When a so-called ascertainable standard is used, a court has the authority to hold the trustee accountable for any decision that deviates from the standard. Fourth, the instrument may contain an ascertainable standard relating to the powerholder’s health, education, maintenance or support (HEMS). This is a subset of the ascertainable standard category, with the court having the authority to hold the powerholder accountable for any withdrawal that is not consistent with the HEMS standard. Finally, in the fifth category of cases, a powerholder’s discretion may be constrained not by trust law or by the trust instrument, but rather by a fiduciary duty that derives from corporate law.

In the first category of cases, where the powerholder may withdraw trust assets with impunity from judicial review, the powerholder is treated as the absolute owner of the trust’s assets for all tax purposes and, thus, the trust is treated as the powerholder’s grantor trust under section 678. The powerholder is in effect deemed to own the trust’s assets outright, making all of the trust’s income directly taxable to the powerholder. Absent this power, the trust would ordinarily

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549. Treas. Reg. § 1.674(b)-5.
551. See, e.g., Woollard, supra; McCoy, supra.
552. The HEMS standard is relevant only in determining whether a powerholder has a general power of appointment for transfer tax purposes. Of course, the use of such a HEMS limitation converts what would otherwise be a general power of appointment into a non-general power.
be respected as a separate entity for income tax purposes.\textsuperscript{553} This 
ownership-equivalence concept makes sense. After all, it would elevate 
form over substance to treat a powerholder with such an unfettered 
right to withdraw trust assets differently.

In the second category of cases, where the powerholder has un-
limited discretion but the court nonetheless has some supervisory 
authority, the ownership equivalence concept applies only for transfer 
tax purposes.\textsuperscript{554} But, inasmuch as the powerholder would not have 
unfettered or unrestricted access to the trust’s assets, however, section 
678 should not apply.

In \textit{Mallinckrodt}, the beneficiary’s power to demand a withdrawal 
of income was not limited by any standard. It would seem that, if a 
third party other than the grantor (for example, a trust beneficiary) 
has unfettered control over the trust income or corpus, then section 
678(a)(1) would apply to make that portion of the trust (the income 
portion or the corpus portion) a grantor trust with respect to the third 
party. If, however, the third party could withdraw only if a condition 
exists, it seems doubtful that section 678(a) would apply unless and 
until the condition arises. For example, assume a trust created by will 
unilaterally permits a child to withdraw all of the property when she 
attains the age of fifty. She has no other right to withdraw income or 
corpus prior to that time. It seems nearly certain that section 678(a)(1) 
will apply only when the child reaches age fifty.

In the estate tax context, a decedent’s power to consume, invade, or 
appropriate property for her own benefit which is limited by an 
ascertainable standard relating to the health, education, support or 
maintenance of the decedent is not deemed to be a general power of 
appointment and therefore not subject to inclusion in the power-
holder’s gross estate for estate tax purposes.\textsuperscript{555} Some practitioners take 
the position that, even though the withdrawal power is limited to a 
HEMS standard to avoid inclusion for estate tax purposes, it is none-
theless sufficient to trigger section 678(a)(1) for income tax purposes.

\textsuperscript{553} See chapter 3 for a discussion of the taxation of trusts.
\textsuperscript{554} The transfer tax treatment of such a power is consistent with the approach 
the Supreme Court has taken in its section 2036 jurisprudence. In 
\textit{O’Malley v. United States}, where the trust grantor served as trustee, the 
Court held that the trust’s assets should be included in the grantor’s gross 
estate under section 2036(a)(2) because of the grantor’s retained discre-
tion, as trustee, to determine which beneficiaries should receive income 
distributions. In reaching this conclusion, the Court did not find that the 
duty of a trustee to act in good faith constituted a sufficient constraint on 
the trustee to justify excluding the value of the trust’s assets from the 
grantor’s gross estate.
\textsuperscript{555} I.R.C. § 2041. I.R.C. § 2514(c)(1) provides for the same test for gift tax 
purposes.
This, however, does not appear to be a tenable position. In cases where the withdrawal power is subject to a HEMS standard, section 678(a)(1) cannot apply because the powerholder does not have unfettered access. In other words, if a state court has the authority to review the propriety of a distribution, section 678(a)(1) would appear to be inapplicable. If, on the other hand, the governing instrument eliminates the state court’s authority to approve or disapprove the distribution, then section 678(a)(1) would apply.

These conclusions are borne out in case law. In *Smither v. United States*, a case decided before the enactment of section 678 in 1954, the court held that a beneficiary would not be treated as the owner of the trust because her withdrawal right was limited to her “support, maintenance, comfort and enjoyment.” In *Smither*, the decedent devised his entire estate to his widow for her own support, maintenance, comfort and enjoyment and for the support, maintenance, education, comfort and the enjoyment of their children. The decedent’s will further provided that the executors had the power to expend such part of the income and to invade the corpus for the support, maintenance, comfort and pleasure of the widow and of the children “as in the discretion of my said executors may appear to be proper or desirable.” The decedent’s two brothers and his widow were appointed as executors. Some years later, the two brothers died and the widow remained as the sole executor. The IRS asserted that, in the years in question during which the widow was the sole executor, she had unlimited discretion to expend all or any part of the income for her own purposes and, therefore, should be treated as the owner of the income and be liable for the tax thereon. The U.S. District Court rejected the Service’s argument and held that the widow’s withdrawal power was not unfettered but rather restricted by the terms of the will. The widow’s power was subject to a “legal obligation,” namely her power to withdrawal was limited to what was “necessary for her support, maintenance, comfort and enjoyment, with a similar right in favor of the children.” This standard, the court explained, was “sufficiently clear and definite to be both understandable and enforceable.”

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557. I.R.C. § 678 is the statutory adoption of Treasury Regulations that were promulgated under the Internal Revenue Code of 1939.
558. Smither, supra note 556.
559. Id.
560. Id. at 772–73.
561. Id. at 773.
562. Id. at 774.
563. Id.
that the needs of maintaining the family in the station in life to which it had become accustomed should be met," 564 and the trust, and not the widow, was the proper taxpayer with respect to the trust income. By holding that the widow did not have unfettered control over the trust assets and that her power was subject to a legal obligation, the Smither Court indicated that it had the authority and indeed exercised that authority to review the propriety of distributions based on the HEMS standard as expressed in the decedent’s Will. It is, therefore, reasonable that section 678(a)(1) should not apply in this case.

The U.S. Courts of Appeal for the Ninth and Third Circuits reached similar decisions in United States v. De Bonchamps 565 and Funk v. Commissioner, 566 respectively. De Bonchamps was a consolidation of three cases where the IRS contended that all three life tenants were taxable as the owners of income. In all three cases, the taxpayers’ powers to withdraw were subject to their “needs, maintenance and comfort.” 567 The U.S. Court of Appeals for the Ninth Circuit ruled that the powers held by each of the taxpayers were “expressly limited to her needs, maintenance and comfort” and that, therefore, she did not have unlimited power to take the corpus for herself. 568 As a result, the taxpayers were not taxable on income.

Similarly, in Funk, the U.S. Court of Appeals for the Third Circuit focused on the word “needs” to bar income taxation to the beneficiary. In that case, the taxpayer had the power to make distribution to herself subject to her “needs, of which she shall be the sole judge.” 569 The U.S. Tax Court seemed to have ignored the standard imposed in the governing instrument and held that the taxpayer should be taxable on the trust income because she had absolute control over the trust’s income under the terms of the trust instrument. 570 The Court of Appeals reversed the Tax Court and ruled that the taxpayer was not the owner of the trust because her power was limited by the word “needs” in the trust instrument. The Court of Appeals explained that, although the word “needs” cannot be defined precisely, it nevertheless established a “standard effectively distinguishing this case from, and taking it out of the rule, of the Mallinckrodt . . . decision.” 571

564. Id.
565. United States v. De Bonchamps, 278 F.2d 127 (9th Cir. 1960).
567. De Bonchamps, 278 F.2d at 128.
568. Id. at 130.
569. Funk, 185 F.2d at 128.
570. Id. For discussion of this point in the Tax Court decision, see 14 T.C. at 213.
571. Id. at 131.
Court of Appeals further explained that the word “needs” has been construed by the state court to mean what is reasonably necessary to maintain a beneficiary’s station in life and it, therefore, “confined the trustee to limits objectively determinable.”

The effect of an ascertainable standard on the applicability of section 678(a) is not beyond debate. There are at least two cases and one private letter ruling that seem to support a contrary position. However, upon closer examination of these cases and private letter ruling, they seem to be distinguishable and cannot be said to offer contrary authority. The first of these cases is Koffman v. United States where the decedent created a trust for the benefit of his widow to be used by her for her “personal support and maintenance, the reasonableness thereof to be determined by her” (emphasis added). The U.S. Court of Appeals for the Sixth Circuit ruled the widow should be taxable on the trust income because she had unfettered right to determine the reasonableness of her withdrawals for her support and that her power was not subject to any limitation. At first blush, it seems that section 678(a) applies even if the beneficiary’s withdrawal right is limited to her support and maintenance. However, a closer examination of the decision indicates that the key language in Koffman, causing the section to be triggered, may not have been the “support and maintenance” standard itself but rather the manner in which the standard was determined to have

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572. Id.
573. It should be noted that Rev. Rul. 81-6, 1981-1 C.B. 385 is not inconsistent with the notion that section 678 can only apply where there is unrestricted or unfettered access to the trust’s assets. In the ruling, the Service ruled that a minor beneficiary of a trust is treated as the owner of any portion of the trust with respect to which the minor has a power to vest the corpus or income in himself, despite the fact that no guardian has been appointed for the minor and the minor does not have the legal capacity to exercise such power. The Service explained that “[f]or purposes of Section § 678 it is the existence of a power rather than the capacity to exercise such a power that determines whether a person other than the grantor shall be treated as the owner of any part of a trust.” The ruling relied on Trust No. 3 v. Comm’r, 285 F.2d 102 [7th Cir. 1960], where the U.S. Court of Appeals for the Seventh Circuit held that minor beneficiaries with a power to terminate a trust and to take possession of the trust property have a vested present right to use all or any part of the trust property upon demand despite the fact that no guardians have been appointed. The Service acknowledged the Court of Appeals’ reasoning that the appointment of a guardian is a routine step that should have no bearing upon the fundamental question of the legal right of the beneficiaries to terminate the trust.
574. Koffman v. United States, 300 F.2d 176 [6th Cir. 1962].
575. Id. at 176.
576. Id. at 177.
been met. The words “reasonableness thereof to be determined by her” could be interpreted to have granted the beneficiary the subjective right to determine whether the standard has been met. If the reasonableness of whether the standard has been met is to be determined solely by the beneficiary and cannot be questioned or enforced by another party, then the beneficiary essentially has unfettered control over the trust assets. 577 This is different from Smither, De Bonchamps and Funk discussed above, because unlike the governing instruments in those cases, the governing instrument in Koffman provided that the propriety of the distribution was to be judged solely by the beneficiary, essentially eliminating a state court’s authority to review the propriety of the distribution. In Smither, De Bonchamps and Funk, the courts made clear that the standard in those cases was one that is “objectively determinable”578 and “understandable and enforceable”579 by the courts. In contrast, the court in Koffman could not objectively determine or enforce the standard set forth by the decedent in the governing instrument.

The second case is Townsend v. Commissioner, 580 in which the U.S. Tax Court held that the beneficiary widow was taxable on the amount of income deemed to be necessary for her support as determined by the state court. The case began as a contested proceeding in the state court involving the accounting of the trustees of a testamentary trust. The decedent’s will provided that the income of the testamentary trust was to be payable to the decedent’s widow as “she deems necessary for her own support and for the maintenance, education and support of [the decedent’s] children.”581 The state court had previously determined that the widow was entitled to $30,000 per year from the trust income for her maintenance and support. 582 The Tax Court relied on this determination and held that the widow was taxable on this $30,000 of income. The Tax Court’s holding that the beneficiary widow should be taxed as the owner of the $30,000 of the trust income does not appear to be based on the support and maintenance standard in the governing instrument but rather on the state court decree that $30,000 was the amount the widow was entitled to receive under such standard. Since a state court had determined what

577. Cf. Matter of Woollard, 295 N.Y. 390 (1946) (ruling that a will that provided the decedent’s widow with the right to income and principal of the trust, as the widow shall deem necessary for her maintenance, comfort or well being is a power granted to the widow that may not be questioned by anyone).

578. Funk, 185 F.2d at 131.


581. Id. at 1381.

582. Id. at 1384.
amount was payable to the widow subject to the standard, then the
widow had unfettered right and control over that amount and should
be taxable on that income. In the absence of any state court decree, it is
unclear whether the standard would been met and whether the widow
would be entitled to any income from the trust. It is also important to
note that Townsend was decided before the U.S. Supreme Court’s
decision in Commissioner v. Bosch, and it is doubtful that a
subsequent court would follow a lower state court decision in its
determination of a federal income tax issue. Lastly, Townsend was
decided by the Tax Court in 1945, just a few years before Funk (where
the Tax Court held that a beneficiary withdrawal power subject to a
“needs” standard is not taxable to the beneficiary), yet Funk did not
mention or cite Townsend. Therefore, it seems likely that the Townsend
holding is limited to its facts and stands only for the proposition that, if
the beneficiary’s withdrawal right is subject to a standard and a state
court has issued a decree (and thus exercised authority to review the
propriety of distributions) granting the beneficiary the right to withdraw
a certain amount based on that standard, then that amount will be
taxable to the beneficiary under section 678(a).

A private letter ruling is another authority potentially contrary to
the proposition that an ascertainable standard limits the applicability
of section 678(a). In this ruling, the IRS ruled that a beneficiary’s
power to invade corpus for her “support, welfare and maintenance”
would be taxable under section 678(a). However, “welfare” is not an
ascertainable standard and therefore is not subject to review by a
state court. In addition, this private letter ruling serves only as an
indicator of what the Service’s position was at the time the ruling was
issued. It has no precedential value.

The authorities seem to suggest that there is indeed no space
between section 678(a)(1) and section 2041 (or section 2514). There-
fore, where a goal is to avoid estate tax under section 2041 (or taxable
gift tax status under section 2514), imposing a HEMS standard on a

583. Comm’r v. Bosch, 387 U.S. 456 (1967) (ruling that only the decree of a
state’s highest court would be binding for federal tax purposes). Cf. Rev.
Rul. 73-142, 1973-1 C.B. 405 (IRS is bound if the court decree is entered
before taxing event).

neither a private letter ruling nor a national office technical advice
memorandum may be cited or used as precedent.

585. Rev. Rul. 77-60, 1977-1 C.B. 282 (“A power to use property for the comfort,
welfare or happiness of the holder of the power is not limited by [an
ascertainable] standard”) (emphasis added).

586. Nevertheless, a private letter ruling may be used, in some cases, to meet a
standard that may permit a taxpayer to avoid certain penalties. See, e.g.,
Treas. Reg. § 1.6662-4(d).
trust beneficiary’s power of withdrawal will likely block grantor trust treatment under section 678(a)(1) with respect to the holder of the power of withdrawal.\textsuperscript{587} It would seem that consistent treatment should be applied to both the taxpayer during his or her lifetime for income tax purposes and his or her estate after his or her death for estate tax purposes (or to the taxpayer during his or her lifetime for gift tax purposes), although estate and income tax provisions, unlike gift and estate tax provisions, are not in pari materia.\textsuperscript{588}

Indeed, a taxpayer probably should be cautious in taking the position that section 678(a) applies, even if his or her withdrawal power is limited by an ascertainable standard, to make the trust a grantor trust with respect to himself or herself for income tax purposes. By taking that position, the taxpayer is essentially representing to the Service that his or her power to withdrawal is an unfettered one and that he or she has absolute control over the trust. If the taxpayer’s withdrawal right were for income tax purposes considered not limited by an ascertainable standard, then would not that withdrawal right, not so limited, constitute a general power of appointment? It might be difficult for the taxpayer’s estate successfully to take such inconsistent positions.

Tax return preparers and advisors also may be somewhat concerned about taking a position or providing advice that a trust is a grantor trust under section 678 with respect to a beneficiary if the beneficiary has a withdrawal right that is subject to an ascertainable standard. Under amended section 6694, a preparer may not take a position on a return and an advisor may not provide advice that the position may be taken unless there is “substantial authority” for the position or unless there is, in fact, a reasonable basis for the position and the position is specifically disclosed (generally by completing and attaching IRS Form 8275 to the return).\textsuperscript{589}

\textsuperscript{587.} Indeed, it appears that the only viable way to make a credit shelter trust a grantor trust with respect to the surviving spouse would be to “super-charge” it as discussed in Mitchell M. Gans, Jonathan G. Blattmachr & Diana S.C. Zeydel, \textit{Supercharged Credit Shelter Trusts}, 21 \textit{Prob. & Prop.} 52 (July–Aug. 2007).

\textsuperscript{588.} Merrill v. Fahs, 324 U.S. 308, 311 (1945) ("The gift tax was supplementary to the estate tax. The two are in pari materia and must be construed together"); Farid-Es-Sultaneh v. Comm’r, 160 F.2d 812 (2d Cir. 1947), 814 ("[I]ncome tax provisions are not to be construed as though they were in pari materia with either the estate tax law or the gift tax statutes").

\textsuperscript{589.} As a further alternative: the preparer includes the necessary disclosure form and the taxpayer removes it before filing it. See Mitchell M. Gans, Jonathan G. Blattmachr & Elisabeth Madden, \textit{Notable Changes Seen with 2008 Amendments to § 6694 and Treasury’s Final Tax Return Preparer Penalty Regulations}, 2009 \textit{Tax Mgmt. Est., Gifts & Tr.} J. 120.
§ 4:5.7 Section 678(b) and the Definition of “Income”

Section 678(b) provides that the rules under section 678(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.” Therefore, on the face of section 678(b), at least with respect to the income of a trust, if the grantor is also treated as the owner of the trust, then the third party who is otherwise treated as the owner of the trust under section 678(a) would not be treated as the owner of the trust for income tax purposes. In other words, the grantor trust rules with respect to the grantor “trump” the grantor trust rules with respect to the third party when determining who should be taxed as the owner of the trust. However, because section 678(b) addresses only “income,” it is unclear, at least on the face of section 678(b), what would happen if both the third party and the grantor are treated as the owners of the trust corpus under the various grantor trust rules.

The answer may be in the definition of “income.”590 The word “income” in section 678(b) seems to mean taxable income (as opposed to accounting income) which includes income in a tax sense allocated to trust accounting income and corpus. Treasury Regulation section 1.671-2(b) provides that, for purposes of Subpart E of Part I of Subchapter J of Chapter 1 (that is, the grantor trust rules)591 the word “income,” unless specifically limited, refers to income determined for tax purposes and not income for trust accounting purposes.

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590. Rev. Rul. 81-6, supra, states, in part, “Section 678(b) provides that Section 678(a) shall not apply if the grantor of the trust or a transferor (to whom Section 679 applies) is otherwise treated as the owner under the provisions of subpart E of Part I of subchapter J, other than Section 678" without limiting that statement to a case where the I.R.C. § 678 power is only over “income” as the statute provides. Although that could be claimed to be a concession by the IRS on the issue, such a claim likely would be unsuccessful as the statement is at most just a general description and is not critical to the holding of the ruling.

591. It is interesting to note that Treas. Reg. § 1.671-2(b] specifically provides that the definitions are to apply as “stated in the regulations under subpart E,” leaving open the possibility that the definitions may not apply as stated in the Code. Treas. Reg. § 1.671-2[b] states “[a]ccordingly, 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.” [emphasis added.] However, Treas. Reg. § 1.678[b]-1 essentially repeats the language of I.R.C. § 678[b]. Therefore, it is likely that the definitions under Treas. Reg. § 1.671-2[b] are to apply to both I.R.C. § 678[b] and Treas. Reg. § 1.678(b)-1.
The regulation further explains that, if it is intended that income is to refer to income for trust accounting purposes, it would use the phrase “ordinary income.” This suggests that, for purposes of section 678(b) (which is under subpart E of Part I of subchapter J of chapter 1), the word “income” refers to taxable income (as opposed to accounting income) and includes tax income allocated to both accounting income and corpus of the trust. Therefore, if both a third party and a grantor are deemed the owners of income allocated to trust accounting income or corpus, or both, then, under section 678(b), the grantor, and not the third party, would be treated as the owner of that portion of the trust.

Section 643(b) further lends support to this proposition. Section 643(b) provides that, for purposes of Subparts B, C and D of Part I of Subchapter J, the word “income” means the “amount of income of the estate or trust for the taxable year determined under the terms of the governing instrument and applicable local law.” The omission of a reference in section 643(b) to Subpart E, the grantor trust rules, seems to suggest that, if the word “income” is used in Subpart E, it would not have the meaning of accounting income. Indeed, it seems that the definition of income (that is, taxable income) under Treasury Regulation section 1.671-2(b) controls for the provisions under Subpart E, including section 678(b).

The Service’s position seems to be consistent with the above proposition. In several private letter rulings, the Service has consistently taken the position that, if a grantor is treated as the owner of a trust under the grantor trust rules, then the grantor will be treated as the owner of the trust despite the fact that a third party is treated as the owner of the trust corpus under section 678.

In a series of private letter rulings issued in 2007, the Service which seem to support the proposition that the grantor would be treated as the owner of a trust despite the fact that a third party otherwise would be treated as the owner of the trust corpus under section 678(a). The facts are similar in all of the rulings: the grantor created an

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592. Indeed, the Treasury Regulations under Subpart E of Part I of Subchapter J of Chapter 1 use the word “ordinary income” on twelve other occasions.


irrevocable trust and retained the power in a non-fiduciary capacity to acquire trust property and to substitute other property in its place which would make such trust a grantor trust under section 675[4][C]. The beneficiary of the trust was given a withdrawal power over an amount equal to the additions made to the trust each year not to exceed the applicable annual exclusion amount. The Service ruled that under such circumstances the grantors were treated as the owners of the trust under sections 675 and 678[b]. Similar to other private letter rulings, the Service did not provide a detailed analysis of how it reached this conclusion.595

A possible counterargument to the above may lie in the wording of section 678 itself. On two occasions, section 678 specifically refers to “corpus” and “income,” thus implying that there is a distinction between the two.596 Similar distinctions are also contained in other parts of the grantor trust provisions that apply to the trust’s grantor.597 If the definition of income under Treasury Regulation section 1.671-2[b] includes income allocated to both accounting income and corpus, then the use of the word “corpus” in two parts of section 678 would seem superfluous. This internal inconsistency in the statutory language is perhaps a legislative oversight as suggested by some commentators.598


596. I.R.C. § 678[a][1] provides that “[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 the income therefrom in himself.” (emphasis added). I.R.C. § 678[c] provides that “[s]ubsection [a] shall not apply to a power which enables such person, in the capacity of trustee or co-trustee, merely to apply the income of the trust to the support or maintenance of a person whom the holder of the power is obligated to support or maintain except to the extent that such income is so applied. In cases where the amounts so applied or distributed are paid out of corpus or out of other than income of the taxable year, such amounts shall be considered to be an amount paid or credited within the meaning of paragraph [2] of I.R.C. § 661[a] and shall be taxed to the holder of the power under I.R.C. § 662.” (emphasis added).

597. See, e.g., I.R.C. §§ 674[a], 674[b] [4]–[8], 674[c][2] and 674[d].

598. William R. Swindler et al., Beneficiary Withdrawal Powers in Grantors Trust—A Crumm(e)y Idea?, 34 EST. PLAN. 30, 33 (Oct. 2007) (“Treasury officials have informally indicated that they view the failure to include ‘corpus’ in I.R.C. § 678[b] as a legislative oversight”). See also Jonathan E. Gopman, Crummey, the Saga Continues, 25 BNA TAX MGMT. EST., GIFTS & TR. J. 194 [July 13, 2000] [citing other commentators who have suggested that the failure to include “corpus” in I.R.C. § 678[b] is a drafting oversight].
§ 4:5.8 When Section 678(b) Exception No Longer Applies

[A] Section 678(b) Releases and Lapses

Further, even though a section 678 power has been partially released or otherwise modified so that the person who held it can no longer vest the corpus or the income of the trust in himself or herself, the powerholder continues to be treated as the owner if, after the release or modification, the powerholder has retained such interest in or control over the trust as would subject a grantor of such a trust to treatment as the owner. For example, this would apply if the powerholder or the powerholder’s spouse were discretionary beneficiary of the trust after the power was released or modified.

Despite the lack of guidance from these revenue rulings, the Service has consistently ruled in multiple private letter rulings that a lapsed power is considered “partially released or otherwise modified” for purposes of section 678(a)(2), causing the third party to be treated as the owner of that portion of the trust for income tax purposes even after the lapse of the power.

Although the Service did not elaborate on the reasoning behind its position in the above private letter rulings cited in note 600, the proposition that a lapse should be treated as a partial release or modification under section 678(a)(2) appears to be logical. First, it would seem that, if section 678(a)(2) is only limited to a partial release or modification, then it would have very limited application as the lapse of a power to withdrawal is much more common than a release or modification. Second, if a lapse is not covered by section 678(a)(2), then similarly situated taxpayers would receive different tax treatments simply because one beneficiary took an action to partially release a power while the other failed to take such action and let the power lapse. In neither case is the beneficiary’s power

599. I.R.C. § 678(a)(2). See also Rev. Rul. 55-38, 1955-1 C.B. 389, as to the taxability of a beneficiary who has temporarily assigned trust income; cf. Rev. Rul. 77-436, 1977-2 C.B. 25 (beneficiary continues to be taxed on income from trust after assignment which is void under state law).


603. Id.
exercised; the only difference is in the mechanical means by which the beneficiary chooses not to exercise the power.

However, the terms “partially released” and “otherwise modified” do not appear to encompass the term “lapse.” In other words, a complete lapse does not seem to be a partial release or otherwise a modification of the power to withdraw. Moreover, the word “lapse” is expressly missing in the statute and the regulations. One may assume that Congress intentionally omitted the word for a reason. In fact, just a few years before the enactment of section 678, Congress enacted statutes that expressly treat a lapse as a release of a power of appointment for gift and estate tax purposes. Yet, Congress did not include the concept of lapse in section 678(a)(2).

The legislative history to the Internal Revenue Code of 1954 did not address the issue of “lapse.” The legislative history of section 678 is brief and only provides a very general description of the Section. It does not discuss section 678(a)(2) specifically or the concept of a lapse. Nonetheless, it is important to note that it does appear to contemplate broad application of the release/modification concept.

Another possible argument as to why a withdrawal power that has lapsed is not considered “partially released or otherwise modified” under section 678(a)(2) is that a lapse could be characterized as a complete release of a power and section 678(a)(2) only refers to a partial release of a power. Commentators have suggested that, perhaps, a lapse would be categorized under the “otherwise modified” language. Although a “lapse” implies that no action is taken by the powerholder and “modify,” in contrast, implies an action of some

604. For gift tax purposes, I.R.C. § 2514(e) provides that “[t]he lapse of a power of appointment created after October 21, 1942, during the life of the individual possessing the power shall be consider a release of such power.” Similarly for estate tax purposes, I.R.C. § 2041(b)(2) provides “[t]he lapse of power of appointment created after October 21, 1942, during the life of the individual possessing the power shall be considered a release of such power.”

605. See generally Blattmachr & Sembler, supra note 602, at 8.


607. See id. [indicating that “a person other than the grantor may be treated as the substantial owner . . . if he has modified the power [by release or otherwise]” . . .].

kind, the “otherwise modified” language could be viewed as a catch-all, intended to apply to any change to a power that would otherwise subject the third party to section 678(a).

If a lapse is a complete release and is, therefore, outside the application of section 678(a)(2), then similarly situated taxpayers would be treated differently depending on the manner in which a given taxpayer allows her withdrawal power to become no longer exercisable. A taxpayer who relinquishes or permits to lapse her withdrawal power on a yearly basis would be treated differently from a taxpayer who relinquishes or permits to lapse her entire withdrawal power, including the power to withdraw in future years. Substantively, the end result is the same but due to the difference in the way the relinquishment or lapse occurs, one taxpayer would not be treated as the owner of the trust for income tax purposes while the other one would.

Perhaps, a possible explanation is that a lapse is a partial release of the power if one considers the power as a whole over the entire term of the trust. On at least one occasion, the Service has made a distinction between a complete release and a partial release. In a 1979 private letter ruling, the grantor created a trust in which the beneficiary has a lifetime power to withdraw principal from the trust. The Service ruled that, if the beneficiary “completely released the power to vest corpus” in himself (as opposed to a partial release or modification), the beneficiary will not be the owner of the trust under section 678(a)(2). This ruling seems to suggest that, if a third party relinquishes her withdrawal power for all future years, then section 678(a)(2) would not apply, but, if the third party simply allows the power to lapse with respect to the property for one year, then section 678(a)(2) would continue to apply. This ruling may lend support to the argument that an annual lapse is a partial release within the meaning of section 678(a)(2). On the other hand, a complete lapse (as opposed to an annual one) is more difficult to view, as indicated above, as a partial release (or modification).

In addition, a review of the language used by the Service in all the private letter rulings cited in this section indicate that the Service has consistently held that a third party who has allowed a withdrawal power to lapse each year or after a number of days (as opposed to a

609. Blattmachr & Sembler, supra note 602.
611. Id.
complete lapse of the power to withdraw in future years] has either “released” or “partially released” the power.\footnote{Priv. Ltr. Rul. 200104005 (Jan. 29, 2001) [a lapse of a power to withdraw after the calendar year is considered “partially released”]; Priv. Ltr. Rul. 200011054 (Mar. 20, 2000) [a lapse of a power to withdraw after thirty days is considered “released”]; Priv. Ltr. Rul. 9504024 (Jan. 27, 1995) [a lapse of a power to withdraw after sixty days is considered “released”]. Under I.R.C. § 6110(k)(3), neither a National Office Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.} With the exception of this private letter ruling, it does not appear that the Service, at least in recent years, has made a distinction between a third party who has “released” or “partially released” a withdrawal power in the context of a lapse.

In any case, it is uncertain that a trust will remain a section 678 trust after a beneficiary’s withdrawal power lapses. As a consequence, it may not be wise to rely on its continuing section 678 status where loss of that status could cause adverse effects.\footnote{For example, the powerholder sells an appreciated asset to a section 678 trust for a note. No gain is recognized. See Rev. Rul. 85-13, \textit{supra}. However, if section 678 status ends before the note is paid and the powerholder dies, gain might occur. See Jonathan Blattmachr, M. Gans & Hugh Jacobson, \textit{Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor’s Death}, \textit{J. Tax’n} 149 (Sept. 2002).}

The application of section 678 after a power is released or lapses creates complex reporting issues when the power is over some portion but less than all of the trust. For example, the typical “five or five” power creates a pseudo-grantor trust for only 5% of the trust when the value of the trust exceeds $100,000 (so that 5% is larger than $5,000). Real complexity arises when the “five or five” power is non-cumulative, but is available annually. The Service takes the position that section 678 applies to an ever-increasing portion of the trust income. Private Letter Ruling 2000-22-035 sets the IRS position:

After each succeeding year in which [the powerholder] fails to exercise the five or five power, [the powerholder] will be treated as the owner of an increasing portion of the corpus of Trust 2. The annual increase of the portion of the corpus of Trust 2 of which [the powerholder] is treated as the owner is the product of the amount which [the powerholder] could withdraw multiplied by a fraction the numerator of which is the portion of trust corpus which [the powerholder] is not already treated as owning and the denominator of which is the total of trust corpus from which the withdrawal could be made.\footnote{Priv. Ltr. Rul. 200022035. Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.}
This means the powerholder will be deemed the grantor for an ever-increasing percentage of the trust, but the percentage will never reach 100%, not even in twenty years, unless the value of the trust is less than $100,000, so that $5,000 is the upper limit of the withdrawal power. Thus, in most instances, some of the trust income will be still subject to regular reporting rules.

[B] Section 678(b)—678 Grantor Trust Status After “True” Grantor Trust Status Ends

As discussed above, section 678(b) provides that, when the grantor is treated as the owner of a trust, then the third party who is otherwise treated as the owner of the trust under section 678(a) will not be treated as the owner of the trust. However, what happens when the grantor is no longer treated as the owner of the trust? Grantor trust status with respect to the grantor ends when the grantor dies or when a condition under which the grantor was deemed to be the owner of the trust no longer applies. In such case, will section 678(a) operate to cause the third party to be treated as the owner of the trust?

Neither the Code nor the Regulations addresses this issue. However, the Service adopted the above view in private letter rulings. Interestingly, the Service’s private letter position changed. In Private Letter Ruling 9321050 (Feb. 25, 1993). In this ruling, the Service reversed its prior position the holding relating to the ownership for federal income tax purpose of the trust upon the wife’s death. The Service did not provide any explanation of its reversal or any analysis of its new position. The Service simply ruled that, after the wife’s death, the husband will not be treated as the owner of the trust for income tax purposes. The Service did not clarify who, if anyone, would be the owner of the trust for income tax purposes. Presumably, because the wife is deceased and the husband is not the owner of the trust, the trust is no longer a grantor trust.

The Service’s reversal of its position would suggest that, if grantor trust status with respect to the grantor is “turned off,” then section 678(a) is no longer operative. In other words, if the third party has partially released or otherwise modified a power that would

615. If the value of the trust were a constant $75,000, for example, a $5,000 right of withdrawal would create a 100% section 678 grantor trust in fifteen years under the apparent IRS position.


617. It is also interesting to note that in the interim, the Service refused to rule on the income tax consequences of a similar trust upon the death of the grantor. Priv. Ltr. Rul. 9141027 (July 11, 1991). Under I.R.C. § 6110[k][3], neither a National Office Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.
have made the trust a grantor trust with respect to the third party under section 678(a)(2), the third party would not be deemed the owner of the trust during and after the time that the trust was a grantor trust with respect to the grantor. Although the ruling did not address the situation of a third party being treated as the owner under section 678(a)(1), it arguably suggests that, even in such a case, the trust would not be a grantor trust with respect to the third party after the grantor trust status with respect to the grantor has been “turned off.”

The income tax treatment under section 678 is unclear for the situation where the trust ceases to be a grantor trust with respect to the grantor. Without further guidance from the Service, it is difficult to understand the Service’s reason in revising its position in later private letter ruling. Taxpayers who find themselves in this situation may be well advised to seek a private letter ruling to clarify this issue.

§ 4:5.9 Section 678(c)—Support Exception

Another exception, contained in section 678(c), makes the entire section inapplicable to a power that enables a person as trustee “merely to apply the income of the trust to the support or maintenance of a person whom the holder of the power is obligated to support or maintain except to the extent that such income is so applied.”618 This parallels the similar provisions for income taxable to grantors under section 677. However, the possible implication of the above quotation is that a person is income taxable where he or she has a power to and does apply income to a dependent’s support (with, perhaps, a further implication of taxability where he or she must so apply it; for example, a trust for support of the grantor’s minor grandchildren with the beneficiaries’ mother or father as trustee).619 This might be a

618. The Senate Finance Committee Report for the 1954 Code adoption provides:

The bill, however, makes a specific exception to the effect that a power to apply the income for support of dependents is not to result in the trust income being taxable to such other person unless the income is actually applied for the support of dependents. S. REP. NO. 1622, supra note 532, at 4719.

619. For a contrary view, see Milton H. Stern, A Tax Trap for the Family Trustee, 33 TAXES 594 (1955). There may be a minimal requirement that the beneficiaries’ father have some connection, at least being the trustee, before he will be taxed. See generally Harry A. Flannery, The “Sprinkler Trust” and Its Inherent Federal Income Tax Problems: Fulfilling of Legal Support Obligations, 54 TAXES 438 (1976); Sydney C. Winton, Taxation of Nongrantors Under Trusts for Support of Their Dependents, 33 TAXES 804 (1955).
tightening of prior law.\textsuperscript{620} The 1954 Committee Reports describe the provision as a “liberalizing provision,”\textsuperscript{621} on the theory that under prior law the holder of the power would have been taxed even if the power had not been exercised. The regulations take the position that the holder of such a power is taxable except to the extent that the powerholder falls exactly within the exception.\textsuperscript{622} On the other hand, probably because of the controversy aroused by section 678(c), the regulations state that section 678(c) has no application to the taxability of income not subject to a power specified in the section, and that the taxability of such income is governed by other provisions.\textsuperscript{623}

The section 678(c) exception does not apply if the power is not held in a fiduciary capacity, that is, the powerholder is not trustee.\textsuperscript{624} Moreover, if the support payment is made from other than current income, that is from principal or accumulated income, sections 661(a)(2) and 662 are applicable instead.\textsuperscript{625}

Apart from this support situation, taxation of a person under section 678 seems avoidable because of the section’s requirement that the power be exercisable solely by the person who is to be taxed, so a jointly-held power is outside the reach of section 678.\textsuperscript{626} This

\begin{itemize}
\item \textsuperscript{620} See Stern v. Comm’r, 137 F.2d 43 (2d Cir. 1943); Welch v. Comm’r, 8 T.C. 1139 (1947) [point not raised]; Joseph v. Comm’r, 5 T.C. 1049 (1945). But cf. Allen v. Nunnally, 180 F.2d 318 (5th Cir. 1950).
\item \textsuperscript{621} H.R. REP. NO. 83-1337, at A212 (1954), as reprinted in 1954 U.S.C.C.A.N. 4017, 4089; S. REP. NO. 1622, supra note 532, at 5013; cf. Treas. Reg. § 20.2041-1[c] (donee holds general power of appointment if exercisable (whether or not exercised for post-1942 powers) in discharge of donee’s legal obligations).
\item \textsuperscript{622} Treas. Reg. §§ 1.678[a]-1[b], 1.678(c)-1[b]; see also Treas. Reg. § 1.662[a]-4. The Code exception is silent about a power of the specified kind if it is to apply to corpus rather than income. The regulations follow the language of the Code, except that there is one broader sentence in Treas. Reg. § 1.678[a]-1[b].
\item \textsuperscript{623} Treas. Reg. § 1.678[c]-1[c]. This does not fully remove the implication, particularly in view of the cross-reference to Treas. Reg. § 1.662[a]-4. See also Rev. Rul. 59-357, 59-2 C.B. 212 [discussing Uniform Gifts to Minors Act, and indicating that income is taxable to any person to the extent used towards a support obligation of such person]. For a general discussion of income taxation of Uniform Gift to Minors Act accounts, see section 3:7.1.
\item \textsuperscript{624} Treas. Reg. § 1.678[c]-1[b]. Cf. I.R.C. § 674(c) [exception for powers to sprinkle income held by independent trustees].
\item \textsuperscript{625} I.R.C. § 678[c], last sentence.
\item \textsuperscript{626} See Treas. Reg. § 1.678[a]-1[b]; Rev. Rul. 67-268, 1967-2 C.B. 226 [beneficiary was cotrustee with husband, who as managing trustee had power to distribute income to her: not taxable to either]; cf. Spies v. United States, 84 F. Supp. 769 (N.D. Iowa 1949), aff’d, 180 F.2d 336 (8th Cir. 1950) [before the effective date of the Mallinckrodt regulations]. T.D. 5488, 1946-1 C.B. 19, 23; Cochran v. United States, 62 F. Supp. 872 (Cl. Ct. 1945).
\end{itemize}
apparently is true even if the other co-powerholder is subordinate to the powerholder’s wishes or the joint powerholders are related to each other.

**§ 4:5.10 Section 678 and Spouses**

Section 678 does not seem to apply even if the power is held by one spouse to make payments to the other spouse. This result does not appear to be altered by the 1986 enactment of section 672(e). Section 672(e) attributes to a grantor powers or interests that are held by the grantor’s spouse, but a person taxed under section 678 is not a grantor. Section 678 provides: “A person other than the grantor shall be treated as the owner. . . .” If funds are actually paid to the spouse, section 678(b) might apply. Moreover, section 672(e) attributes powers and interests held by the grantor’s spouse to the grantor for grantor trust purposes; it does not attribute the grantor’s powers to the spouse. Thus, a trust would not be described in section 678 with respect to the spouse; rather, to the extent the grantor could transfer the trust property to his or her spouse, it might be a grantor trust with respect to the grantor under sections 674, 676 and 677. Similarly, to the extent the grantor’s spouse could direct the trust property to the grantor, it would be a grantor trust with respect to the grantor, under at least those same sections.

**§ 4:6 Switching or Toggling Grantor Trust Status On and Off**

**§ 4:6.1 Generally**

Although grantor trust status generally may be advantageous, sometimes it may be desirable not to be a grantor trust. In other situations, being able to switch back and forth between grantor and nongrantor trust status may be desirable. For example, a grantor may be concerned with being liable for what potentially could be huge amounts of income and capital gains taxes on trust income indefinitely into the future. Being able to “turn off” the grantor trust status when the grantor no longer wishes to pay income taxes on the trust income can be an important factor in the grantor being willing to create a grantor trust initially. Similarly, it may be desirable to switch status if the grantor moves from a low or no income tax state (for example, Wyoming) to a high or higher income tax state (for example,
California] where the trust would not be subject to state income taxes because of its “domicile.”\textsuperscript{630} Moreover, it may be appropriate to switch grantor trust status “on” when the grantor has a capital gain or loss and it is expected that the trust will have the “reverse” gain or loss. Thus, planning flexibility, for whatever reason, is increased if grantor trust status may be toggled on or off.\textsuperscript{631}

\section*{§ 4:6.2 Turning Off Grantor Trust Status}

Sometimes, turning off grantor trust status is as easy as releasing the power or beneficial interest that caused grantor trust status.\textsuperscript{632} In other circumstances, it is accomplished by changing trustees to those who may have the grantor-trust sensitive power without causing grantor trust status.\textsuperscript{633} Some grantor trust triggers seem to allow toggling by their very nature, such as actual borrowing of trust assets by the grantor under section 675(3).\textsuperscript{634} However, in a few circumstances, converting the trust to nongrantor status may not be possible.\textsuperscript{635} The ability to convert will depend on why the trust is a grantor trust.

Maximum flexibility of grantor trust planning involves restoring grantor trust status to a nongrantor trust that once was a grantor trust or making a trust a grantor trust that has never been one. However, several traps must be avoided. For example, when the grantor or the grantor’s spouse has the authority to relinquish the power that causes grantor trust status, only a third party should be given the authority to reinstitute that power, that is, to toggle back “on” the grantor trust status.\textsuperscript{636} If the grantor or the grantor’s spouse has the right to

\begin{itemize}
\item \textsuperscript{630} It should be noted that different statutes use different criteria to impose their income taxes on trusts that are not grantor trusts. \textit{Cf.} New York Tax Law § 605, \textit{with} California. CAL. REV. & TAX. CODE §§ 17742(a) \textit{et seq}.
\item \textsuperscript{631} For an excellent discussion of these issues, see Videotape: Ellen L. van Hoften, Planning With Intentionally Defective Grantor Trusts \textit{[A.L.I.-A.B.A. Video Law Review Mar. 26, 1997]. \textit{See also} Howard M. Zaritsky, \textit{Toggling Made Easy—Modifying a Trust to Create a Grantor Trust}, 36 EST. PLAN. 48 \textit{[2009]}.}
\item \textsuperscript{632} \textit{E.g.}, a section 675[4]|(C) power. \textit{See supra} section 4:5.3[F].
\item \textsuperscript{633} \textit{E.g.}, a section 674[c] power. \textit{See supra} section 4:5.2[B].
\item \textsuperscript{634} \textit{See} I.R.C. § 675[3]. Whether grantor trust status exists for a particular year depends on whether the grantor has actually borrowed trust assets during the year. \textit{See supra} section 4:5.3[C].
\item \textsuperscript{635} \textit{E.g.}, a section 673 power. \textit{See supra} section 4:3.
\item \textsuperscript{636} The grantor’s retention of the right to toggle grantor trust status arguably might, in some cases, constitute a section 2036[a]|2] estate inclusion power or the gift to the trust might conceivably be an incomplete gift. It might be argued that if one person has the power but has released it, and another may reinstate the power, that in fact the power still exists because
\end{itemize}
relinquish a power that causes grantor trust status but has the right to reacquire that same power, the relinquishment likely would not be given effect. The regulations provide specifically that if the grantor has a power sufficiently broad to permit an amendment causing the grantor to be treated as the owner of the portion of the trust under section 675, the grantor will be treated as the owner of the portion from the trust’s inception.\footnote{637}

Many of the grantor trust powers must be exercisable without the consent of any adverse party to result in grantor trust status.\footnote{638} However, the power to eliminate or reinstate a grantor trust power could be held by either an adverse party or a nonadverse party. Having the status of an adverse or a nonadverse party is important for the person who holds the power that may make a trust a grantor trust, but that distinction has no relevance for a person who has the authority to eliminate or reinstate that power. Thus, a beneficiary might be given the power to toggle on or off grantor trust status.

Either the trustee or the grantor could be given the authority to relinquish the trustee’s power to make loans to the grantor without requiring adequate security.\footnote{639} To toggle on grantor trust status, someone other than the grantor could be given the power to reinstate the power to loan without adequate security.\footnote{640} If desirable, one person, who is not the grantor, or related or subordinate to the grantor—to put the grantor in the best position to argue that the power to lend without adequate security does not cause estate inclusion—could be given the power to both terminate the lending power in one taxable year and reinstate the lending power in a subsequent taxable year. However, to provide additional checks and balances, different persons could be given the authority to terminate and reinstate the power to lend without adequate security.

A person who is given the authority to add one or more persons (other than later-born or later-adopted) as beneficiaries could also be given the authority to relinquish the right to add beneficiaries and thereby turn off grantor trust status when the authority to add to the

\footnote{637. See Treas. Reg. § 1.675-1(a).} \footnote{638. See supra section 4:5.2.} \footnote{639. See supra section 4:5.3[B].} \footnote{640. See the caveat given supra note 636.}
class was what alone caused grantor trust status. If a potential toggle is desired, another party should be given the authority to reinstitute the power to add beneficiaries. (If the original party has the power to reinstitute the authority to add beneficiaries, he or she would be treated as never having relinquished the authority to add beneficiaries.) Even if different persons are used, some commentators are concerned that the Service may view the two persons together as still holding the power. To ameliorate that concern, the instrument might provide that if the power to add beneficiaries is relinquished in any particular year, it could only be reinstated in a subsequent taxable year. In that case, if the power is ever relinquished, the trust would seem to be a nongrantor trust for the balance of that year.

When grantor trust status is achieved under section 674(c) using related or subordinate trustees with the authority to make discretionary distributions not covered by a reasonably external standard, a third party could be given the power to remove and replace the trustees. This power could be exercised in a manner that would cause no more than one-half of the trustees to be related or subordinate parties if grantor trust status is not desired, or reversed to cause more than half of the co-trustees to be related or subordinate parties if grantor trust status is desired. The grantor should not hold the power to remove and replace successor trustees, unless the successor must be someone who is not a related or subordinate party in order to meet the “safe harbor” provided in estate tax Revenue Ruling 95-58.

Using this mechanism may be mechanically cumbersome unless the grantor is willing to give the party who has the removal power (or perhaps another party) a power to replace the removed trustee rather than a power to add additional trustees. A second potential problem exists if the grantor wishes to include a list of specified successor trustees in the event that a trustee fails to serve, as in some circumstances it could be difficult to determine at the time that the trust is

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641. See, e.g., Ronald D. Aucutt, Installment Sales to Grantor Trusts, in A.L.I.-A.B.A. Course of Study: Planning Techniques for Large Estates 1539, 1556 (2007) (“The ability to reacquire the power may be viewed as tantamount to having the power itself. Even if the power is held by someone other than the trustee (such as a ‘protector’), that probably only means that the trustee and the protector together still have the power.”), quoted in Akers & Zeydel, supra note 369, at R-60.

642. The trustees must be subservient to the wishes of the grantor for their positions to cause grantor trust status. That is a factual issue that cannot be determined with complete certainty. If their position does cause grantor trust status, eliminating them as trustees, or reducing the number of them so that no more than half of them are trustees, will foreclose grantor trust status for that reason.

agreement was prepared whether or not the next successor would be a related or subordinate party.

A grantor’s spouse could have the power that results in grantor trust status power directly and could be authorized to relinquish the grantor trust power.\(^{644}\) This method might be helpful in some circumstances, because powers that could not be held by the grantor without risking estate inclusion could generally be held by the grantor’s spouse. However, beware of section 672(e), which indicates that any powers held by the spouse will be deemed to be held by the grantor for income tax purposes.\(^{645}\) Thus, if the grantor’s spouse is given the power to relinquish and to reacquire the grantor trust power, the grantor might be treated as holding the power to reacquire the grantor trust power, and grantor trust status arguably would not be cut off by relinquishment of the power causing grantor trust status.

The powers used to result in grantor trust status may be very “significant” powers. For example, the power to add beneficiaries might permit the trustee to alter who might receive the income or principal distributed by a grantor trust. Giving different persons the authority to exercise those powers, to relinquish them, or to reinstate them, may provide useful checks and balances against the ability to misuse those powers. A private letter ruling\(^{646}\) illustrates the technique: An unrelated trustee could add a qualified charity (which would cause grantor trust status). However, the designation of a charity as an additional beneficiary could not be made without the approval of the taxpayer’s spouse.\(^{647}\) Other parties—a majority of the taxpayer’s adult descendants—were given the power to cut off grantor trust status by terminating the trustee’s authority to designate additional beneficiaries.\(^{648}\)

The release of a grantor trust power should indicate specifically whether or not it is binding on successor trustees or successor persons holding the power. Maximum flexibility could be retained by not

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\(^{644}\) For example, the exception contained in section 674(c) to the general grantor trust rule of section 674[a] does not apply if the grantor’s spouse is the trustee.

\(^{645}\) See I.R.C. § 672(e).

\(^{646}\) See Priv. Ltr. Rul. 90-10-065 [Mar. 9, 1990]. The trust instrument in this letter ruling contains an intricate checks and balances system. Under I.R.C. § 6110[k][3], neither a National Office Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

\(^{647}\) If the spouse were not living, the approval of the taxpayer’s sibling was required. See id. Under I.R.C. § 6110[k][3], neither a National Office Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

\(^{648}\) See id. Under I.R.C. § 6110[k][3], neither a National Office Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.
having the release binding on all successors, so that a third party could reinstate the power. In that case, the trust document, perhaps, should provide that the reinstatement power could only be exercised in the year after taxable year of the reinstatement, to help clarify that the trust is not a grantor trust in the year in which the relevant power is relinquished.

The person being given the authority to remove and replace trustees should be protected by broad exculpatory provisions so that decisions regarding the grantor trust tax status of the trust will not be challenged by the grantor or by the beneficiaries or result in liability for the person holding the power for exercising or not exercising it.

Sometimes an irrevocable trust may be modified by either a court or by decanting. Thus, it may be possible to change the terms of a grantor trust to remove the grantor trust power.

I.R.S. Notice 2007-73 identifies two rather complicated series of transactions involving toggling of grantor trusts. In each, a grantor trust would be formed that creates a unitrust interest and a non-contingent remainder interest for the grantor. The non-contingent remainder interest causes grantor trust status. The goal of the scenarios is either to generate a tax loss to the grantor that is not a real economic loss or to avoid the recognition of gain. The Notice states “transactions that are the same as, or substantially similar to, the transactions described in this notice are identified as transactions of interest” that require disclosure. The complicated transactions described in the two scenarios do not appear to be “garden variety” grantor trusts (even though grantor trust status has been toggled). The Notice states explicitly that merely terminating grantor trust status does not invoke the Notice: “The transactions in this notice, as described above, do not include the situation where a trust’s grantor trust status is terminated, unless there is also a subsequent toggling back to the trust’s original status for income tax purposes.”

At first blush, the quoted language seems to suggest that toggling grantor trust status off and then back on might be a “transaction of interest.” However, the quote more likely means that if the described

650. 2007-36 C.B. 545.
651. See id.
652. See id.
653. See id.
654. Id.
655. Id. See generally JONATHAN G. BLATTMACHR & MITCHELL M. GANS, CIRCULAR 230 DESKBOOK § 3.2.1[A][6] (PLI 2009) (discussing “transactions of interest”).

underlying *transaction* is toggled off, but not back on, it is not a “transaction of interest.” If the Service means otherwise, the Notice is not delivering the message.

Despite the apparent technical ability to toggle grantor status off and back on, some planners are reluctant to exercise the “toggle back on” step for fear that the process appears artificial and might seem abusive of the grantor trust system. While the Notice does not indicate that toggling back on grantor trust status is necessarily a “transaction of interest,” the Notice does provide some level of support for those who are reluctant to exercise the “toggle back on” step.

§ 4:6.3 Turning On Grantor Trust Status

When a lifetime trust is not originally a grantor trust, it may be possible to convert it to a grantor trust. One way might involve changing the trustees. For example, if the trust allows distributions without a reasonably definite external standard, changing trustees so that more than half of the trustees are related or subordinate parties will result in grantor trust status under sections 674(a) and 674(c) if those trustees are, in fact, subservient to the wishes of the grantor or if the grantor’s spouse is the trustee.656 A domestic trust may be converted into a section 679 foreign trust by adding a foreign trustee or co-trustee or replacing the trustee with a foreign trustee.657 Actual borrowing of assets from the trust by the grantor without giving adequate security, but adequate interest, will make a trust a grantor trust under section 675(3) if loans are permitted under the terms of the trust agreement and the loan is not repaid before the beginning of the tax year.658 In addition, grantor trust status might be achieved by paying the assets of the nongrantor trust over to a grantor trust pursuant to a “decanting” power or statute.659

An irrevocable trust may be modified by either a court or by decanting.660 Thus, it may be possible to change the terms of a nongrantor trust to add an appropriate grantor trust power.

When a nongrantor trust is converted into a grantor trust, the trust usually does not become a grantor trust for the entire year, but only for

656. *See supra* section 4:5.2[B].
657. *See supra* notes 505–27 and accompanying text.
658. *See supra* section 4:5.3[C].
659. *See, e.g.*, N.Y. EST. POWERS & TRUSTS LAW § 10-6.6 (McKinney 2009); ALASKA STAT. § 13.36.157 (2009).
660. *See* Burford & Char, *supra* note 649. *See also* Diana S.C. Zeydel & Jonathan G. Blattmachr, *Tax Effects of Decanting—Obtaining and Preserving the Benefits*, 111 J. TAX’n 288 [Nov. 2009]. The IRS ruled that the modification of a trust “in accordance with State law” by the execution of a modification by the grantor and all beneficiaries of the trust to add a nonfiduciary substitution power would convert a
a fraction of the year. However, for some triggers, such as borrowing from the trust during the tax year, the trust will become a grantor trust for the entire year.661

§ 4:6.4 Tax Consequences of Toggling On and Off Grantor Trust Status

A change in the grantor trust status of a trust may cause unexpected income tax consequences. Issues involve pass-through entities, estimated payments, suspended losses and deductions, basis, and carryovers.662 In Chief Counsel Advisory 2009-23-024, the Service concluded that “[t]he conversion of a nongrantor trust to a grantor trust is not a transfer for income tax purposes . . . that requires recognition of gain to the owner.”663 For a more detailed discussion see section 4:7, infra.

§ 4:7 The Termination of Grantor Trust Status—Tax Consequences664

It is the position of the Service that the existence of a wholly grantor trust is ignored for income tax purposes.665 Such a trust does not appear to be ignored for estate, gift, and generation-skipping transfer tax purposes.666 In fact, it seems that the use of a grantor trust may help

661. See supra notes 407–10 and accompanying text.
662. For an excellent review of potential income tax effects of toggling grantor trust status, see Laura H. Peebles, Mysteries of the Blinking Trust, TR. & EST., Sept. 2008, at 16. For an extensive discussion of the issues concerning terminating grantor status, see section 4:8.
664. This section is derived, in part, from Jonathan G. Blattmachr et al., Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor’s Death, 97 J. TAX’N 149 [2002].

(Blattmachr, Rel. #3, 10/10) 4–133
to achieve certain estate planning results. Grantor trusts are used affirmatively to enhance three common estate planning strategies:

1. to permit the income earned by the trust to grow free of income tax, because the tax burden is imposed upon the grantor, and the payment of the income tax is not a gift;  

2. to permit assets to be sold by the grantor to the trust for their fair market value without the imposition of gift tax or income tax even if the assets sold are appreciated, and  

3. to permit the purchase or exchange by the grantor shortly before death, without the imposition of income tax, of low-basis assets in exchange for higher-basis assets, such as cash, so the low-basis assets will be included in the grantor’s gross estate at death and have a basis, once the grantor dies, equal to their estate tax values.

Even if the grantor receives a note in exchange for the transfer of trust assets to the trust, he or she incurs neither income nor gift tax liability at the time of the sale: for gift tax purposes, because the individual taxpayer receives full consideration, the transaction is viewed as a sale and, therefore, is not subject to gift tax; for income tax purposes, on the other hand, because the grantor of the trust is deemed to own all of the assets in the trust, no sale is deemed to occur and, therefore, no part of the gain inherent in the asset becomes taxable by reason of the sale from the grantor to the trust.


669. An individual makes a gift only to the extent the taxpayer receives back consideration in money or money’s worth that is less than the value of what the taxpayer transferred. I.R.C. § 2512(b).

670. I.R.C. § 1014(a).

671. See I.R.C. § 2512.


673. See id. Also, because the grantor is deemed to continue owning all of the assets in the trust, the provisions in the note calling for payment of interest (inserted to avoid imputed-interest taxable gifts) do not result in income or deduction to the grantor or to the trustee.
§ 4:7.1 Termination of Grantor Trust Status During the Grantor’s Lifetime

[A] Third-Party Indebtedness

If, during the individual taxpayer’s lifetime, a trust ceases to be a grantor trust, the income tax consequences appear to be certain: the grantor is deemed for federal income tax purposes to have transferred the assets in the trust at that time. For example, if there is indebtedness on the assets held by the trust, the grantor will be deemed to have sold them. If liabilities owed to a third party secured by the assets are in excess of the basis of the assets and the grantor does not remain liable for such debt, the grantor will realize gain.

By a parity of logic, the trust takes as its basis in the assets the amount of such indebtedness.

[B] Grantor Indebtedness

Although some commentators have concluded that gain similarly will be recognized where liabilities secured by the assets are in excess of the basis of the assets and the grantor does not remain liable for such debt, even where the indebtedness is owed not to a third party but to the grantor, no authority so holds and the conclusion may not be correct. Under the official position of the Service, there never is any debt for federal income tax purposes during the period that the trust is a grantor trust.

Thus, although the property is treated as though it was transferred from the grantor to the trust at the time grantor trust status ends, the property was not treated at that time as being subject to indebtedness. As a result, authority that holds that the grantor is treated as though the grantor transferred a debt-laden asset when the debt that was recognized as being in existence, for federal income tax

674. See Treas. Reg. § 1.1001-2, Example 5; see also Rev. Rul. 77-402, 1977-2 C.B. 222 (containing the same analysis that is now embodied in that example). See also I.R.S. Chief Couns. Adv. 200923024 (conversion of nongrantor trust to grantor trust not a taxable event at least where debt on trust’s assets did not exceed income tax basis). Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

675. The trustee’s basis is equal to cost, as it would be in the case of any purchase under section 1012. See Treas. Reg. § 1.1015-4[a].


purposes, before grantor trust status terminated is inapposite. Never-
theless, where the debt owed on the property is recourse to the trust (at
least once grantor trust status terminates during the grantor’s lifetime),
it seems the grantor is treated as though he or she sold the property
to the trust in exchange for the amount of the debt [although
timing of recognition of income by the grantor may not be immedi-
ate]. The result may well be the same where the debt is non-resource
to the trust [that is, the assets are treated as transferred to the non-
grantor trust subject to the indebtedness], but there is no authority
discusses the issue; it may be that income is recognized only as
the debt is paid off, as section 453 installment reporting is automatic
unless elected out of or the asset sold does not qualify for an
installment sale.

§ 4:7.2 Termination of Grantor Trust Status by Reason of the Grantor’s Death

Where, however, the trust ceases to be a grantor trust as a result of
the grantor’s death, well-developed tax principles seem to support with
reasonable certainty that neither the grantor nor his or her estate
should be viewed as having made a sale of the assets in the trust. In
addition, it appears relatively certain that no income in respect of a
decedent is created by reason of the grantor’s death for the assets of
the trust. Under current law, there does not seem to be a clear answer
to what the basis of the assets held in a grantor trust after the death of
the grantor is in all cases.

[A] Basic Rule of No Gain at Death

Although no section of the Code explicitly addresses the question,
the traditional, well-ingrained view is that gain is not recognized by
the transferor in connection with a testamentary or lifetime gift.Indeed,
some argue that a contrary approach would raise constitutional
questions, thereby obliging the courts to avoid any construction that
would tax gain at death in the absence of an unambiguous direction

678. I.R.C. § 691 sets up the basic framework for income in respect of a
decedent [IRD].
679. See Campbell v. Protho, 209 F.2d 331 (5th Cir. 1954); see also Int’l
Freighting v. Comm’r, 135 F.2d 310 (2d Cir. 1943). Of course, if liabilities
exceed basis, gain is recognized when inter vivos gifts are made. See
680. See, e.g., JAMES J. FREELAND ET AL., FUNDAMENTALS OF FEDERAL INCOME
TAXATION: CASES AND MATERIALS 18 (11th ed. 2000). But see Stanley S.
Surrey, The Supreme Court and the Federal Income Tax: Some Implica-
tions of the Recent Decisions, 5 ILL. L. REV. 779, 791 (1941); see also Bruce
Ackerman, Taxation and the Constitution, 99 COLUM. L. REV. 1, 52 (1999).
from Congress.\(^{681}\) Not only does the Code fail to contain such a direction, it implicitly reflects the no-gain approach. In section 1001(b) of the Code, the term “amount realized” is defined “as including cash and the fair market value of other property received upon a sale or disposition of an asset.” Therefore, in the case of a lifetime gift, which ordinarily does not involve the receipt of any consideration, gain is not recognized.\(^{682}\) The no-gain implication in section 1001 is consistent with the rule in section 1015 that the donee of a lifetime gift takes, as a general matter, the donor’s basis, again implying that the donor does not recognize any gain.\(^{683}\)

Similarly, in the case of a bequest, there being no consideration, neither the decedent nor the estate is required to recognize gain.\(^{684}\) In its landmark decision in *Crane v. Commissioner*,\(^{685}\) the Supreme Court’s treatment of the legatee strongly suggests that testamentary gifts do not trigger gain. In *Crane*, the legatee inherited an asset that was encumbered by a liability exactly equal to its fair market value. Given that equality, the Court could have treated the transfer as a sale and given the legatee a cost basis for the purchase under the predecessor of current section 1012 of the Code. Instead, the Court treated it as a devise and, therefore, determined the legatee’s basis under the predecessor of section 1014, which provides, as a general rule, for the basis of each asset included in a decedent’s gross estate to be equal to its estate tax value. In refusing to treat the legatee as a purchaser, it tacitly rejected the view that the decedent or the estate had made a sale.

Ironically, many years later, the Supreme Court relied on a different aspect of its analysis in *Crane* to establish an exception to the no-gain rule. In *Diedrich v. United States*,\(^{686}\) the Court held that, in the case of a lifetime gift under which the donee of the gift agreed to pay the gift tax, *Crane* requires that the donor be treated as having made a sale in part and as having recognized a gain when the liability encumbering the gifted asset exceeds the donor’s basis. The exception recognized by the Court in *Diedrich* has never been applied in the case of a testamentary gift. Indeed, while the regulations under section 1001 do not affirmatively state that the exception to the no-gain rule is

\(^{681}\) See INS v. St. Cyr, 533 U.S. 289, 300 (2001) [statutory interpretation that would raise constitutional questions should be avoided where alternative interpretation is “fairly possible”].


\(^{685}\) Id.

\(^{686}\) Diedrich v. United States, 457 U.S. 191 (1982); see also Ebben v. United States, 783 F.2d 906 (9th Cir. 1986).
limited to lifetime transfers, it would be difficult to read them as contemplating otherwise. Neither the text nor any of the examples of the section 1001 regulations suggest that gain is triggered on a testamentary transfer of an asset encumbered by a liability in excess of the decedent’s basis. 687

Limiting the exception to lifetime transfers is not only consistent with Crane’s logic but also appears to make sense as a matter of policy. The Crane decision can be read as having established two propositions. First, the Court held that the testamentary transfer of an asset that is fully encumbered by liability is to be treated as a bequest or devise, not a purchase. Also, as suggested, that implies that neither the decedent nor the decedent’s estate should be viewed as having made a sale. Second, the Court held that when a taxpayer transfers an asset encumbered by a liability, the amount of the liability is to be included in the taxpayer’s amount realized in computing gain or loss. These two holdings are somewhat in tension with each other. Under the latter holding, one might conclude that a testamentary transfer of an encumbered asset should result in gain. But, under the former holding, a decedent should not be viewed as having made a sale or taxable disposition at death. The treasury regulations under section 1001 688 implicitly resolve this tension by creating the exception to the no-gain rule only for lifetime transfers. The treasury regulations contain no indication that the exception should be applied in the case of a testamentary transfer.

In terms of policy, the exception to the no-gain rule for lifetime transfers is critical to prevent potential abuse by taxpayers, whereas there is no necessity for such an exception regarding testamentary transfers. In the absence of the exception, a taxpayer could borrow against an asset an amount equal to its value and then “gift” it subject to the liability without recognizing the gain—in effect converting the asset to cash on a tax-free basis. The potential for such abuse makes an exception to the no-gain rule necessary for lifetime transfers. In recognizing the need for the exception for such transfers in Diedrich, the Supreme Court—although ostensibly basing its decision on Crane—obviously perceived the policy-based need for

687. See Treas. Reg. § 1.1001-2 (indicating that a disposition by “gift” triggers the exception and containing several examples that all involve transfers during life). Self-cancelling installment notes (SCINs) present unique issues for estates of decedents. The typical SCIN provides that no payments are due the decedent-seller or the seller’s estate after the decedent’s death. In Estate of Frane v. Comm’r, 998 F.2d 567 [8th Cir. 1993], aff’g in part and rev’g in part, 98 T.C. 341 [1992], the U.S. Court of Appeals for the Eighth Circuit held that cancelling the installment sale obligation triggered income under section 453B(f).

688. Id.
the exception. In the case of a testamentary transfer, in contrast, the potential for abuse is much more limited because taxpayers seeking to enjoy the benefit of the no-gain rule must first die to come within its scope. And while, as a matter of policy, it might be contended that a similar exception to the no-gain rule should apply in the testamentary context as well, the justification for extending the exception is certainly not as compelling as the justification for the exception in the lifetime context.689

In legislation enacted in 2001,690 Congress explicitly rejected an exception to the no-gain rule in the testamentary context. In explaining section 1022 of the Code, the new carryover-basis-at-death regime that is operative during the year 2010 [when the estate tax is not operative], the Conference Committee explained: “The bill clarifies that gain is not recognized at the time of death when the estate or heir acquires from the decedent property subject to a liability that is greater than the decedent’s basis in the property.”691

Given that framework, the issue may become whether the transfer should be treated as lifetime [and, therefore, subject to the exception] or testamentary [and, therefore, not subject to the exception]. Initially, it might appear that the transaction seems more in the nature of a lifetime transfer. After all, the transfer is made by the taxpayer during life into a lifetime trust. On closer scrutiny, however, it would seem more appropriate to treat it as a testamentary transfer. The reason is that when a taxpayer engages in transactions with a grantor trust there are no income tax consequences.692 That is, transactions between the grantor and a grantor trust are completely disregarded for federal income tax purposes until the trust ceases to be a grantor trust.693

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689. Cf. I.R.C. § 1022(g)(1), (2) [gain must be recognized under the carryover basis rules effective in 2010 in some cases where a debt-laden asset is bequeathed to a tax-exempt entity].
691. See H.R. REP. NO. 107-84 at 113 [2001], as reprinted in 2001 U.S.C.C.A.N. 46,311. Nevertheless, the Committee’s “clarification” was not made part of the statute. Moreover, while such a clarification may be determinative regarding future cases, the courts will often refuse to give weight to an opinion offered by a later Congress as to the intent of an earlier one. See, e.g., United States v. Price, 361 U.S. 304, 312–13 [1960]. In other words, had Congress embodied the clarification in the statute and explicitly made it effective retroactively, it would unquestionably control the disposition of any pending or future litigation. Nevertheless, the report is consistent with, and therefore confirms the validity of, the widely accepted rule that death does not trigger gain, even where liabilities are in excess of basis.
693. See id.
Consequently, it would seem that, if the trust is to be disregarded for income tax purposes until the grantor’s death, the transfer should be viewed as occurring at the time of the grantor’s death and, therefore, treated as testamentary in nature. The regulations under section 1001 contain an example where the taxpayer transfers an asset encumbered by a liability to a grantor trust and then, in a subsequent transaction, renounces the power that causes it to be a grantor trust. The example concludes that a sale is deemed to occur (that is, gain must be recognized to the extent that the encumbering liability exceeds the grantor’s basis in the asset) at the time the power is renounced, not when the transfer to the grantor trust occurred. That is simply an application of the exception to the no-gain rule for lifetime transfers. In the circumstances of the example, it would be inappropriate to treat the transfer as a testamentary one given that, during the grantor’s life, the asset ceases to be owned by the grantor and the donee becomes obligated to discharge the encumbering liability. If the exception were not applicable on those facts, taxpayers would be able to convert their appreciated assets into cash on a tax-free basis through the simple expedient of making the transfer in three steps: by encumbering the appreciated asset; then contributing it to a grantor trust; and then relinquishing the power that caused it to be a grantor trust.

Treating an incomplete lifetime transfer as if it were a testamentary one is somewhat analogous to the approach taken for wealth transfer tax purposes. Where a power is retained by the grantor at the creation of a lifetime trust that renders the gift incomplete for gift tax purposes, the subsequent termination of the power completes the transaction and triggers a taxable gift at that time. However, if the power terminates because of the grantor’s death, it is treated as a testamentary transfer:

695. See id.
696. For a case reaching the same conclusion even before the promulgation of the regulations, see Madorin v. Comm’r, 84 T.C. 667 (1985); see also Rev. Rul. 77-402, 1977-2 C.B. 222. Chief Couns. Adv. 200923024 (conversion of nongrantor trust to grantor trust not a taxable event at least where debt on trust’s assets did not exceed income tax basis). The CCA notes that:

[T]he rule set forth in these authorities [Treas. Reg. § 1.1001-2[c], Ex. 5, Madorin v. Comm’r, 84 T.C. 667 (1985), Rev. Rul. 77-402, 1977-2 C.B. 222] is narrow, insofar as it affects inter vivos lapses of grantor trust status, not that caused by the death of the owner which is generally not treated as an income tax event.

Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

the gift tax does not apply; instead, the trust corpus is included in the grantor’s gross estate.\textsuperscript{698} In \textit{DiMarco v. Commissioner},\textsuperscript{699} the government argued that an incomplete gift became complete for federal gift tax purposes and, therefore, subject to the gift tax at the time of the donor’s death. The court rejected that argument, holding that the gift tax regulations require that an incomplete lifetime transfer be treated as a testamentary transfer (that is, become subject to estate tax, not the gift tax) where the power making the gift incomplete terminates at the grantor’s death. Assuming the same analysis is applied in the income tax setting, a transfer of assets to a grantor trust subject to indebtedness owed to the grantor should be treated as a testamentary transfer that does not trigger gain unless the power or right causing grantor trust status is released before death.\textsuperscript{700}

Section 684 of the Code, provides that, as a general rule, a transfer to a foreign trust requires the transferor to recognize all gain inherent in the transferred asset at the time of transfer. The section was clearly designed to apply to lifetime gifts in trust, even in the absence of an encumbering liability.\textsuperscript{701} Thus, the section contemplates at least a partial qualification of the no-gain rule. Echoing the notion in the domestic (non-foreign) trust setting that transactions or sales between the grantor and a grantor trust are to be disregarded, section 684(b) provides that the section does not apply and that gain, therefore, is not recognized where the transfer is made to a grantor trust.

The Treasury Department has issued regulations that seem to reveal its views about the no-gain rule in the context of a grantor trust that retains its character as such until the grantor’s death. In setting forth the scope of that provision, the regulations address the same questions that arise in the case of a sale to a domestic (U.S.) grantor trust: (1) whether a sale is deemed to occur if the grantor trust status ends during the grantor’s lifetime; and (2) whether the cessation of grantor-trust status by reason of the grantor’s death triggers gain under the section. As to the first issue, the regulations provide, as do the regulations under section 1001, that gain must be recognized when grantor trust status ends.\textsuperscript{702} Unlike the regulations under

\begin{footnotes}
\footnotetext[698]{See Treas. Reg. § 25.2511-2[f].}
\footnotetext[699]{DiMarco v. Comm’r, 87 T.C. 653 acq. 1990-2 C.B. 1.}
\footnotetext[700]{It may be appropriate to note that the regulation at issue in DiMarco (Treas. Reg. § 25.2511-2) does state that transfers deemed to occur at death are not subject to the gift tax. Although there is no comparable provision in the regulations under section 1001 explicitly stating that termination of grantor trust status at death should not be subject to the income tax, the section 1001 regulations do, as previously indicated, implicitly take this position.}
\footnotetext[702]{See Treas. Reg. § 1.684-2(e).}
\end{footnotes}
section 1001, however, which provide that the sale is deemed to occur at the moment grantor trust status ceases, the section 684 regulations create the fiction that a sale is deemed to occur immediately before the cessation of such status.\textsuperscript{703} As to the second issue, extending the fiction, the regulations provide that the grantor is deemed to make the sale immediately before death.\textsuperscript{704}

As indicated in the preamble to the final regulations to Code section 684, one commentator questioned the authority for abandoning the no-gain-at-death rule.\textsuperscript{705} Implicitly recognizing the foundational nature of this rule, the Treasury Department justified its departure from the rule by making an argument specific to section 678 of the Code (which provides that a beneficiary of a trust who is not its grantor may be treated as the owner of the trust for income tax purposes in certain situations). The preamble maintains that the language of the section, particularly when considered against the backdrop of language in sections 679 and 6048[a][3][A][ii] (which provides special and essentially adverse rules for foreign trusts and transfers to foreign trusts), reveals that Congress intended to tax testamentary transfers under section 684.\textsuperscript{706} Even so, it seems that the regulations make only a modest departure from the rule, providing that gain need not be recognized if section 1014 of the Code will determine the basis of the assets in the hands of the trustee.\textsuperscript{707}

As a consequence, as reflected in the preamble to the section 684 regulations, the Treasury Department acknowledges the foundational nature of the no-gain-at-death rule and the need for a clear indication of Congress’s intent before any departure from the rule is warranted. With no such indication from Congress in the context of a sale to a domestic grantor trust, the Treasury Department’s apparent logic inexorably leads to the conclusion that the cessation of grantor trust status by reason of the grantor’s death does not trigger gain.

\textsuperscript{703} See id.
\textsuperscript{704} See Treas. Reg. § 1.684-2(e)(2), Example 2. It may be noted that this is not only inconsistent with the rule under the I.R.C. § 1001 Treasury Regulations, but may well be inconsistent with I.R.C. § 684 itself. For, under subsection [b], no gain is to be recognized as long as the trust remains a grantor trust. And since immediately before the grantor’s death the trust is still a grantor trust, it would appear that the fiction cannot be applied in the case of death without violating subsection [b].
\textsuperscript{705} See T.D. 8956; 2001-32 C.B. 112.
\textsuperscript{706} See id.
\textsuperscript{707} See Treas. Reg. § 1.684-3(c). Note that even where the assets in the trust are encumbered by a liability in excess of their basis, no gain is recognized under the I.R.C. § 684 Treasury Regulations if I.R.C. § 1014 determines the basis of the assets in the hands of the trustee after the death of the grantor.
In *Frane v. Commissioner*, the Tax Court held that the cancellation of an installment note at the death of the obligee constituted a disposition of the note that triggered gain on the seller’s final return under section 453B(f). Although this decision might be viewed as deviating from the no-gain-at-death rule, it should be emphasized that the decedent had elected installment reporting during his life. Under the cited section, a taxpayer electing this method of reporting gain implicitly agrees, in exchange for the privilege of deferring gain, that any cancellation of the note will result in the eventual recognition of the remaining untaxed gain. In contrast, in the case of an installment sale to a grantor trust, no taxable sale or disposition is made by the grantor during life and, of course, no installment-method election is or could be made. Nor has Congress enacted a provision analogous to section 453B(f) that would make death a taxable event as a general matter or that would force the grantor of a grantor trust to recognize gain at death. If the section is relevant at all, it is in its implication that the Code should be understood as embracing the no-gain-at-death rule as generally controlling in the absence of a specific section to the contrary, such as section 453B(f) or 684. Of course, the Eighth Circuit reversed the Tax Court and held that the balance of the installment note was reportable by the decedent’s estate.

In sum, given:

- the constitutional questions that taxing gain at death might raise and the rule that statutes should be construed so as to avoid such questions;
- the fundamental nature of the no-gain-at-death rule; Congress’s rejection of a liability-in-excess-of-basis exception to the rule;
- the Supreme Court’s implicit recognition of the rule in *Crane*; the Treasury Department’s implicit recognition of the rule in the section 1001 treasury regulations and in the drafting of the section 684 treasury regulations;
- the lack of any clear indication from Congress that departure from the rule is appropriate, outside of section 684, where grantor-trust status terminates by reason of the grantor’s death; and
- the notion that the assets in a grantor trust are deemed to be owned by the grantor as long as grantor-trust status has not terminated,

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709. *See id.* at 351.
710. *See section 2:3.1 and accompanying text for a discussion of IRD and Frane.*
it seems nearly certain that there is no viable ground to lead to taxing gain at the death of a grantor with respect to which the trust is indebted at the grantor death.

[B] Income in Respect of a Decedent

As previously stated, section 1014 provides, as a general rule, that the income tax basis of an asset included in a decedent’s estate for federal estate tax purposes is equal to its estate tax value. An exception is created for “income in respect of a decedent” (IRD), described in treasury regulations under section 691. IRD is taxable income to which the decedent was entitled at death (such as accrued interest or the unrecognized gain from a sale being reported under the installment method of reporting) and which is not properly reportable for a period before the decedent’s death.

Whether or not IRD is triggered at the death of the grantor where there is indebtedness on property owned by a grantor trust is an issue that seems to be closely related to whether the grantor’s death caused gain to be realized at that time. The reason is that, under section 691, any gain attributable to the collection of an installment note constituting IRD would be taxable to the estate (or the beneficiary who receives collection on the note).

Inherent gain will represent IRD where the grantor (or the grantor trust) has made a sale before the grantor’s death, which is being recognized under the installment sale rules of section 453. However, the rule applies where indebtedness is owed to the grantor (or the grantor trust). That rule does not, by its terms at least, apply where the trust owes indebtedness, regardless of how the indebtedness arose. As explained above, no income is recognized by the taxpayer or his or her estate by reason of dying and owning property subject to indebtedness, even if the liability exceeds the taxpayer’s income tax basis at death.

Similarly, where a grantor trust is indebted on property it owns, there should be no gain recognition. Of course, property that a taxpayer owns at death will be included in his or her gross estate for federal estate tax purpose. Property held by a grantor trust may not be. Nevertheless, it does not seem that the result should be any different. As a general rule, IRD means taxable income to which the decedent was entitled at death (but is not properly included in a pre-death estate).

711. Treas. Reg. § 1.691[a]-1. For a detailed discussion of IRD, see chapter 2.
712. See, e.g., Rollert v. Comm’r, 80 T.C. 619 [1983] [indicating the estate’s distribution of the right to receive IRD makes the recipient taxable at the time of ultimate collection of the IRD item].
713. Crane v. Comm’r, 331 U.S. 1 [1947].
714. I.R.C. § 2033.
income tax return of the decedent). The payment by the grantor trust (treated for federal income tax purposes as paid by the grantor) cannot result in income to the grantor even if the payment is made during the grantor’s lifetime. Therefore, there should be no IRD generated by reason of indebtedness owed by the trust to someone other than the grantor.

As mentioned above, there could be indebtedness owed by the trust to the grantor. But that indebtedness should not represent IRD.

The regulations under section 691 provide that where the decedent enters into an agreement providing for a sale that is to occur at the time of death, the sale proceeds do not constitute IRD. Indeed, relying on these regulations, the Tax Court has stated that a sale does not result in IRD where “the sale is only effective upon the decedent’s death.” Because a sale by the grantor to a grantor trust is ignored for income tax purposes, the earliest moment at which a sale should be viewed as having occurred is immediately after the grantor’s death. And because sales occurring at the moment of death are not within the scope of the IRD concept, there is no basis for subjecting such an installment sale to the IRD rules under section 691.

[C] Trustee’s Basis

An additional issue for grantor trusts is: what is the income tax basis of the assets in the grantor trust immediately following the death of the grantor that terminates grantor trust status? There does not seem to be adequately developed law to provide a certain answer.

To attempt to provide an answer, it may be appropriate to characterize the trustee’s acquisition. If the trustee is viewed as acquiring the assets by bequest or devise, section 1014 will determine basis, in which case it will equal the fair market value of the assets in the trust on the date of the decedent’s death. If, in contrast, the trustee is

716. See Treas. Reg. § 1.691[a]-2(b), Example 4 (indicating that gain on the sale of stock under a buy-sell agreement is not IRD because the sale is not consummated until the decedent’s death).
717. See Estate of Peterson v. Comm’, 74 T.C. 630, 641 (1980). Although the court in Peterson does indicate that its definition of IRD is not “ironclad,” id. at 639 n.9, its discussion of the rule that a sale that is consummated at death does not create IRD suggests that the rule is not a flexible one. Indeed, the court reads the Treasury Regulation as creating a per se limitation on the IRD concept. Id. at 641.
718. If the executor elects to use alternate valuation under I.R.C. § 2032 for federal estate tax purposes, value will be determined on the alternate valuation date. Note that for individuals dying in 2010, no asset that passes from the decedent receives a “step-up” in basis pursuant to I.R.C. § 1014(a). See I.R.C. § 1014(f).
viewed as acquiring the assets by purchase, the trustee’s basis will equal cost under section 1012. Or if the acquisition is viewed as either a lifetime gift or a transaction that is in part a purchase and in part a gift, section 1015 will govern.\(^719\)

Initially, it might seem that section 1014 is inapplicable if the terms of the grantor trust preclude it from being included in the grantor’s gross estate for federal estate tax purposes. Indeed, section 1014 is commonly understood as applying only where the asset is included in the decedent’s gross estate. A careful reading of the section, however, suggests more complexity. Although subsection \(b\)(9) of section 1014 does explicitly depend on estate-tax inclusion, subsection \(b\)(1) does not. It simply requires that the asset be acquired by bequest, devise or inheritance (or by the decedent’s estate from the decedent). Also, the regulation interpreting subsection \(b\)(1) appears to contemplate that it will only apply in the case of property passing under the decedent’s will or under the laws of intestacy.\(^720\) However, neither the regulation nor the statutory language affirmatively precludes transfers made under a lifetime trust from qualifying as a bequest or devise.

In a colloquial sense, only an individual and not a lifetime trust effects a bequest or devise. Nevertheless, assets held by a grantor trust are deemed to be owned by the grantor for federal income tax purposes. Therefore, for federal income tax purposes, it seems that assets held in such a trust may be viewed as passing as a bequest or devise when the trust ceases to be a grantor trust at the moment of death. Ignoring the lifetime character of the transaction under state law in favor of its tax-determined status is not without precedent. The grantor trust example, discussed above, in the section 1001 treasury regulations adopts the tax fiction that the grantor owns a partnership interest that, in fact, is owned for all non-income tax purposes by the trust. And, based on this fiction, the example subjects the grantor to the provisions in Subchapter K of the Code\(^721\) that apply only to taxpayers who actually own a partnership interest. Also, in DiMarco, the Tax Court treated the grantor of a lifetime trust as having made a testamentary transfer for tax purposes, even though it clearly would have been viewed as lifetime in character for all other purposes.

The most likely reply to this argument would be based on subsections \(b\)(2) and \(b\)(3) of section 1014. They make the section applicable in the case of certain lifetime trusts. In addition, because both of the lifetime trusts described in these subsections would constitute

\(^{719}\) See Treas. Reg. § 1.1015-4 [providing the basis rule for a part sale/part gift].

\(^{720}\) See Treas. Reg. § 1.1014-2(a)(1).

\(^{721}\) Subchapter K of the Code provides the fundamental income tax rules for partnerships and their partners.
grantor trusts, one might infer in these subsections a negative implication that the assets in a grantor trust cannot be viewed as having been transferred by bequest or devise simply because they are deemed to be owned until death by the grantor (for if that were the case, there would have been no need to include these subsections in section 1014 given subsection (b)(1)). This was presumably the view that the Treasury Department took of the section when it drafted the regulations under section 684. These regulations provide that, where a grantor trust ceases to be such upon the grantor’s death, a sale is deemed to occur immediately before death unless section 1014 determines the trustee’s basis in the assets. Thus, the Treasury Regulations under section 684 reflect the impression that section 1014 does not contemplate that it will apply in every case in which the assets are held in a grantor trust at the time of the grantor’s death.

The weakness in that reply is that its premise, the negative implication, is not particularly compelling. None of the various subsections in section 1014 was enacted after the Service issued Revenue Ruling 85-13. Thus, at the time of enactment, it was not at all clear that grantor trusts should be disregarded for all income tax purposes. Indeed, in Revenue Ruling 85-13, in adopting the approach that all transactions between the grantor and a grantor trust should be disregarded for all income tax purposes, the Service expressly rejected the Second Circuit’s then-recent decision in Rothstein v. United States.722 In short, given that history, it would be difficult to infer that, in drafting subsection (b)(1) of section 1014, Congress contemplated that it would not apply to assets in a trust that remained a grantor trust until the grantor’s death.

As a matter of policy, the argument that subsection (b)(1) of section 1014 applies to all grantor trusts that terminate at the time of the grantor’s death is attractive. Were the rule otherwise, taxpayers would easily be able to circumvent it provided they had access to competent counsel and did not die precipitously. In other words, as the rationale of Revenue Ruling 85-13 suggests, a taxpayer deemed to own the assets of a grantor trust having a basis less than value, if properly advised and assuming death were not completely unexpected, could purchase the assets for cash from the trustee without triggering a gain and thereby make the basis of the assets equal to their value under section 1014. Because it seems to make no sense—and, arguably, would be inequitable—to create an advantage for taxpayers who have more competent counsel or who have an advance indication of the time of their death, it is preferable to read subsection (b)(1) as applicable to all trusts that remain grantor trusts until the grantor’s

death. That is not to say that the law should continue to permit the estate tax freeze that sales to such trusts presently provide while, at the same time, allowing the trustee’s basis to be determined under section 1014. It is, rather, to say that it would be inappropriate to deny section 1014 treatment where the taxpayer dies without having made the repurchase while permitting such treatment where the taxpayer has the foresight to accomplish the repurchase before death.

Finally, it might be contended, at least where the indebtedness is owed by the grantor trust to the grantor at death, that the presence of an encumbering liability makes it inappropriate to apply section 1014. In other words, if the trustee has given a note to the grantor as consideration for acquiring the assets, it makes more sense to view the transaction as a purchase than as a bequest or devise. This strand of analysis was rejected, however, in *Crane*, where the Supreme Court applied the predecessor of section 1014 even though the asset acquired by the legatee was encumbered by a liability equal to its value. Consequently, the fact that the trustee undertakes the liability in connection with the acquisition (or, more precisely, the grantor’s estate) does not inexorably render section 1014 inapplicable. To be sure, a reply might be made that *Crane* involved a devise and the transaction under inquiry has more of a lifetime flavor. Nevertheless, as indicated, the trust must be ignored for income tax purposes until the grantor’s death, so it may be more appropriate to view the trustee’s acquisition as a bequest or devise and to apply, therefore, *Crane*’s analysis.

In the alternative, the trustee’s acquisition could possibly be viewed as a purchase. Under this view, given the requirement that the transaction be ignored during the grantor’s life, the trustee would be treated as having acquired the assets in exchange for the note at the moment of the grantor’s death. The trustee’s basis would, as a result, be equal to cost under section 1012, which would be the amount of the note (assuming the post-death interest rate on the note is sufficient or the note is immediately payable). This, of course, would have the asymmetrical effect of treating the trustee as having made a purchase while treating neither the decedent nor the estate as having made a sale. But, pointed out above, there is no basis under current law for treating the decedent or the estate as having made a sale where grantor-trust status terminates by reason of the grantor’s death.

723. Cf. *Farid-Es-Sultaneh v. United States*, 160 F.2d 812, 815 [2d Cir. 1947] (indicating that the presence of consideration suggested that the transaction should be viewed as a purchase, rather than a lifetime gift, for purposes of determining basis).

724. See Treas. Reg. § 1.1274-5[d].
It seems that the final alternative is to view the trustee as having acquired the assets by lifetime gift. That, of course, implicates section 1015, which provides the basis rule for assets acquired by gift. There are three different rules under section 1015 that might conceivably be employed to determine the trustee’s basis.\(^{725}\)

First, if the acquisition is viewed as a “pure gift” (that is, as if the assets were acquired without any consideration), then section 1015(a) would determine basis.\(^{726}\) Under this subsection, for purposes of computing gain on any subsequent sale (as well as for purposes of computing depreciation),\(^{727}\) the trustee’s basis in the assets would be equal to the grantor’s basis. For purposes of computing loss on any subsequent sale, however, the trustee’s basis would be equal to the lesser of (a) the donor’s basis or (b) the fair market value of the asset on the date of the gift.\(^{728}\) The requirement that fair market value be used as the donee’s basis for purposes of computing loss, where less than the donor’s basis, is designed to prevent the shifting of losses that accrue during the donor’s ownership to the donee.

In the case of a loss, one would have to determine the date of the gift because of the requirement that the fair market value on the date of the gift be ascertained. Under the regulations, the donee is treated as acquiring the asset when the donor relinquishes dominion over it. Does this suggest that the date of the gift, for this purpose, is the date of the sale to the grantor trust? But this violates the rule that transactions between the grantor and a grantor trust be ignored for income tax purposes—and, of course, section 1015 is an income tax provision.\(^{729}\) Second, it might be argued that, because of the liability undertaken by the trustee, section 1015(b) should determine the basis. This subsection applies to a transfer in trust other than by gift, bequest or devise. In other words, it contemplates that it will apply where

\(^{725}\) Whichever approach is followed, there should, in addition, be an adjustment for gift tax paid under I.R.C. § 1015(d).

\(^{726}\) See Malone v. United States, 326 F. Supp. 106, 113–14 [N.D. Miss. 1971], aff’d, 455 F.2d 502 [5th Cir. 1972] (indicating that section 1015(a) only applies in the case of a “pure gift” and that, where a trustee acquires an asset that is encumbered by a liability, it is not a pure gift and, therefore, I.R.C. § 1015(b) governs).

\(^{727}\) See Treas. Reg. § 1.167(g)-1.

\(^{728}\) I.R.C. § 1015; Treas. Reg. § 1.1015-1(c).

\(^{729}\) See Newman v. Comm’r, 4 T.C. 226 [1944] (discussing the government’s argument that a distribution from a grantor trust to the grantor’s child should be viewed as effecting a gift to the child on the date of the distribution, thus, making the fair market value on that date determinative for purposes of computing loss).
(a) the transfer is in trust, not outright, and (b) there is at least some consideration present.\textsuperscript{730}

When it applies, the trustee’s basis is equal to the sum of the donor’s basis and the amount of gain recognized by the donor on the transfer (or the donor’s basis reduced by any recognized loss). The congressional purpose in creating this differentiation in these two subsections was to prevent the shifting of losses for transactions falling under the former subsection while permitting it for transactions falling under the latter subsection. Apparently, Congress was of the view that abusive loss-shifting strategies that could be deployed in the context of an outright gift were not as problematic where the transfer is made in trust for a consideration. In contrast, in terms of determining basis for purposes of computing gain or depreciation, Congress intended the two subsections to be parallel: basis, for purposes of computing gain or depreciation, would be the same under either subsection.

To illustrate why Congress may have decided it was unnecessary to include a loss-shifting provision in subsection (b) of section 1015, assume a taxpayer owns an asset with a basis of $200,000 and a value of $100,000. If the taxpayer were to sell the asset to a trust for its value of $100,000, the basis of the asset in the hands of the trustee would be $100,000 under subsection (b)—the trustee’s basis, under the subsection, would be equal to the taxpayer’s basis of $200,000 less the taxpayer’s recognized loss of $100,000. Applied in this fashion, subsection (b) does not permit the trustee to deduct a loss on any subsequent sale that accrued economically during the taxpayer’s ownership of the asset. Therefore, if so applied, subsection (b) does not permit loss-shifting to occur, making unnecessary the kind of rule designed to prevent it in the context of subsection (a) of section 1015.

\textsuperscript{730} As indicated in note 531, supra, in Malone, the court concluded that, because the trustee acquired the asset by undertaking to pay an encumbering liability, it was not, in the language of the court, a “pure gift.” As a result, the court held, subsection (b) of I.R.C. § 1015 controlled the determination of the trustee’s basis—the court indicating that all transfers in trust fall under subsection (b) unless they constitute a “pure gift” (i.e., no consideration). It could, however, be maintained that the court’s analysis was flawed, as the court indicated that, were it not to apply subsection (b), it would create an unsatisfactory result as a matter of policy in that the trustee’s basis would not be increased by the amount of gain recognized by the grantor on the transfer. In making this assumption, however, the court failed to appreciate (or even cite) Treas. Reg. § 1.1015-4, under which the trustee’s basis would reflect the gain recognized by the grantor. In other words, contrary to the court’s assumption, the correct result in terms of policy could have been reached without invoking subsection (b).
transactions. It is, however, possible that subsection (b) might, contrary to Congress’ expectations, permit loss-shifting. If, in this example, the taxpayer had first created the trust (even if the taxpayer made no contribution of funds) and the loss on the sale to the trust was consequently disallowed because it was a sale between a trust grantor and the fiduciary,\textsuperscript{731} the trustee’s basis would be $200,000. Thus, the loss that accrued economically during the taxpayer’s ownership of the asset is shifted to the trust on a subsequent sale.

Third, the part-sale-part-gift provision contained in the regulations might apply.\textsuperscript{732} Under this provision, the trustee’s basis would be equal to the greater of (a) the grantor’s basis or (b) the amount paid by the trustee.\textsuperscript{733} While this provision is commonly understood as producing a basis in the recipient’s hands equal to the sum of the donor’s basis and the amount of gain recognized by the donor on the transaction, it might, surprisingly, produce a different result if applied in the context of a sale to a grantor trust. To illustrate, assume that the grantor has an asset with a basis of $1 million and a value of $2 million. If the asset is sold to a grantor trust for $2 million, the part-sale-part-gift provision produces a basis in the hands of the trustee of $2 million (because the consideration paid, $2 million, is greater than the grantor’s basis, $1 million). The provision obviously assumes that, to the extent that the recipient has furnished consideration, consideration enters into the grantor’s amount realized and is therefore subjected to income tax. But the assumption does not hold if, as earlier suggested, neither the decedent nor the decedent’s estate recognizes any gain on the sale. The predicate for invoking this provision is that the transaction be in part a gift and in part a sale. Seeking to limit the trustee’s basis to the grantor’s basis, the Service would presumably argue in response to any taxpayer argument based on this provision that it does not apply where the sale is for a consideration equal to the asset’s value. In terms of planning, therefore, it might be appropriate to consider making the sale for a consideration that is somewhat less than full value.

In sum, it appears that a more compelling argument can be made to have the basis of assets held in a grantor trust at the grantor’s death determined under section 1014 than under either section 1012 or 1015.

Note that a trustee may choose to report the trust’s income, deductions and credits on Form 1041 (the U.S. Fiduciary Income

\textsuperscript{731} I.R.C. § 267(b)(4) (denying loss deduction on sale between grantor and fiduciary); Treas. Reg. § 1.671-2(e) (implying that a person who creates a trust but who does not fund it should nevertheless be viewed as a grantor).

\textsuperscript{732} See Treas. Reg. § 1.1015-4.

\textsuperscript{733} See id.
Tax Return) regardless of whether the trust is a “grantor trust” in its entirety with respect to one or more persons, and this option should be considered at each stage of the analysis.

§ 4:8 Income Tax Reporting Requirements for Grantor Trusts

Although grantor trusts are “ignored” generally for purposes of calculating taxable income of the trust; they are not ignored for purposes of reporting taxable income. Historically, the income, deductions, and credits of trusts were reported on the U.S. Fiduciary Income Tax Return (Form 1041), if any reporting was required. Because of the rise in popularity of revocable trusts, however, general income tax reporting requirements for trusts were modified to provide that, at least in the case of a revocable trust, where the grantor is the trustee, no income tax return need be filed for the trust. Effective January 1, 1996, the Service issued final regulations on the income tax reporting requirements of grantor trusts. The regulations permit a trustee to file a Form 1041 with a statement attached showing items of income, deductions, and credits or the use the procedure discussed below.

Treasury Regulations section 1.671-4 provides that the trustee of a trust that is a grantor trust in its entirety has two basic options for reporting a trust’s income. The trustee may either file the U.S. Fiduciary Income Tax Return (Form 1041) or comply with the provisions of Treasury Regulations section 1.671-4. A trustee may not use the regulation reporting regime, however, if the trust is characterized as


735. “The trustee of any portion of which is treated as owned by one or more grantors or other persons must report pursuant to this section for taxable years beginning on or after January 1, 1996.” Treas. Reg. § 1.671-4(a). See Lardas v. Comm’, 99 T.C. 490 (1992) (the filing of the grantor’s income tax return, not that of the trust, starts the statute of limitation for income of a grantor trust that is attributed to grantor under the grantor trust rules); Olson v. Comm’, T.C. Memo 1992-711 (same); Bartol v. Comm’, T.C. Memo 1992-141 (same); Field Service Advice 2002-07-007 (“case law suggests strongly that the ‘return’ of a passthrough entity, such as a grantor trust . . . does not start the statute of limitations because [that] statute should apply to the person who pays the tax”). Under I.R.C. § 6110(k)(3), neither a National Office Technical Advice Memorandum nor a Private Letter Ruling may be cited or used as precedent.

736. Treas. Reg. § 1.671-4(b)[1].

737. Id.
(i) a common trust fund, as defined in section 554;

(ii) a trust that has its situs or any of its assets located outside the United States;

(iii) a trust that is a qualified subchapter S trust;

(iv) a trust all of which is treated as owned by one grantor or one other person who is a fiscal-year taxpayer;

(v) a trust all of which is treated as owned by one grantor or one other person who is not a U.S. person; or

(vi) a trust all of which is treated as owned by two or more grantors or other persons, one of whom is not a U.S. person.  

If the trust does not fall into one of those ineligible categories, the trustee must first determine whether the trust is treated for income tax purposes as owned by only one person or by more than one person, to ascertain the precise steps a trustee must take to comply with Treasury Regulations section 1.671-4. If the trust has just one grantor (or just one other person which is treated under section 678 as owner of the trust assets), the trustee must follow a particular set of rules. If the trust is treated as owned by two or more grantors or other persons, the trustee follows a different set of rules. See Figure 4-1 at the end of the chapter.

In the case of a trust that is a grantor trust in its entirety for one person only, a trustee has two options for complying with the alternatives permitted by Treasury Regulations section 1.671-4. First, the trustee may furnish to all income payors the grantor’s name (or the section 678 owner’s name) and taxpayer identification number as well as the trust’s address. The payors then annually send the trustee the Forms 1099. The trustee delivers those to the grantor, who then presumably files them with his or her income tax return. The regulations explicitly provide that the trustee should not provide a copy of Form W-9, discussed below, to a payor, because the W-9 shows the grantor’s address, not the trust’s address (which the regulations require).

It is important to note that for a trustee to be able to report to any income payor the required taxpayer identification information for the trust’s grantor (as opposed to the trust itself), the trustee must require

741. It should be noted that for purposes of these regulations, a husband and wife are treated as one person. Treas. Reg. § 1.671-4(b)(8).
the grantor to provide the trustee with a complete Form W-9 or an acceptable substitute Form W-9 signed under the penalties of perjury.\textsuperscript{743} If that Form W-9 then indicates that the grantor or other person is subject to backup withholding, the trustee has an affirmative duty to notify all payors of reportable interest and dividend payments of their obligation to backup withhold.\textsuperscript{744} Interestingly, however, the trustee does not have a corresponding duty to notify payors that backup withholding is not required, in the event that the Form W-9 does not indicate that the grantor or other trust owner is subject to backup withholding.\textsuperscript{745}

In the case of a trust that is a grantor trust in its entirety as to one taxpayer,\textsuperscript{746} once the trustee has furnished to each payor the grantor’s name and taxpayer identification number, along with the trust’s address, the trustee has no further reporting obligations depending on yet another variable: whether or not the trust’s grantor is the trustee or co-trustee of the trust. If the grantor is the trustee or co-trustee, the trustee has no further reporting requirements, once the trustee provides the income payors with the grantor’s name, taxpayer identification number and the trust’s address.\textsuperscript{747} A husband and wife are treated as one person for these purposes.\textsuperscript{748} Note, however, that the regulations do not specifically address the case of a trust created jointly by husband and wife. In such a case, presumably the trustee satisfies the requirements of the regulations by furnishing either grantor’s taxpayer identification number. Note also that this raises complexities when the husband and wife file separate tax returns. In such a case, it

\textsuperscript{743.} Treas. Reg. § 1.671-4(b)(1). Form W-9 (or an acceptable substitute) is used when one person with the Service reporting obligations needs to obtain another U.S. person’s (or resident alien’s) correct taxpayer identification number. A correct taxpayer identification number is needed to report income paid to a particular taxpayer, contributions by the taxpayer to an IRA, mortgage interest paid by the taxpayer, abandonment of secured property, and cancellation of indebtedness. Form W-9 may also be used to certify that a provided taxpayer identification number is correct, to certify that an individual is not subject to backup withholding, and to claim exemption from backup withholding. Note that only U.S. persons may use Form W-9; foreign persons use Form W-8 instead.

\textsuperscript{744.} Treas. Reg. § 1.671-4(e).

\textsuperscript{745.} Id.

\textsuperscript{746.} Id.

\textsuperscript{747.} Treas. Reg. § 1.671-4(b)(2)(i)(A). To simplify reporting, it may be appropriate to make the grantor a trustee but to limit his or her powers to avoid including any portion of the trust in the gross estate of the grantor for estate tax purposes, if avoiding such inclusion is appropriate. In such a case, and perhaps others, it may be preferable for the grantor’s spouse to be trustee or co-trustee.

\textsuperscript{748.} Treas. Reg. § 1.671-4(b)(8).
may be advisable for the trustee to furnish both grantors’ taxpayer identification numbers.

If the grantor is not the trustee or co-trustee of a particular grantor trust, however, the regulations require the trustee to take another step after providing the payors with the taxpayer identification information for the grantor, described above. The trustee must furnish to the grantor a statement with the following information:

- all of the trust’s items of income, deduction, and tax credit for the taxable year;
- identification of the payor of each item of income;
- the information necessary to take the items into account (for example, cost basis) when determining the grantor’s own taxable income; and
- notice that the grantor is treated as the owner of all of the trust’s income, deductions and credits for the taxable year, and that such information must be included on the grantor’s income tax return for that year.\footnote{749}

Upon providing this information to the grantor, the trustee has satisfied its reporting obligation and is not required to make any further filings with the Service.\footnote{750}

Instead of furnishing to income payors the grantor’s name and taxpayer identification number, along with the trust’s address, the trustee may choose instead to furnish to all payors the trust’s name, taxpayer identification number, and address.\footnote{751} If so, each income payor will then issue a Form 1099 to the trustee showing the trust as payee of the particular item of income.\footnote{752} The trustee must then file with the Service the appropriate Forms 1099, reporting the income and gross proceeds received during the taxable year, showing the trust as the payor, and showing the grantor as both the owner of the trust and as payee.

Generally speaking, the trustee has the same obligations for filing Forms 1099 with the Service as any payor would have, except that the trustee must report income aggregated by type and must report each item of gross proceeds separately.\footnote{753} It is important to note, however, that the amounts that must be included on the Forms 1099 filed by the trustee do not include any information that the original payor

\footnote{749} Treas. Reg. § 1.671-4(b)(2)(ii).
\footnote{750} Treas. Reg. § 1.671-4(b)(2)(ii)(B).
\footnote{751} Treas. Reg. § 1.671-4(b)(2)(i)(B).
\footnote{752} Treas. Reg. § 1.671-4(b)(2)(iv), Example 2(ii)(A).
\footnote{753} Treas. Reg. § 1.671-4(b)(2)(iii).
would not have reported on a Form 1099. Thus, in the case of a grantor trust that holds partnership units, for example, because the partnership itself does not report its income to its partners on Forms 1099 (it reports income to its partners on Forms K-1), the grantor’s share of partnership income and gain is not included on any Forms 1099 filed by the trustee. Note also that in choosing to furnish each payor with the name and taxpayer identification number of the trust, instead of those of the grantor, the trustee has added another layer to the trustee’s administrative responsibilities. The trustee must sift through each item of income and deduction to categorize and report it correctly to the grantor. Furthermore, the trustee must understand whether, in the hands of the original payor, the income would have been reportable by the original payor on Form 1099 or not. That may require a commitment of time and expertise that many trustees, including institutional trustees with hundreds of trusts under administration, may not want to make.

Assuming that the trustee has furnished the payors with the trust’s name and taxpayer identification number, once the relevant Forms 1099 have been filed by the trustee with the Service, whether the trustee has any further reporting obligation again turns on whether the grantor is the trustee (or co-trustee) of the trust. If the grantor is a trustee, the trustee has satisfied its responsibilities under Treasury Regulations section 1.671-4. If the grantor is not a trustee, however, the trustee again must provide the grantor with a statement that shows the trust’s income, deductions, and tax credits; identifies the payor of each item of income; provides the grantor with information he or she needs to compute his or her own taxable income; and informs the grantor that he or she is treated as the owner of all the trust’s income, deductions, and credits, and that such information must be included in the grantor’s income tax return for that year.

In the case of a trust that is treated as owned in its entirety by two or more grantors or other persons, the trustee does not have the option to report to all income payors the grantor’s name and taxpayer identification number. Instead, the trustee is limited to furnishing to the payors the trust’s name, taxpayer identification number, and address. Presumably, that is because in the case of a trust of which the income, deductions, and tax credits are attributable to more than one person, the Service has decided that the trustee, not the initial

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payor, should be responsible for the allocation of income, for example, between or among trust grantors.

Treasury Regulations section 1.671-4 provides that, after furnishing to each payor the trust’s name, taxpayer identification number, and address, each payor will then issue a Form 1099 to the trustee showing the trustee as payor.758 The trustee then files with the Service the appropriate Forms 1099, reporting the income paid to the trustee as payor and each grantor as payee, in proportion to the grantor’s deemed ownership of the trust assets. Thus, again the trustee has the same obligations for filing Forms 1099 with the Service as any payor would have, except that the trustee must report income aggregated by type and each item of gross proceeds separately.759

Once Forms 1099 have been filed with the Service, in the case of a trust with multiple owners for income tax purposes, the trustee must furnish statements to each grantor of the trust.760 As in the case of the statements furnished to a single-grantor trust’s owner, each owner of a multiple-grantor trust must receive a statement of the items of income, deductions, and tax credits attributable to the portion of the trust owned by the grantor; the information necessary to compute the grantor’s taxable income; and a statement that the grantor must take into account the items of income, deduction, and tax credit shown on the statement.761

It is possible to switch between methods.762 The regulations set forth the steps that a trustee must take to change the reporting method to the method described in Treasury Regulations section 1.671-4[b]. The trustee must file a final Form 1041 for the taxable year immediately before the year in which the trustee wishes to begin reporting under Treasury Regulations section 1.671-4[b].763 On the front of that Form 1041, the trustee must write: “Pursuant to section 1.671-4[g], this is the final Form 1041 for this grantor trust.”764

If, in contrast, a trustee has in the past reported trust income pursuant to Treasury Regulations section 1.671-4[b] specifically by furnishing the grantor’s name and taxpayer identification number to all payors and the trustee wishes to report in future years by means of Form 1041, the trustee must furnish to the income payors the trust’s name, taxpayer identification number, and address.765

758. Treas. Reg. § 1.671-4[b][3][ii].
759. Id.
760. Treas. Reg. § 1.671-4[b][3][ii][B][1].
761. Id.
762. Treas. Reg. § 1.671-4[g].
763. Treas. Reg. § 1.671-4[g][1].
764. Id.
765. Treas. Reg. § 1.671-4[g][2].
Similarly, if the trustee was reporting pursuant to Treasury Regulations section 1.671-4(b)(2)(i)(B), or (b)(3)(i) (and therefore furnished to the payors the trust’s name, taxpayer identification number, and address and filed Forms 1099 with the Service), but the trustee wishes to switch to reporting on Form 1041, in the last taxable year of its compliance with Treasury Regulations section 1.671-4(b) the trustee must file with the Service Form 1096, Annual Summary and Transmittal of U.S. Information Returns, on which it indicates that it is making its final return by such method. Although the regulations refer to the filing of “final” Forms 1041 and “final” Forms 1099 for a trust, they do not contemplate explicitly that an election to report income either by means of Form 1041 or pursuant to Treasury Regulations section 1.671-4(b) is irrevocable. Indeed, by implication, a trustee may comply by a different method from year to year.

766. Form 1096 is used to transmit paper Forms 1099, among others, to the IRS. This form must be filed by income payers, among others. Other persons required to file this form include a recipient of mortgage interest payments or student loan interest, an educational institution, a broker, a person reporting real estate transactions, and a lender who acquires an interest in secured property or who has reason to know that such property has been abandoned.

767. Note, however, that the regulations do not seem to contemplate a mid-year switch in reporting methods.