CREATING INTENTIONAL GRANTOR TRUSTS

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Editors' Synopsis: The changes in the progressive tax structure over the past decades have greatly reduced the tax incentive to divert income from a taxpayer with substantial income to a trust or its beneficiaries. As a result, although grantor trusts were once avoided, the "intentional grantor trust" has become a viable option that can, if properly structured, produce significant tax savings for many taxpayers. In this Article, the authors present an overview of the mechanics of a grantor trust and provide guidance on how to structure an intentional grantor trust to produce tax savings and avoid the potential hazards that may arise.

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I. INTRODUCTION

A. History

Since the enactment of income taxes, taxpayers have sought to reduce tax burdens. It seems as natural as breathing. Long ago, the legendary Judge Learned Hand of the United States Second Circuit Court of Appeals noted "that there is nothing sinister in so arranging one's affairs as to keep taxes as low as possible. . . . [F]or nobody owes any public duty to pay more [taxes] than the law demands. . . ."[1]

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*[2] is the classic example of courts not permitting income earned by one taxpayer to be taxed to another through a contractual assignment of income.[3]

Deflecting income from higher tax brackets to potentially lower tax brackets was contested by the Service. The landmark decision *Helvering v. Clifford*[4] 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[5] 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

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[1] Commissioner v. Newman, 159 F.2d 848, 850–51 (2d Cir. 1947) (Hand, J., dissenting). Similarly, Judge Hand, in *Helvering v. Gregory*, 69 F.2d 809, 810 (2d Cir. 1934), on behalf of the court, said: "Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes." (citing United States v. Isham, 84 U.S. (17 Wall.) 496, 506 (1873); Bullen v. Wisconsin, 240 U.S. 625, 630 (1916)).

[2] 281 U.S. 111 (1930).

[3] *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.

[4] 309 U.S. 331 (1940).

[5] *See* Treas. Reg. § 9.22(a)-1 (1939) (defining gross income); Treas. Reg. § 29.22(a)-21 (1946) (stating trust income taxable to grantor as substantial owner following provisions of T.D. 5488, 1946-1 C.B. 19).

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[6] that generally followed the *Clifford* regulations.

The 1948 adoption of joint returns for married couples[7] 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.[8]

The Tax Reform Act of 1986,[9] 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.[10] In addition, the 1986 Act all but eliminated lower tax brackets for trusts.[11] 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 $650 in income taxes.[12] In 2009, a trust reaches the top income tax bracket at about $11,150

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[6] *See* I.R.C. §§ 671–679. Unless otherwise noted, "Code" and "I.R.C." refer to the Internal Revenue Code of 1986, and "section" refers to a section of the Code. Note that I.R.C. § 679 was added to the Code in 1976.

[7] *See* Revenue Act of 1948, Pub. L. No. 471, ch. 168, sec. 303, § 51(b), 62 Stat. 110, 115.

[8] 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).

[9] Pub. L. No. 99–514, 100 Stat. 2085.

[10] 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).

[11] *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.

[12] 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).

of taxable income. [13] As a result, the use of a trust's lower brackets will save something in the neighborhood of $1,000. Neither sum would justify the planning and administration expenses of creating a separate trust.

B. Overview

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, 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 now 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.[14] 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. In any event, a grantor trust, whether or not it is viewed as defective, has potential planning opportunities presented by that tax status.[15]

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

[13] 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).

[14] The income tax status of a grantor trust is the same whether or not achieved intentionally.

[15] *See* Howard M. Zaritsky, *Open Issues and Close Calls—Using Grantor Trusts in Modern Estate Planning*, 43 ANN. HECKERLING INST. ON EST. PLAN. ¶ 300 (2009).

payment of the trust's income tax liability by the grantor is not a gift;[16]

permitting assets to be sold by the grantor to the trust for fair market value without the imposition of gift tax[17] or income tax, even if the assets sold are appreciated;[18] 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.[19]

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 S corporation) as to income and corpus.[20] In addition, the $250,000 ($500,000 for joint returns) exclusion from income under section 121 for the sale of a

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[16] *See* Rev. Rul. 2004-64, 2004-2 C.B. 7; *see also infra* notes 28–33 and accompanying text.

[17] 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.

[18] 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).

[19] 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).

[20] *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 F. LADSON BOYLE & JONATHAN G. BLATTMACHR, BLATTMACHR ON INCOME TAXATION OF ESTATES AND TRUSTS § 7:3 (15th ed., rev. 2008).

principal residence by an individual is available if the residence is owned by a grantor trust with respect to that individual.[21]

Tax reporting for a grantor trust is different from reporting for other trusts.[22] If a trust is a grantor trust, the grantor reports on his or her income tax return all income, deductions, and credits against the tax attributable to the trust property, although a grantor trust either must file a Form 1041 or follow the alternate reporting procedures described in Treasury Regulation section 1.671-4(b)(2).[23]

The affirmative use of grantor trusts as a tax planning tool has been aided by several published rulings. In Revenue Ruling 85-13,[24] 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,[25] but until revoked the Service is obligated to follow its own published ruling.[26] Moreover, the Service more

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[21] *See* Rev. Rul. 85-45, 1985-1 C.B. 183; I.R.S. Priv. Ltr. Rul. 91-18-017 (May 3, 1991) (prior section 121 provision excluding gain on sale of residence by individual over age fifty-five).

[22] *See* I.R.C. § 671.

[23] If the trust files a Form 1041, the entry lines for income, deductions, etc. on the form are left blank, and a statement is attached indicating the income, deduction, and tax credit information that has been communicated to the grantor for inclusion on the grantor's Form 1040. The grantor trust box on the Form 1041 should be checked. In some circumstances, no Form 1041 need be filed (and the trustee of the grantor trust does not need to obtain a taxpayer identification number). Under Treasury Regulation section 1.671-4(b), if the trust: (1) is a grantor trust, all of which is treated as owned by one grantor or one other person; (2) if the grantor or other person who is treated as the owner of the trust provides to the trustee a completed Form W-9; and (3) if the trustee gives the grantor's (or other person's) name and taxpayer identification number to all payors to the trust during the taxable year, the trust need not file a Form 1041, and the items of income will be reported directly to the grantor. *See* Treas. Reg. § 1.671-4(b)(1), 4(b)(2)(i), and 4(b)(2)(ii)(B). Furthermore, if the grantor also is the trustee or co-trustee, the trust is not required to give a reporting information statement to the grantor. *See* Treas. Reg. § 1.671-4(b)(2)(ii). If the conditions described above are satisfied, the grantor trust does not need to obtain a taxpayer identification number until either the first taxable year of the trust in which all of the trust is no longer "owned" by the grantor or another person, or until the first taxable year of the trust for which the trustee no longer reports pursuant to Treasury Regulation section 1.671-4(b)(2)(i)(A). *See also* Treas. Reg. § 301.6109-1(a)(2)(i). For a more extensive discussion, see BOYLE & BLATTMACHR, *supra* note 20, § 4:7.

[24] 1985-1 C.B. 184.

[25] *See* Rothstein v. United States, 735 F.2d 704 (2d Cir. 1984).

[26] *See* Rauenhorst v. Commissioner, 119 T.C. 157 (2002).

recently has reaffirmed its Revenue Ruling 85-13 position in Revenue Ruling 2004-64.[27]

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.[28] The Service has since changed its position, however. In Revenue Ruling 2004-64,[29] 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.[30] In addition, the Service ruled similarly in Revenue Ruling 2004-64, if the reimbursement is in the discretion of an independent trustee.[31] 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).[32] The ruling also addressed whether either a mandatory or discretionary reim-

[27] *See* Rev. Rul. 2004-64, 2004-2 C.B. 7; *see also supra* note 16.

[28] In Private Letter Ruling 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 Private Letter Ruling 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).

[29] 2004-2 C.B. 7.

[30] *See id.* (Situation 1).

[31] *See id.* (Situation 3).

[32] *See id.* (Situation 2).

bursement clause would cause inclusion of trust assets in the grantor's estate under section 2036.[33]

The "spousal-unity" rule enacted by Congress in 1986 broadens the potential scope of the grantor trust rules.[34] Under section 672(e), as amended

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[33] 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 section 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. 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 section 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 or herself as successor trustee, *cf.* Rev. Rul. 95-58, 1995-2 C.B. 1, or if such discretion permitted the grantor's creditors to reach the trust under applicable state law. *See* Rev. Rul. 2004-64, 2004-2 C.B. 7 (Situation 3). Some states have passed statutes specifically providing that a settlor's right in the trustee's discretion to be reimbursed for income taxes does not permit the settlor's creditors to reach the trust's assets. *See, e.g.*, TEX. PROP. CODE ANN. § 112.035(d) (Vernon 2004); N.H. REV. STAT. ANN. § 564-B:5-505(a)(2) (2006).

Revenue Ruling 2004-64 deals with a fact situation in which the trust agreement requires that the trustee be a person who is not related or subordinate to the grantor of the trust. The ruling does not address the issue of when the reimbursement is discretionary and the trustee is related or subordinate to the grantor. In that situation, the Service might argue that an implied agreement to reimburse might exist that would then cause estate inclusion under section 2036.

[34] *See* Tax Reform Act of 1986, Pub. L. No. 99-514, tit. XIV.A, sec. 1402, § 672(e), 100 Stat. 2085, 2711 (effective for transfers after Mar. 1, 1986).

in 1988,[35] 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,[36] "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."[37] 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.[38]

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.[39] Only the portion of the trust that remains is subjected to the remaining rules concerning the income taxation of trusts and their beneficiaries.[40] 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 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,[41] but grantor trust status

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[35] *See* Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, sec. 1014, § 672(e), 102 Stat. 3342, 3559.

[36] *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).

[37] *Id.*

[38] 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.

[39] I.R.C. § 671.

[40] *See id.*

[41] *See* BOYLE & BLATTMACHR, *supra* note 20, § 4:1.2.

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.[42] 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.

The ultimate question thus becomes how to achieve grantor trust tax status without causing other adverse tax consequences. Discussed below are various grantor trust rules that may be used to achieve grantor trust status, including consideration of the common choices and some of the not-so-common grantor trust rules that may be used intentionally to create a trust whose income is attributed to the grantor.

II. SECTION 673—RETAINED REVERSIONS

Section 673 provides that a trust is a grantor trust as to the fiduciary accounting income portion of the trust if the grantor retains a reversionary interest in the corpus of a trust, and if at the time the trust is created the reversionary interest is valued at more than 5%.[43] 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[44] is 4%, the trust must last more than seventy-six years before the reversion may take effect, to avoid section 673.[45] 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.[46]

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

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[42] *See* Rev. Rul. 2004-64, 2004-2 C.B. 7.

[43] *See* I.R.C. § 673(a).

[44] *See* I.R.C. § 7520 (providing the methodology to value term, life, and remainder interests).

[45] 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.

[46] This interpretation is based on a literal reading of the statute. No authority exists to suggest otherwise. *See* I.R.C. § 673.

grantor trust status as to income allocable to principal because of the reversionary interest.[47]

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.[48] In addition, section 2702 will treat the entire transfer to the trust for the benefit of a "member of the transferor's family"[49] 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.[50]

As an alternative to a grantor retaining a reversionary interest, a grantor might seek grantor trust status under section 673 by transferring a term certain interest in the trust to a child or other beneficiary and by giving his or her spouse a remainder interest. The spousal-unity rule of section 672(e) will make section 673 applicable if a remainder interest is given to the grantor's spouse and the value exceeds 5%.[51] Section 2702 will not apply to a grantor's transfer to a spouse and children if the grantor has given away his or her entire interest in the property.[52] The remainder interest given to the spouse should qualify for the gift tax marital deduction, if the spouse is a United States citizen, because it is not a terminable interest.[53] The remainder interest given to the spouse will be included in the spouse's estate[54] and the actuarial value of the remainder will increase as time passes even if the value of the underlying assets remains constant. Thus, this route to grantor trust status has its drawbacks, particularly if the trust is a financial success (that is, it experiences significant appreciation over time). Whether grantor trust status will be maintained if the spouse disposes of the remainder interest is uncertain, unless it results in the trust's termination. The test of grantor trust status as to income under section 673 is made at the time the transfer to trust is made and no apparent escape from grantor trust status exists once it is established under that section. Thus, turning off grantor trust status may not be possible even if the grantor wishes to stop paying taxes on the income earned by the trust.

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47 *See infra* Part VI.

48 *See* I.R.C. §§ 673(c), 2033.

49 *See* I.R.C. § 2702(a)(1). For the definition of *family member*, see section 2704(c)(2).

50 *See* I.R.C. § 2702; Treas. Reg. § 25.2702-3.

51 *See* I.R.C. §§ 672(e), 673. *See also* BOYLE & BLATTMACHR, *supra* note 20, § 4:5.2.

52 *See* I.R.C. § 2702(a)(1) (stating applies only to retained interests).

53 *See* I.R.C. § 2523; Treas. Reg. § 20.2056(b)-4(e).

54 *See* I.R.C. § 2033.

III. SECTION 674—POWERS TO CONTROL BENEFICIARY ENJOYMENT

Section 674(a) triggers grantor trust treatment if the grantor or a nonadverse party holds a power over the beneficial enjoyment of trust assets. Section 674(a) is not applicable to any power that requires "the approval or consent of any adverse party."[55] For example, if one of two co-trustees 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.[56] 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 portion rule is discussed with each of the exceptions noted below.

A. Section 674(b)—Exceptions for Certain Powers to Control Beneficiary Enjoyment

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.[57] 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.[58]

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

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[55] I.R.C. § 674(a). "Adverse party" is defined in section 672(a) 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 of appointment over the trust property. *Id.*

[56] *See* I.R.C. § 674(a).

[57] *See* I.R.C. § 674(b)(1)-(8).

[58] *See* Treas. Reg. § 1.674(b)-1.

income is so applied or distributed.[59] 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.[60] In other words, when section 677(b) applies, section 674 is not applicable.[61] 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[62] if distributions are mandatory or are subject to an ascertainable standard.[63]

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.[64] 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.[65]

Section 674(b)(3) excepts a testamentary power of dispostion over a trust from section 674(a) grantor trust status.[66] Excepted from the section 674(b)(3) exception is a power held by the grantor to appoint the income of a trust.[67] 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 a grantor testamentary power, thereby

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[59] *See* I.R.C. § 674(b)(1).

[60] *See* I.R.C. § 674(b)(1).

[61] See *infra* Part VI for a detailed discussion of Code section 677.

[62] *See* Treas. Reg. § 20.2036-1(b)(3).

[63] 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. Commissioner, 72 T.C. 721 (1979) (holding irrevocable *inter vivos* trusts for children were support trusts and included in decedent's gross estate).

[64] *See* I.R.C. § 674(b)(2).

[65] *See* Treas. Reg. § 20.2036-1(b)(3).

[66] *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.

[67] *See id.*

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.[68] 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.[69] 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.[70] 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).[71]

A grantor-retained power to appoint accumulated income also is not a wise choice for grantor trust status, however, as section 2036 would apply, causing an estate inclusion for the grantor's estate, regardless of who held the power to accumulate income.[72] 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.[73] The portion rule limits the grantor trust status under section 674(b)(3) to the

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[68] *See id.*

[69] 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.

[70] Section 674(a) is not applicable to any power that requires the consent or approval of any adverse party.

[71] *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).

[72] *See* I.R.C. § 2036.

[73] *See* I.R.C. § 672(e). *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 75 regarding a power limited to allocating income among charitable beneficiaries.

income portion of the trust, however.[74] 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.[75] The grantor retaining such a power will result in an estate inclusion for the grantor under section 2036(a)(2) and section 2038.[76] 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,[77] but is not likely 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,[78] 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.[79] 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,[80] *or* if separate shares are created for the respective beneficiaries and distributions are charged against the beneficiary's share.[81]

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[74] *See* Treas. Reg. § 1.671-3(b)(1).

[75] *See* I.R.C. § 674(a); Treas. Reg. § 1.674(b)-1(b)(3).

[76] *See* I.R.C. §§ 2038(a), 2036(a)(2).

[77] *See* Treas. Reg. § 20.2036-1(c).

[78] *See id.* § 20.2038(a)(3) (sections 2036 and 2038 applicable only to the transferor).

[79] *See* I.R.C. § 674(b)(4).

[80] 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.

[81] *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).

Therefore, to establish a grantor trust by not 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.[82] 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.[83]

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;[84] (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;[85] 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."[86]

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[82] *See* I.R.C. § 674(c). If the grantor is a trustee, estate inclusion will occur under section 2036(a)(2) or section 2038(a)(1).

[83] *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* Part III.D.

[84] *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).

[85] *See* I.R.C. § 674(b)(6)(B).

[86] *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."[87] 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.[88] 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.[89]

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.[90] 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.[91] 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.[92]

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.[93] However, there is no

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[87] Treas. Reg. §1.674(b)-1(b)(6)(i)(c).

[88] *See id.*

[89] *See id.* § 1.674(b)-1(b)(6)(ii) Ex. 1.

[90] *See id.* Ex. 2.

[91] *See id.* Ex. 3.

[92] *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* Part III.D.

[93] *See* I.R.C. § 674(b)(7).

requirement that the accumulated income ultimately be payable to the beneficiary, the beneficiary's estate, or the beneficiary's appointees.[94] Thus, if grantor trust status is 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.[95]

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.[96] This exception is consistent with a similar rule for estate tax purposes.[97]

B. Section 674(c)—Discretionary Sprinkle Powers Held by Independent Trustees

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."[98] 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.[99] "Person" is not defined for this purpose.[100] 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) excep-

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[94] *See* Treas. Reg. § 1.674(b)-1(b)(7).

[95] *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* Part III.D.

[96] *See* I.R.C. § 674(b)(8).

[97] *See* Old Colony Trust Co. v. United States, 423 F.2d 601, 603 (1st Cir. 1970).

[98] I.R.C. § 674(c).

[99] 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 190–193 and accompanying text.

[100] *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."

tion.[101] 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 fiduciary capacity and who is not adverse will negate the section 674(c) exception.[102]

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.[103] 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.[104] Subsection (c) does not require the spouse to be living with the grantor,[105] as is required in section 674(d).[106] 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.[107]

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."[108] The spouse should not have any obligation to support the trust beneficiaries or the spouse will be adverse

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[101] Code section 674(a) is not applicable to any power that requires the consent or approval of any adverse party.

[102] 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 150 and accompanying text about the use of powers of appointment to create grantor trust status.

[103] *See* I.R.C. § 674(c).

[104] *See* I.R.C. §§ 2038(a), 2036(a)(2).

[105] *See id.* § 674(c) (citing *id.* section 672(e)(2)).

[106] Section 674(d) applies for trustees "none of whom is the grantor or spouse living with the grantor. . . ." *Id.* § 674(d).

[107] Obviously, a deceased spouse cannot be a trustee to cause grantor trust status.

[108] 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 80–82 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 90–91 and accompanying text. For a discussion of the "reasonably definite standard" exception under section 674(d), see *infra* notes 122–131. *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).

and the general rule of section 674(a) will not apply.[109] 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 reasonably definite external standard.[110] The term "related or subordinate party" is defined in section 672(c), and includes the grantor's spouse[111] (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."[112]

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."[113]

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?[114] *Estate*

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[109] 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.

[110] 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 108.

[111] I.R.C. § 672(c). This provision is in addition to the rule of section 672(e). As discussed *infra* note 124 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.

[112] I.R.C. § 672(c).

[113] S. REP. NO. 83–1622, at 365 (1954), *reprinted in* 1954 U.S.C.C.A.N. 4621, 4719.

[114] *See* I.R.C. §§ 2036, 2038.

of Goodwyn v. Commissioner[115] 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.[116] Nevertheless, whether or not someone is subservient is a question of fact, and whether that determination 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.[117]

The portion rule will apply to limit grantor trust status to trust income if the section 674(c) power is solely over income.[118] 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.[119]

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,[120] 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.[121]

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[115] 32 T.C.M. (CCH) 740 (1973); *see also* United States v. Byrum, 408 U.S. 125 (1972).

[116] *See Goodwyn*, 32 T.C.M. (CCH) at 740.

[117] *See* I.R.C. § 672(e). *See supra* notes 35–38 and accompanying text.

[118] *See* Treas. Reg. § 1.671-3(b)(1).

[119] *See id.* § 1.671-3(b)(2).

[120] *See* I.R.C. §§ 2041, 2514.

[121] *See* I.R.C. § 674(c) (next to last sentence). See *infra* Part III.D for a discussion of the power to add beneficiaries.

C. Section 674(d)—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.[122]

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.

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 excep-

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[122] *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 *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:

> 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. . . . [h]owever, 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 . . . . [h]owever, the fact that the governing instrument is phrased in discretionary terms is not in itself an indication that no reasonably definite standard exists.
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> *Id.*

tions 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).[123] The confusion is compounded by the fact that section 674(c) specifically mentions section 672(e), while section 674(d) does not.[124] 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).

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.[125] 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.[126]

The standard under section 674(d) is a "reasonably definite external standard."[127] Note that this standard is not necessarily the same as an "ascertainable standard" under section 2041 and section 2514.[128] 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.[129] Also, the "reasonably definite external standard"

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[123] *See* I.R.C. § 672(e)(2).

[124] *See* I.R.C. § 674(c), (d).

[125] *See id.* §§ 672(e)(1)(A); 674(d).

[126] For a discussion of section 676, see *infra* notes 275-290, and accompanying text; see *infra* notes 291–312 and accompanying text as to section 677.

[127] I.R.C. § 674(d).

[128] *See id.* §§ 2041, 2514.

[129] *See, e.g.*, Estate of Jones v. Commissioner, 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

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.[130] 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.[131] In addition, care

services or hospitalization" not an ascertainable standard); Priv. Ltr. Rul. 78-41-006 (June 19, 1978) (power to invade corpus for "emergency" without "qualifying 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 "frivolous" before, it became so after *Sowell* decision of the Tenth Circuit was issued); Estate of Sowell v. Commissioner, 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 invade for emergencies is generally not ascertainable, but ruled that this standard was ascertainable in light of *Martin* decision).

[130] *See* I.R.C. § 674(d). *See generally*, Stephen R. Akers, *Selection of Trustees: A Detailed Review of Gift, Estate, and Income Tax Effects and Non-Tax Effects*, 38 ANN. HECKERLING INST. ON EST. PLAN., ¶ 300, ¶¶ 312.6–312.7 (2004).

[131] 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(c), (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 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 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 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.[132] 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.[133]

D. Power to Add Beneficiaries

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."[134] 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.[135]

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an ascertainable standard; transfer subject to such standard was a completed gift), *rev'g* 581 F. Supp. 252 (C.D. Ill, 1984).

132 *See* I.R.C. § 674(b)(5).

133 *See* I.R.C. § 674(b)(7)(B). See *infra* Part III.D for a discussion of the power to add beneficiaries.

134 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).

135 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

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).[136] However, 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.[137] 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.[138] 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.[139] 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.

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have mandatory rights to distributions to cause the limitations to these grantor trust rule exceptions to apply.

[136] The power to add beneficiaries exception in Sections 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.

[137] 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. *See* Treas. Reg. § 25.2511-1(g)(2); *see also* Regester v. Commissioner, 83 T.C. 1 (1984) (exercise of limited power of appointment by beneficiary with mandatory income interest resulted in a taxable gift).

[138] *See* Treas. Reg. § 25.2511-2(c), (f); *see also* Estate of Sanford v. Comm'r, 308 U.S. 39 (1939).

[139] A spouse who is adverse negates the application of section 674(a).

The power to add beneficiaries might be granted to the trustee of a trust.[140] 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,[141] 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 power is exercisable in a nonfiduciary capacity. But can a trustee ever do anything with respect to a trust in a nonfiduciary 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.[142] 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.

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[140] *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).

[141] *See, e.g.*, 1 MARK L. ASCHER ET AL., EDS, SCOTT AND ASCHER ON TRUSTS § 2.1.5 (5th ed. 2006).

[142] *See* Treas. Reg. § 1.674(d)-2(b).

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.[143] For example, if the power is to add spouses 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.[144] 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.[145] 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.[146] These provisions include giving the power-

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[143] *See, e.g.*, Virginia F. Coleman, *The Grantor Trust: Yesterday's Disaster, Today's Delight, Tomorrow's ?*, 30 ANN. HECKERLING INST. ON EST. PLAN. ¶ 800, ¶ 803.2 n. 31 (1996).

[144] *See* Madorin v. Commissioner, 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.

[145] Section 674(a) is not applicable to any power that requires the consent or approval of any adverse party.

[146] *See* Stephen R. Akers & Diana S.C. Zeydel, *Transfer Planning, Including Use of GRATs, Installment Sales to Grantor Trusts, and Defined Value Clauses to Limit Gift Exposure—Putting Grantor Trusts to Work*, 43 ANN. S. FED. TAX INST., R, R-55–57 (2008).

holder the right to remove any beneficiary that is added.[147] 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.[148]

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 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.[149]

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.[150] 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):

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[147] *See id.*

[148] *See id.*

[149] Toggling is discussed in greater detail in Part VIII, *infra.*

[150] *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).

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.[151]

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 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.[152]

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.[153] 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,[154] 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

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[151] *See* I.R.C. § 674(a). *See also supra* text accompanying note 150.

[152] Section 674(a) and the exceptions in section 674(b)(5)-(7), (c), (d) do not apply. *See supra* Part III.A.

[153] *See supra* notes 80–82 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 87–92 and accompanying text. The exception in section 674(c) does not apply.

[154] If the trustee has a legal obligation to support all beneficiaries, the trustee may not be adverse. *See supra* note 109.

> against a beneficiary's share.[155] 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.[156]

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. 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).

IV. SECTION 675—ADMINISTRATIVE POWERS

Section 675 provides that certain administrative powers will cause grantor trust status.[157] 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 "violating" section 675, the power must affect both income and principal in their entireties.[158]

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[159] or any nonadverse party, or both, to deal with the trust assets for less than full and adequate consideration results in grantor trust status.[160] Creating a grantor trust in such a manner may be unwise, however, because that power likely will cause estate tax problems for the powerholder.[161]

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155 The exceptions in sections 674(b)-(d) do not apply. *See supra* notes 80–133 and accompanying text.

156 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 110–116 and accompanying text.

157 *See* I.R.C. § 675.

158 *See* I.R.C. § 671; *see also* Treas. Reg. § 1.675-1(a) (referring to Treas. Reg. §§ 1.671-2 and 1.671-3).

159 The grantor's spouse is included as a result of section 672(e).

160 *See* I.R.C. § 675(1).

161 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.

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

Section 675(2) provides that a power in the grantor or the grantor's spouse[162] to borrow trust income or corpus without adequate security or without adequate interest being charged will result in grantor trust status.[163] Excepted from this provision is a power in the trustee to make similar loans to others (besides the grantor or the grantor's spouse).[164] The mere existence of the "prohibited" 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,[165] 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.[166]

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 section 675(2) even if the grantor cannot compel the loan.[167] As discussed below, a power of a nonadverse party 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.[168] 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 authori-

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[162] Or the grantor's spouse as a result of section 672(e).

[163] *See* I.R.C. § 675(2).

[164] The grantor's spouse, as a result of section 672(e).

[165] *See infra* Part IV.C.

[166] *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).

[167] *See* Treas. Reg. § 1.675-1(b)(2); Priv. Ltr. Rul. 2008-40-025 (Oct. 3, 2008).

[168] *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).

ty 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).[169] If a trustee makes the decision to lend funds to the grantor without adequate collateral, the trustee may require a 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. A safer choice for trustee might be someone who is not a "related or subordinate party" to the grantor. Revenue Ruling 95-58,[170] an estate tax revenue ruling, which permits a grantor to remove a trustee without risking estate inclusion under sections 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.[171]

C. Section 675(3)—Actual Borrowing of the Trust Assets By the Grantor

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.[172] Grantor

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[169] *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 Private Letter Ruling 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.*

[170] 1995-2 C.B. 191.

[171] *See id.*

[172] *See* I.R.C. § 675(3).

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.[173] 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.[174]

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,[175] regardless of the ability to make similar loans, but such a loan is not described in section 675(2).[176] 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[177] makes a loan to the grantor or the grantor's spouse with or without adequate security and with or without adequate interest.[178] 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.[179]

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[173] "Related or subordinate party" is defined in section 672(c).

[174] *See supra* notes 34–38 and accompanying text.

[175] *See* I.R.C. § 675(3).

[176] 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.*

[177] And who is subservient to the wishes of the grantor. *See id.* § 675(3).

[178] 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.

[179] *See supra* notes 154–156 and accompanying text discussing the meaning of "related and subordinate trustees."

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.[180] 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.[181] 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 the outstanding case and its own Revenue Ruling that it is obligated to follow.[182]

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.[183] 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.[184] 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

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[180] "The grantor has . . . borrowed . . . and has not completely repaid . . . before the beginning of the taxable year." I.R.C. § 675(3).

[181] *See* Mau v. United States, 355 F. Supp. 909 (D. Haw. 1973); Rev. Rul. 86-82, 1986-1 C. B. 253 (following *Mau*).

[182] *But see* Rauenhorst v. Commissioner, 119 T.C. 157 (2002) (holding Commissioner cannot "litigate against officially published rulings without first withdrawing or modifying them").

[183] *Compare* Bennett v. Commissioner, 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. Commissioner, 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).

[184] *See* I.R.C. § 675 (3).

should not provide for adequate security.[185] 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. [186] 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.[187]

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."[188] In addition, a nonfiduciary power to reacquire trust corpus and replace with property of equivalent value will result in grantor trust status.[189] 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

[185] 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 159–161 and accompanying text.

[186] 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.

[187] *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."). However, the Second Circuit held that such a purchase of trust assets for a note caused the trust to be a grantor trust as to future transactions, but the purchase transaction itself resulted in gain recognition. *See* Rothstein v. United States, 735 F.2d 704, 710 (2d Cir. 1984).

[188] I.R.C. § 675(4)(A). Voting control significance is not defined in the Code or Regulations for purposes of section 675(4)(A).

[189] *See* I.R.C. § 675(4)(C).

capacity primarily in the interests of the beneficiaries.[190] Under the regulations, if a power is not exercised by a person as 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."[191] 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.[192] 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.[193] This position seems questionable when the

[190] *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. Commissioner, 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. Commissioner, 22 T.C. 843 (1954). As to the standards for creation of an oral trust, see *Del Drago v. Commissioner*, 214 F.2d 478 (2d Cir. 1954). For cases of nontaxability where administrative powers were retained as trustee, see, for example, *Cushman v. Commissioner*, 153 F.2d 510 (2d Cir. 1946) (some powers held as grantor considered "negligible"); *Fruehauf v. Commissioner*, 12 T.C. 681 (1949); *Welch v. Commissioner*, 8 T.C. 1139 (1947); *Smith v. Commissioner*, 4 T.C. 573 (1945); and *Weisman v. Commissioner*, 3 T.C.M. (CCH) 723 (1944). *See also* Priv. Ltr. Ruls. 96-42-039 (Oct. 18, 1996) (section 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).

[191] Treas. Reg. § 1.675-1(b)(4); *see also* Richards v. Commissioner, 213 F.2d 494 (5th Cir. 1954), *rev'g* 19 T.C. 366 (1952); Moskin v. Johnson, 115 F. Supp. 565 (S.D.N.Y. 1953), *aff'd*, 217 F.2d 278 (2d Cir. 1954); *cf.* Estate of Hamiel v. Commissioner, 253 F.2d 787 (6th Cir. 1958); Hemphill v. Commissioner, 8 T.C. 257, 265 (1947) (irregularities in the administration of a trust, subsequently corrected, did not transform income otherwise taxable to the trust into income taxable to the grantor). *See generally* Query v. Commissioner, 13 T.C.M. (CCH) 891 (1954); Morgan v. Commissioner, 5 T.C. 1089 (1945). Several private letter rulings indicate the Service's position is that whether or not the power to substitute property of equivalent value is held in a nonfiduciary capacity is a question of fact even if the trust agreement expressly provides it is held in a nonfiduciary capacity. *See, e.g.*, Priv. Ltr. Ruls. 93-35-028 (Sept. 3, 1993); 91-26-015 (June 28, 1991); *cf.* Priv. Ltr. Rul. 93-45-035 (Nov. 12, 1993).

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

[193] *See, e.g.*, Priv. Ltr. Ruls. 2007-31-019 (Aug. 3, 2007); 2007-15-005 (Apr. 13, 2007); 1999-42-017 (Oct. 22, 1999); 96-45-013 (Nov. 8, 1996); 95-25-032 (June 23, 1995); 94-07-

power is made exercisable only in a nonfiduciary capacity within the meaning of section 675(4).

1. *Section 675(4)(A) and (B)—Powers Over Closely Held Stock*

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[194]—may have some utility but are limited to situations in which the trust is funded with closely held stock.[195] 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.[196] 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.[197] 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

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014 (Feb. 18, 1994); 93-52-007 (Dec. 30, 1993); 93-52-004 (Dec. 30, 1993); 93-37-011 (Sept. 17, 1993); 93-35-028 (Sept. 3, 1993); 92-53-010 (Jan. 1, 1993). Other letter rulings have not applied the facts and circumstances requirement but have held that the substitution power caused the trust to be a grantor trust. *See* Priv. Ltr. Ruls. 94-51-056 (Dec. 23, 1994); 93-52-017 (Dec. 30, 1993); 93-51-005 (Dec. 24, 1993); 93-45-035 (Nov. 12, 1993). Some rulings have applied a compromise approach, stating the grantor trust determination depends on the facts and circumstances but, assuming exercise of a section 675(4)(c) power in a nonfiduciary capacity, the trust would be treated as a grantor trust. *See, e.g.*, Priv. Ltr. Ruls. 98-10-019 (Mar. 6, 1998) (charitable lead trust); 2004-34-012 (Aug. 20, 2004) (power of substitution held by person(s) other than the grantor or the grantor's spouse causes trust to be a grantor trust under section 675(4)(C), if in fact held in a nonfiduciary capacity).

[194] *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."

[195] *See* S. REP. NO. 83–1622, at 365 (1954), *reprinted in* 1954 U.S.C.C.A.N. 4621, 4719. *See also* United States v. Byrum, 408 U.S. 125 (1972) (estate tax not applicable to transferred property, even though power to vote retained); Holdeen v. United States, 297 F.2d 886 (2d Cir. 1962) (for year 1946: grantor permitted to give investment advice to trustees); Estate of Gilman v. Commissioner, 65 T.C. 296 (1975), *aff'd*, 547 F.2d 32 (2d Cir. 1977).

[196] *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.*

[197] *Cf. Bryum*, 408 U.S. at 137–38.

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).[198] 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 trust is an "eligible" shareholder of an S corporation.

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.[199] It does not apply to a partnership.

2. *Section 675(4)(C)—Power Exercisable in a Nonfiduciary Capacity to Reacquire Assets by Substituting Assets of Equivalent Value*

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.[200] 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.[201]

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."[202] Because grantor trust status depends upon

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[198] *See* Treas. Reg. § 1.671-3(d)(2).

[199] *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.

[200] I.R.C. § 675(4)(C).

[201] *See* Treas. Reg. § 1.671-3(b)(3).

[202] Treas. Reg. § 1.675-1(b)(4). See *supra* notes 190–193 and accompanying text for a discussion of the nonfiduciary capacity requirement.

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).[203] 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.[204]

The power should not be held by an adverse party if grantor trust status is sought by reasons of the power. Even though several other clauses of section 675 require that a power be exercisable by a nonadverse party to cause the trust to be a grantor trust,[205] subsection 675(4) merely refers to powers held "by any person."[206] 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."[207] Despite the clear contradiction of the statute and regulations, the regulation possibly might be upheld under the broad deference standard announced in *Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc.*[208] 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 *State Street Trust Co. v. United States*,[209] the court concluded in a "very close"[210] case that broad management powers retained by the grantor, including the power to

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[203] 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.

[204] *See* Treas. Reg. § 1.675-1(b)(4).

[205] *See* I.R.C § 675(1), (2).

[206] I.R.C. § 675(4).

[207] Treas. Reg. § 1.675-1(b)(4).

[208] 467 U.S. 837 (1984). *See* Mitchell M. Gans, *Deference and the End of Tax Practice*, 36 REAL PROP. PROB. & TR. J. 731 (2002).

[209] 263 F.2d 635 (1st Cir. 1959) (Magruder, C.J., dissenting).

[210] *Id.* at 638.

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.[211] After the *State Street* decision, the Service argued in *Estate of Jordahl v. Commissioner*[212] 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.[213] The court viewed that situation as being no different from a case in which a settlor retains the power to direct investments.[214] The Service subsequently acquiesced in the *Jordahl* decision.[215]

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."[216] The ruling concluded that the substitution power would not cause estate inclusion under sections 2033, 2036(a), 2036(b), 2038, or 2039.[217] The ruling focused on the fact that the instrument said that the substitution power could be exercised only in a fiduciary capacity.[218] In *Jordahl*, the decedent was a co-trustee,[219] 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 *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

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211 *See id.* at 638–640.

212 65 T.C. 92 (1975), *acq. in result*, 1977-2 C.B. 1.

213 *Id.* at 96.

214 *See id.* at 96–97.

215 1977-2 C.B. 1.

216 Priv. Ltr. Rul. 2006-03-040 (Jan. 20, 2006).

217 *See id.*

218 *See id.*

219 *See* Estate of Jordahl v. Commissioner, 65 T.C. 92, 93 (1976), *acq. in result*, 1977-2 C.B.1.

> could not exercise the power to deplete the trust or to shift trust benefits among the beneficiaries.[220]

According to the Service's analysis of 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.[221] 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.[222]

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.[223] 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).[224] Nevertheless, the *Jorhahl* 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

[220] Priv. Ltr. Rul. 2006-03-040.

[221] *See* Priv. Ltr. Rul. 2006-06-006 (Feb. 10, 2006).

[222] 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.*

[223] *See Jordahl*, 65 T.C. at 97.

[224] *See* I.R.C. § 675(4)(c).

> benefits would not be substitutions of property "of equal value."[225]

The regulations and other authority under estate tax sections 2036 and 2038 say that how the power is held makes no difference.[226] 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 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.[227] In addition, several private letter rulings have ruled that a substitution power held in a nonfiduciary capacity would not cause estate inclusion.[228]

Revenue Ruling 2008-22[229] 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

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225 *Jordahl*, 65 T.C. at 97 (internal citations omitted).

226 *See* Treas. Reg. §§ 20.2036-1(b)(3) ("[I]t 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.").

227 *See, e.g.*, U.S. TRUST, PRACTICAL DRAFTING 3753–57 (Richard B. Covey ed., 1994).

228 *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, 2035–2038, 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).

229 Rev. Rul. 2008-22, 2008-1 C.B. 796.

2038.[230] The ruling cites *Jordahl*, but says that section 2038 did not apply because the decedent was bound by fiduciary standards.[231] 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.[232] 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."[233] 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 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.[234]

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

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[230] *See id.* at 797.

[231] *See id.*

[232] *See id.*

[233] *Id.* at 798.

[234] *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.

Id. (emphasis added).

among trust beneficiaries. Some commentators recommend relying on state law and general fiduciary principles; others have suggested drafting those requirements into the trust instrument.[235]

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[235] 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 beneficiates, the Trustee shall have the power to reinvest the trust 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 146, 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 an 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

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 a "power of administration . . . exercisable in a nonfiduciary capacity by any person *without the approval or consent of any person in a fiduciary capacity*."[236] 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."[237]

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.[238]

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*.[239] 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

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> 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).

236 I.R.C. § 675(4) (emphasis added).

237 Rev. Rul. 2008-22, 2008-1 C.B. 796 (emphasis added).

238 *See* Akers & Zeydel, *supra* note 146, at R-52.

239 *See* Michael D. Mulligan, *Power to Substitute in Grantor Does Not Cause Inclusion, With a Significant Caveat*, 109 J. TAX'N 32, 33 (July 2008).

trust.[240] 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. [241] The AOD provides:

> Applying the Second Circuit's rational [sic] in *Estate of Hector R. Skifter v. Commissioner*. . . that it was Congresses [sic] intent that Code § 2042 should operate to give insurance policies estate tax treatment roughly parallel to the treatment given other types of property under Code §§ 2036, 2037, 2038, 2041, 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.[242]

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.[243] 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.[244] 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.[245] The Service lost that argument in *Estate of Smith v. Commissioner*.[246] 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.[247]

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[240] *See* Estate of Jordahl v. Commissioner, 65 T.C. 92 (1975), *acq.in result* 1977-2 C.B. 1. *See also* Priv. Ltr. Rul. 94-13-045 (Apr. 1, 1994) (citing and relying on *Jordahl*).

[241] *See Jordahl*, 65 T.C. at 92, *action on dec.*, 1977-129 (Apr. 15, 1977).

[242] *Id.* (internal citations omitted).

[243] *See* Rev. Rul. 79-46, 1979-1 C.B. 303.

[244] *See id.*

[245] *See id.*

[246] 73 T.C. 307 (1979), *action on dec.*,1981-66 (Jan. 12, 1981), *acq. in result*, 1981-1 C.B. 2.

[247] *See id.*

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."[248]

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 "controlled corporation" for purposes of section 2036(b).[249] 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.[250] 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.[251]

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).[252] 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 substitu-

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[248] Priv. Ltr. Rul. 98-43-024 (Oct. 23, 1998).

[249] *See* Zaritsky, *supra* note 15, ¶ 301.2[B].

[250] *See* I.R.C. § 2036(b)(2).

[251] *See* I.R.C. §§ 2036(b)(3); 2035 (a)(1).

[252] I.R.C. § 2036(b)(1). *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 sections 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. *See* Rev. Rul. 2008-22, 2008-1 C.B. 796.

tion 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.[253]

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.[254] 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 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.

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.[255] 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."[256] The regulations refer to a power held "by any nonadverse party."[257]

A concern with third-party substitution powers is that subsection 675(4)(C) applies if "a power to *reacquire* the trust corpus" is present.[258] 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

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[253] *See supra* note 199 and accompanying text.

[254] *See* Estate of Jordahl v. Commissioner, 65 T.C. 92 (1975), *acq.* 1977-2 C.B. 1.

[255] *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).

[256] I.R.C. § 675(4) (power "exercisable in a nonfiduciary capacity by *any person*") (emphasis added).

[257] Treas. Reg. § 1.675-1(b)(4) (referring to "existence of powers of administration exercisable in a nonfiduciary capacity by any nonadverse party").

[258] I.R.C. § 675(4) (emphasis added).

lead trust was sufficient to cause grantor trust treatment for income tax purposes.[259]

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).[260] One of the sample forms is for a CLAT that is a grantor trust CLAT, which uses a third-party substitution power to cause grantor trust status.[261] Similarly, Revenue Procedure 2008-45 uses the same approach for the sample form of *inter vivos* CLUT that is a grantor trust.[262]

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

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259 *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 Private Letter Ruling 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.

260 *See* Rev. Proc. 2007-45, 2007-2 C.B. 89.

261 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).

262 *See* Rev. Proc. 2008-45, 2008-2 C.B. 224.

> question of fact. Note, that the exercise of a § 675(4) power may result in an act of self-dealing under § 4941.[263]

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 . . . ."[264]

If there is concern that a nonfiduciary grantor substitution power may cause estate inclusion, despite Revenue Ruling 2008-22, [265] 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 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.[266]

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.[267] 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

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[263] Rev. Proc. 2007-45, § 8.09(1), 2007-2 C.B. 89.

[264] *Id.* § 3, 2007-2 C.B. 89.

[265] *See* Rev. Rul. 2008-22, 2008-1 C.B. 796. *See also supra* notes 229–234 and accompanying text.

[266] *See infra* Part VIII.

[267] *See* I.R.C. § 672(e).

a trial (or a concession by the Service) after the fact.[268] As a result, caution suggests that section 675(4)(C) alone should not be relied upon to cause grantor trust status.[269]

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.

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.[270] 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.[271]

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[268] 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, *When Using a Power of Substitution—Take Nothing for Granted*, EST. PLAN., Aug. 2007, at 3.

[269] *See id.* Other commentators have similarly cautioned against sole reliance on section 675(4)(C). *See, e.g.*, Coleman, *supra* note 143, ¶ 803.1.

[270] *See* Rev. Rul. 85-13, 1985-1 C.B. 184, discussed *supra* note 24 and accompanying text.

[271] *See, e.g.*, Priv. Ltr. Rul. 2008-46-001 (Nov. 14, 2008) (approving substitution power that determined value of shares exchanged using "mean between highest and lowest quoted selling prices" on day of exchange).

E. 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 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.[272] 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,[273] planners may be comfortable using grantor substitution powers. The trust instrument should specifically state that the substitution power is exercisable in

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[272] For example, a child of the grantor will always be the grantor's child and thus related and subordinate.

[273] 2008-1 C.B. 796. *See supra* notes 227–254 and accompanying text.

> 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.[274]

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

V. SECTION 676—POWERS TO REVOKE[275]

Section 676(a) provides that a grantor of a trust is treated as the owner if the grantor has a power to revoke the trust.[276] Section 676(a) also applies if the grantor's spouse[277] or a nonadverse party, or both, have the power to revest title in the grantor.[278] 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.[279] In that circumstance, the income may be taxed to the grantor under section 673. A revocable trust might also fall under section 674, because of a power to control beneficial enjoyment, but revocable trusts are treated separately under section 676. Section 676 is not applicable to powers that affect "the beneficial enjoyment of the income" for the time period permitted in section 673.[280]

How the power to revest may be labeled or how the power must be exercised does not affect the applicability of section 676. For example, a reserved power to purchase the trust corpus for a nominal consideration is a

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274 *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.

275 Portions of this discussion may be found in BOYLE & BLATTMACHR, *supra* note 20, and appear herein with permission.

276 *See* I.R.C. § 676(a). Section 676 applies if the power to revest title in the grantor 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. Section 676(b) excepts from the section 676 rule powers that affect beneficial enjoyment only after a period of time that prevents the trust from being a grantor trust under section 673. *See also* Treas. Reg. §§ 1.672(d)-1; 1.676(b)-1. 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. *See* UNIF. TRUST CODE § 602 (2005), 7C U.L.A. 546 (2006). This presumption reverses the common law rule that trusts are presumed irrevocable unless a power to revoke was reserved at the time of creation. *See, e.g.*, 76 AM. JUR. 2D *Trusts* § 71 (2005).

277 As a result of section 672(e).

278 *See* I.R.C. § 676(a).

279 *See* Helvering v. Wood, 309 U.S. 344 (1940).

280 See *supra* notes 43–54 and accompanying text for a discussion of section 673.

power to revoke to the extent the value of the property that may be reacquired exceeds the consideration to be paid.[281] The income is likewise taxable to the grantor if the grantor reserves the power to appoint an individual other than the grantor to exercise the right to terminate the trust.[282]

Contingent powers are not necessarily within the scope of section 676.[283] In addition, the power to substitute securities that produced substantially an equal income for securities held in the trust is not a power to revest,[284] nor is a power to purchase trust assets at a fair price.[285]

The retained power to direct investments does not result in grantor trust status under section 676.[286] Similarly, a power to appoint the remainder by deed or will,[287] or the reserved power to change the beneficiaries or to modify the distributive shares, is not a power to revest the corpus in the grantor.[288]

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 is not a choice for creating a grantor trust.[289] 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. 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

[281] *See* Fisher v. Commissioner, 28 B.T.A. 1164 (1933); *see also* I.R.C. § 675(1) (treating this reserved power as a taxable administrative power).

[282] *See* Pulitzer v. Commissioner, 36 B.T.A. 964 (1937).

[283] *See* Commissioner v. Betts, 123 F.2d 534 (7th Cir. 1941); Commissioner v. O'Keefe, 118 F.2d 639 (1st Cir. 1941); Corning v. Commissioner, 104 F.2d 329 (6th Cir. 1939). Coverage may depend upon the likelihood of the contingency. *See* I.R.C. § 673(a); Treas. Reg. § 1.673(a)-1(c), (d). *But cf.* Treas. Reg. 118, § 39.166-1(b)(1)(ii) (1939). *See* Mills v. Commissioner, 39 B.T.A. 798 (1939); *cf.* I.R.C. § 675(4)(c).

[284] *See* Frick v. Driscoll, 42-2 U.S. Tax Cas. (CCH) ¶ 9,508, 29 A.F.T.R. (P-H) 794 (W.D. Pa. 1941), *rev'd on other grounds*, 129 F.2d 148 (3d Cir. 1942).

[285] *See* Palmer v. Commissioner, 40 B.T.A. 1002 (1939), *aff'd*, 115 F.2d 368 (2d Cir. 1940) (holding that reservation of option to repurchase stock not reservation of power of revocation).

[286] *See* Maloy v. Commissioner, 45 B.T.A. 1104 (1941).

[287] *See* Commissioner v. Bateman, 127 F.2d 266 (1st Cir. 1942).

[288] *See* Knapp v. Hoey, 104 F.2d 99 (2d Cir. 1939); Donner v. Commissioner, 40 B.T.A. 80 (1939); Downs v. Commissioner, 36 B.T.A. 1129 (1937). *But cf.* Todd v. Commissioner, 32 B.T.A. 1067 (1935), *aff'd*, 82 F.2d 1020 (2d Cir. 1936).

[289] *See* I.R.C. §§ 2036, 2038.

of appointment and an estate problem for 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).[290]

VI. SECTION 677—INCOME FOR BENEFIT OF GRANTOR OR GRANTOR'S SPOUSE

Section 677(a) provides that a grantor is treated as the owner of any portion of a trust if the income *may* be paid to the grantor or the grantor's spouse without the consent of an adverse party.[291] Nevertheless, 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.[292]

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.[293] 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.[294]

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

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290 *See* I.R.C. § 2041. As to the impact of an ascertainable standard or distribution, see *supra* notes 127–131 and accompanying text.

291 *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).

292 *See* Treas. Reg. § 1.677(a)-1(g) Ex.1.

293 *See* Priv. Ltr. Ruls. 95-04-021 (Jan. 27, 1995); 94-51-056 (Dec. 23, 1994); 94-49-012 (Dec. 9, 1994), *modified by* 1999-51-031 (Dec, 24, 1999); 94-44-033 (Nov. 4, 1994); *modified by* 95-43-049 (Oct. 27, 1995); 94-150-12 (Apr. 15, 1994). *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).

294 *See* Priv. Ltr. Rul. 96-25-021 (June 21, 1996). For a description of a GRAT, see Treasury Regulation section 25.2502-3.

as to the corpus under sections 674(a) and 674(b)(3).[295] 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.[296]

If the grantor's spouse is the beneficiary of a section 677 grantor trust as to trust income and principal, grantor status may be achieved without an estate inclusion,[297] but upon the death of the spouse or a divorce, grantor trust status terminates as section 672(e) no longer applies.

A grantor is treated as the owner of any portion of the trust whose income may be applied to the payment of premiums of policies of insurance on the life of the grantor or the grantor's spouse.[298] This statutory provision appears to be very broad. Read literally, it seems to indicate that giving a trustee the power to pay life insurance premiums from the income of a trust conceivably could cause all of the income and corpus of the trust to be a grantor trust. In fact, not prohibiting the trustee from making such payments would seem sufficient to trigger creation of a grantor trust if under local law the trustee could do so.

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[295] *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).

[296] 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.

[297] *See* Priv. Ltr. Rul. 2008-42-007 (Oct. 17, 2008) (ruling no estate tax inclusion, but grantor trust status under sections 671 and 677(a) "because all of the income and principal of Trust may be distributed to Spouse in the discretion of a nonadverse trustee").

[298] *See* I.R.C. § 677(a)(3); Treas. Reg. § 1.677(a)-1(b)(2)(iii). *See generally* Howard M. Zaritsky, *Drafting and Planning Life Insurance Trusts for Policies Both Traditional and Unusual,* 28 ANN. HECKERLING INST. ON EST. PLAN. ¶ 400, ¶ 403.2.D.2.a (1994).

However, cases have imposed restrictions on grantor trust status resulting from the power to pay life insurance premiums. For example, if the trust does not actually own a life insurance policy on the grantor's life, older cases have concluded that the mere power to purchase an insurance policy and to pay premiums from income would not be sufficient to cause grantor trust status.[299] Even if the trust owns policies on the grantor's life, some cases have concluded that the grantor will be treated merely as the owner of so much of the income as is actually used to pay premiums.[300]

The Service has not always agreed with the courts, however. A Field Attorney Advice Memorandum[301] takes the position that the power to purchase life insurance on the grantor's life causes grantor trust treatment, in a ruling involving a foreign trust in which it was in the Service's interest for the trust to be a grantor trust. 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."[302]

One private letter ruling held that grantor trust status arises only to the extent of premiums payable by the trust for the current year.[303] Another private letter ruling provides that a power to pay premiums alone causes the entire trust to be a grantor trust.[304]

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.

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[299] *See* Corning v. Commissioner, 104 F.2d 329, 333 (6th Cir. 1939); Moore v. Commissioner, 39 B.T.A. 808, 812 (1939), *acq*. 1939–2 C.B. 25.

[300] *See* Weil v. Commissioner, 3 T.C. 579 (1944), *acq*. 1944-1 C.B. 29; Iversen v. Commissioner, 3 T.C. 756 (1944); Rand v. Commissioner, 40 B.T.A. 233 (1939), *acq*. 1939-2 C.B. 30, *aff'd*, 116 F.2d 929 (8th Cir. 1941), *cert*. *denied*, 313 U.S. 594 (1941).

[301] I.R.S. Field Att'y Advice Mem. 20062701F (July 7, 2006).

[302] *Id.* at 10.

[303] *See* Priv. Ltr. Rul. 6406221750A (June 22, 1964).

[304] *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 prohibited paying life insurance premiums from income and trust accounted payments as paid from corpus).

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.[305] 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.[306]

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.[307] 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; that is, one made within nine months of the creation of the interest.[308] 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

[305] 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).

[306] *See* Treas. Reg. § 20.2036-1(b)(2).

[307] *See* United States v. Estate of Grace, 395 U.S. 316 (1969), *reh'g denied*, 396 U.S. 881 (1969).

[308] *See* Treas. Reg. § 25.2518-2 (requirements for a qualified disclaimer).

not for estate tax purposes.[309] Note, however, that the split gift election is not available if the spouse's interest in the trust cannot be quantified.[310]

If the grantor, rather than the grantor's spouse, is a discretionary beneficiary, there is some likelihood that the trust assets would be included in the grantor's estate under section 2036, unless the trust is formed in a state where a grantor can be a discretionary beneficiary without subjecting the trust assets to the grantor's creditors.[311] Even in such a "self-settled trust" state, however, if the trustee actually 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.[312]

If section 677 is being utilized 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.

A. Summary of Viable Choices for Grantor Trust Under Section 677

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. A power to pay life insurance premiums on a policy insuring the grantor's life may be added to other provisions that will result in grantor trust status, but should not be relied on alone as ensuring grantor trust status.

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[309] *See* I.R.C. §§ 2513(a)(1); 2652(a)(2). No analogous estate tax provision exists. *See, e.g.*, Rev. Rul. 74-556, 1974-2 C.B. 300 (no section 2038 inclusion for spouse of grantor).

[310] *See generally* Diane S. C. Zeydel, *Gift Splitting—A Boondoggle or a Bad Idea? A Comprehensive Look at the Rules*, 106 J. TAX'N 334 (June 2007).

[311] *Compare* Outwin v. Commissioner, 76 T.C. 153 (1981) (applying Massachusetts law), *with* Estate of German v. United States, 7 Cl. Ct. 641 (1985) (applying Maryland law).

[312] *Cf.* Rev. Rul. 2004-64, *supra* note 27 (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).

VII. SECTION 679—FOREIGN TRUSTS

Section 679 provides that a foreign trust is a grantor trust if the trust was created by a United States person and any beneficiary of the trust is a United States taxpayer.[313] As to such a trust, the trust income is attributable to the United States person who is the grantor.[314]

A. Generally

A trust is a foreign trust unless both of the following tests are satisfied: (1) a United States court is able to exercise primary supervision over the trust; and (2) one or more United States persons have the authority to control all substantial trust decisions.[315] A United States 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.[316]

When a foreign person has control over at least one substantial decision, foreign trust status results.[317] Substantial decisions are defined in the regulations to mean "those decisions . . . that are not ministerial."[318] 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.[319] 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.[320] Thus, a domestic trust becomes a foreign trust if a non–United States person or persons come into control of a substantial decision. With multiple trustees, the non–United States person or persons must hold a

313 *See* I.R.C. § 679.

314 *See id.*

315 *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 United States 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 BOYLE & BLATTMACHR, *supra* note 20, § 5.

316 *See* I.R.C. § 7701(a)(30).

317 *See* I.R.C. § 7701(a)(31)(B).

318 Treas. Reg. § 301.7701-7(d)(1)(ii).

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

320 *See id.* § 301.7701-7(d)(1)(ii)(H), (I).

minority vote to make any substantial decision of the trust for the trust to remain a United States trust.[321]

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 United States 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).[322] However, if that occurs 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.[323]

Section 672(f) provides that the grantor trust rules will not apply if they would cause someone other than a United States citizen, resident, or domestic corporation to be treated as the owner of the income.[324] 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 United States 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*[325] withdrawal power over all contributions to the trust.[326]

Foreign trusts are subject to additional rules not generally applicable to domestic trusts. United States beneficiaries (including a grantor) who receive, directly or indirectly, any distribution from a foreign trust must report information to the Service on Form 3520.[327] Additional required information is described in Notices 97-34 and 2003-75.[328] A United States

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[321] *See id.* § 301.7701-7(d)(1)(iii).

[322] *See* I.R.C. § 684.

[323] *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.*

[324] *See* I.R.C. § 672(f).

[325] *See* Crummey v. Commissioner, 397 F.2d 82 (9th Cir. 1968).

[326] 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).

[327] *See* I.R.C. § 6048(c)(i).

[328] *See* I.R.S. Notice 97-34, 1997-1 C.B. 422, *as amended by* I.R.S. Notice 2003-75, 2003-2 C.B. 1204.

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.[329] In addition, the foreign trust must file an annual return, and if it does not, the United States 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.[330] If a United States trust becomes a foreign trust during the lifetime of a United States grantor, the United States grantor must report the transfer.[331] When a grantor foreign trust converts to nongrantor status, such as when the grantor dies and the trust continues as a foreign trust, the United States 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.[332] 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.[333] In addition, the tax under the throwback rule is increased by an interest charge.[334] Some loans made by foreign trusts are deemed distributions and indirect distributions may be reclassified as direct distributions to a United States person.[335] Section 1441 requires withholding at the source on distributions to foreign trusts.[336]

A foreign trust is not an eligible S corporation shareholder.[337] This rule negates one reason why grantor trust status might be attractive if the grantor is a United States individual who is a permissible S corporation shareholder.

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[329] *See* I.R.C. § 6677(a).

[330] *See* I.R.C. § 6677(b).

[331] *See* I.R.C. § 679(a)(5).

[332] *See* I.R.C. § 643(a)(3), (a)(6)(C).

[333] *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.*

[334] *See* I.R.C. §§ 667(a)(3), 668.

[335] For a comprehensive discussion of these issues, see BOYLE & BLATTMACHR, *supra* note 20, § 5.

[336] *See* I.R.C § 1441. For a comprehensive discussion of these issues, see BOYLE & BLATTMACHR, *supra* note 20, § 5.

[337] *See* I.R.C. § 1361(c)(2) (last sentence).

B. Summary of Viable Choices for 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. Certainly, knowledge of the foreign trust rules and experience with them is critical for the planner who suggests this route to grantor trust status.

VIII. SWITCHING OR TOGGLING GRANTOR TRUST STATUS ON AND OFF

A. 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. 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" income or loss deduction. Thus, planning flexibility, for whatever reason, is increased if grantor trust status may be toggled on or off.[338]

[338] For an excellent discussion of these issues, see Videotape: Ellen L. van Hoften, Planning With Intentionally Defective Grantor Trusts (A.L.I.-A.B.A. Video Law Review Mar. 26, 1997). *See also* Howard M. Zaritsky, *Toggling Made Easy—Modifying a Trust to Create a Grantor Trust*, 36 EST. PLAN. 48 (2009).

Sometimes, turning off grantor trust status is as easy as releasing the power or beneficial interest that caused grantor trust status.[339] In other circumstances, it is accomplished by changing trustees to those who may have the grantor-trust sensitive power without causing grantor trust status.[340] 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).[341] However, in a few circumstances, converting the trust to nongrantor status may not be possible.[342] 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.[343] If the grantor or the grantor's spouse has the right to 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.[344]

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[339] *E.g.*, a section 675(4)(C) power. *See supra* Part IV.D.2.

[340] *E.g.*, a section 674(c) power. *See supra* Part III.B.

[341] *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. *See supra* Part IV.C.

[342] *E.g.*, a section 673 power. *See supra* Part II.

[343] 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 of the combined power of the two, and thus grantor trust status has not been toggled off. Under this view, terminating grantor trust status may be impossible. While this argument seems farfetched, for drafters who have such concerns, the trust instrument might specifically provide that the power to reinstate may not be exercised in the same year that the power is released. Then, on January 1st of each year, the initial powerholder may re-affirm the release of the power for the upcoming year, unless toggling back on may be desirable.

[344] *See* Treas. Reg. § 1.675-1(a).

Many of the grantor trust powers must be exercisable without the consent of any adverse party to result in grantor trust status.[345] 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.[346] 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.[347] 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 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.[348] To ameliorate that concern, the

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345 *See supra* Part III.

346 *See supra* Part IV.B.

347 See the caveat given *supra* note 343.

348 *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 146, at R–60.

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[349] 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.[350]

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 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.[351] 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.[352] Thus, if the

[349] 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.

[350] 1995-2 C.B. 191.

[351] 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.

[352] *See* I.R.C. § 672(e).

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[353] 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.[354] 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.[355]

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 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.

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353 *See* Priv. Ltr. Rul. 90-10-065 (Mar. 9, 1990). The trust instrument in this letter ruling contains an intricate checks and balances system.

354 If the spouse were not living, the approval of the taxpayer's sibling was required. *See id.*

355 *See id.*

Sometimes an irrevocable trust may be modified by either a court or by decanting.[356] 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[357] 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.[358] The non-contingent remainder interest causes grantor trust status.[359] 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.[360] 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.[361] 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."[362]

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 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

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[356] *See* William R. Burford and Patricia H. Char, *Renegotiating the Irrevocable Trust: Amending, Decanting, and Judicially Modifying*, A.L.I.-A.B.A. EST. PLAN. COURSE MAT. J., Dec. 2008, at 37.

[357] 2007-36 C.B. 545.

[358] *See id.*

[359] *See id.*

[360] *See id.*

[361] *Id.*

[362] *Id. See generally*, JONATHAN G. BLATTMACHR, MITCHELL M. GANS & DAMIEN RÍOS, CIRCULAR 230 DESKBOOK § 3:2.1[A][6] (2009) (discussing "transactions of interest").

does provide some level of support for those who are reluctant to exercise the “toggle back on” step.

B. 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.[363] 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.[364] 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.[365] 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.[366]

An irrevocable trust may be modified by either a court or by decanting.[367] 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 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.[368]

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363 *See supra* Part III.B.

364 *See supra* notes 315–337 and accompanying text.

365 *See supra* Part IV.C.

366 *See, e.g.*, N.Y. EST. POWERS & TRUSTS LAW § 10-6.6 (McKinney 2009); ALASKA STAT. § 13.36.157 (2009).

367 *See* Burford & Char, *supra* note 356. 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 nongrantor trust into a grantor trust in any year in which the power was determined to be a nonfiduciary power. Priv. Ltr. Ruls. 2008-48-006 (Nov. 27, 2008), 2008-48-015 (Nov. 28, 2008), 2008-48-016 (Nov. 28, 2008), and 2008-48-017 (Nov. 28, 2008). In those rulings, the IRS expressed no opinion on the gift tax effects of the modification or of an exercise of the substitution power.

368 *See supra* notes 180–183 and accompanying text.

C. 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.[369] 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."[370]

IX. CONCLUSION

If the planner wants to trigger grantor trust status, he or she should use one (or more, to be safe) of the following: (1) Select trustees and dispositive powers to "flunk" all of the exceptions in section 674—generally, a discretionary trust where more than one-half of the trustees (or the persons holding the discretion if not a trustee) are related or subordinate parties and there is no reasonably definite external standard for discretionary distributions; (2) Give a nonadverse party the power to add beneficiaries; (3) Give a nonadverse trustee the power to make a loan to the grantor and not require adequate security for the loan; (4) Give a non-beneficiary/non-trustee person an *inter vivos* limited power of appointment; (5) Give anyone a substitution power in a nonfiduciary capacity (realizing that the Service takes the position that whether it is exercisable in a nonfiduciary capacity is a question of fact, to be determined in every year in every case); (6) Create a trust in which the grantor's spouse is a discretionary beneficiary of both income and principal; (7) Create a foreign trust by having one or more foreign trustees who control at least one substantial decision.

Grantor trust status may be turned off and back on by providing that the power or interest that results in grantor trust may be released or the trustees changed. Grantor trust status is regained by providing that a third party may reinstate the released power or interest or again change the composition of trustees.

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[369] 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 BOYLE & BLATTMACHR, *supra* note 20, § 4:8.

[370] I.R.S. Chief Couns. Adv. 2009-23-024 (June 5, 2009).