Developments Involving Grantor Trusts

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A. What Is A Grantor Trust?

1. A trust is treated as a grantor trust when a grantor or another person is treated as the owner of the trust income or principal or both for federal income tax purposes.

   a. This means the grantor or such other person must include in the computation of taxable income all items of "income, deductions, and credits against tax of the trust" attributable to the portion of the trust over which the grantor or such other person is deemed to be the owner. In other words, the grantor or such other person treated as the owner of the trust is taxed to the same extent as if he or she had received the item directly. Section 671; Treas.Reg. §1.671-2(d).

2. Sections 673 through 679 set forth the situations in which a grantor or another person is deemed to be the owner of the trust, thereby creating a grantor trust. It generally is desirable, when creating a grantor trust, to ensure that the grantor is treated as the owner as to the entire trust, as it is possible that a grantor is treated as the owner only of a portion of the trust. If the grantor is deemed to be the owner of only a portion of the trust, then

the grantor includes only those items of income, deductions, and credits allocable to that portion. Treas.Reg. §1.671-3(a).

3. There are three ways a grantor can own a portion of a trust.

   a. *Income Or Principal Only*. The grantor owns either the ordinary income portion of the trust or the principal portion of the trust. This occurs when the power or interest creating grantor trust status extends only to income or only to principal. If a wholly grantor-owned trust is desired, it is important to ensure that the powers or interests conferred upon the grantor cause the grantor to be treated as the owner of both the income and the principal of the trust for federal income tax purposes.

   b. *Fractional Or Pecuniary Share*. The grantor can be deemed the owner of both income and principal but only as to a fractional or pecuniary share of such income and principal. This occurs when the trust can be treated as a grantor trust as to one or more individuals. It also can occur when the power or interest does not extend fully. For example, if a grantor retains the right to borrow up to one-half of the trust assets, the grantor owns a 50 percent share of the trust and is allocated 50 percent of the income, deductions, and credits of the trust.

   c. *Specific Assets*. Finally, a grantor can be deemed the owner of both income and principal but only as to specific assets of the trust. For example, the grantor retains the right to substitute assets under section 675(4) excluding life insurance policies. The grantor would not be deemed the owner of the life insurance policies for federal income tax purposes.

4. *Section 673: Reversionary Interests*

   a. Section 673(a) applies when a grantor has retained a reversionary interest in either the trust principal or trust income, the value of which, at the time of the creation of the trust or the portion over which the grantor has such reversionary interest, exceeds five percent of the value of the trust or such portion. The following illustrates the concept of a reversion.

      i. *Example*. A creates a trust for the benefit of B, under which B may receive distributions of income or principal or both in the discretion of the trustee. Upon B's death, any property remaining in the trust reverts to A, if A is living, or, if not, to A's estate. A has retained a reversionary interest in the trust.

   b. A reversion alone will not cause a trust to be treated as a grantor trust. Only if the value of the reversion at the time the trust is created exceeds five percent of the value of the entire trust will the trust be considered a grantor trust. The five percent test in section 673 corresponds to the five percent test in section 2037, which states that a decedent's estate includes assets that the decedent had transferred during the decedent's lifetime in which the decedent retained a reversionary interest worth more than five percent of the total value of the assets on the date of the decedent's death. To value the reversionary interest, use the section 7520 tables. *See* Rev.Rul. 76-178, 1976-1 C.B. 273. These tables combine the current interest rate and the age of the life beneficiary or years until the interest will revert.

   c. While the retention of a reversionary interest may create a grantor trust, it also can result in estate tax inclusion. The times at which the five percent test is measured are different, with the measure-

ment for grantor trust status occurring on the creation of the trust and the measurement for estate tax inclusion at the time of the grantor's death. It is possible that a reversion will not cause inclusion. It is impossible to determine, however, what the interest rates will be when the grantor passes away. Thus section 673 is not an often used provision to create a grantor trust.

5. *Section 674: Power To Control Beneficial Enjoyment*

   a. Section 674(a) provides that a grantor will be treated as the owner of any portion of a trust over which the grantor has retained a power of disposition. A power of disposition includes any power that can affect the beneficial enjoyment of the trust property. Treas.Reg. §1.674(a)-1(a). For example, a power to allocate income among the beneficiaries of the trust is a power of disposition. Similarly, a power to add more beneficiaries is a power of disposition, unless the power is limited so that only after-born or after-adopted children can be added. *See* Section 674(b)(5).

   b. To qualify as a grantor trust, such power must be exercisable by the grantor or a nonadverse party or both without the consent of an adverse party. Section 674(a). An "adverse party" is a person with a substantial beneficial interest in the trust that will be adversely affected by the exercise or nonexercise of a power possessed by such party. Section 672(a). An interest in the trust is substantial if "its value in relation to the total value of the property subject to the power is not insignificant." Treas.Reg. §1.672(a)-1(a). Generally an interest of a remainderman is only adverse as to the exercise of a power over principal. Treas.Reg. §1.672(a)-1(d). The interest of an ordinary income beneficiary, however, may be adverse to just a power over income but could also be adverse to a power over principal. Treas.Reg. §1.672(a)-1(c). A "nonadverse party" is anyone who is not an adverse party. Section 672(b).

   c. There are eight exceptions that, even though technically a power of disposition, will not cause the trust to be treated as a grantor trust.

      i. *Power To Apply Income To Support Dependent*. If the trustee, the grantor, or any other person has authority to pay or apply trust income to discharge the grantor's legal obligation to support a dependent, the trust will not be treated as a grantor trust. Section 674(b)(1). If, however, income is actually distributed in a manner that discharges the grantor's legal obligation to support a dependent, then the trust will be treated as a grantor trust. Sections 674(b)(1) and 677(b). Note that if the trust income (or principal) can be used to discharge the grantor's legal obligation to support a beneficiary of the trust and the grantor passes away, the trust property will be included in the grantor's estate for federal estate tax purposes. Treas.Reg. §20.2036-1(b)(2).

      ii. *Power Affecting Beneficial Enjoyment Only After Occurrence Of Event*. A power to affect the beneficial enjoyment of the trust property that only arises after the occurrence of an event will not cause a trust to be treated as a grantor trust. Section 674(b)(2). If, however, the power is postponed for a period that, if such power were a reversionary interest, would cause the trust to meet the five percent test under section 673, then the trust will be treated as a grantor trust. *Id.* In other words, the power must be postponed for a long enough period of time that the value of such power is less than five percent of the value of the trust. Once the event occurs, the trust could become a grantor trust, unless the power has been relinquished. *Id.*

iii. *Power Exercisable Only By Will.* If the grantor only may exercise the power of disposition by will, then the trust will not be treated as a grantor trust unless the power is to appoint income that has been "accumulated for such disposition by the grantor or may be so accumulated in the discretion of the grantor or a nonadverse party, or both, without the approval or consent of any adverse party." Section 674(b)(3). Thus a grantor may retain a testamentary power of appointment over the trust principal without causing grantor trust status. Such power of appointment could, however, also cause the trust property to be included in the grantor's estate for federal estate tax purposes. Section 2041. In addition, if the grantor is able to appoint the trust principal to the grantor's creditors or to the grantor's estate, the power could be deemed to be a reversionary interest, in which case section 677(a) may apply, causing the trust to be treated as a grantor trust. Treas.Reg. §1.674(b)-1(b)(3).

iv. *Power To Allocate Among Charitable Beneficiaries*. A trust will not be treated as a grantor trust when the grantor or a nonadverse party or both have the power to make distributions to charitable beneficiaries. Section 674(b)(4). For example, a grantor can retain the right to designate the remainder beneficiaries of a charitable remainder trust, and the trust will not be treated as a grantor trust.

v. *Power To Distribute Corpus Subject To Reasonably Definite Standard Or To Advance Principal*. The grantor, a nonadverse party, or both may hold a power to distribute principal if the power is limited by a reasonably definite standard set forth in the trust agreement without causing the trust to be treated as a grantor trust. Section 674(b)(5)(A). Examples of a reasonably definite standard include: education, support, maintenance, or health of the beneficiary; reasonable support and comfort; to enable the beneficiary to maintain his or her accustomed standard of living; and to meet an emergency. Treas. Reg. §1.674(b)-1(b)(5)(i).

(1) Alternatively, a power to distribute principal for the "pleasure, desire, or happiness of a beneficiary" is not a reasonably definite standard. Furthermore, if the trust agreement provides that the trustee's determination is conclusive with respect to the exercise or nonexercise of the power, the power will not be limited by a reasonably definite standard. *Id.* Note that if the power is limited to a reasonably definite standard the trust property should not be included in the grantor's estate for federal estate tax purposes.

(2) Additionally, the power to make distributions to current income beneficiaries when such distributions are charged against those beneficiaries' proportionate shares of the trust principal will not cause the trust to be treated as a grantor trust. Section 674(b)(5)(B). With respect to such advances, the trustee must treat the beneficiary's share of the trust principal as a separate trust. Treas.Reg. §1.674(b)-1(b)(5)(ii).

(3) If, however, the grantor, a nonadverse party, or both retain one of the two powers above and anyone has the power to add beneficiaries to the trust, other than after-born or after-adopted children, then the trust will be treated as a grantor trust. Section 674(b)(5). The exception to this rule is that a beneficiary can be granted a power of appointment over his or her portion of the trust without causing the trust to be treated as a grantor trust. Treas.Reg. §1.674(d)-2(b).

vi. *Power To Withhold Income Temporarily*. A trust will not be a grantor trust if income of the trust can be withheld from the income beneficiary, so long as such income must ultimately be distributed in any of the following ways: to the beneficiary; to the beneficiary's estate; to the beneficiary's appointees subject to a broad limited or special power of appointment; or on the termination of the trust, or with current principal distributions, to the current income beneficiaries in shares irrevocably specified in the trust agreement. Section 674(b)(6).

(1) Even though a grantor could be one of the possible appointees under a broad limited or special power of appointment, such inclusion will not cause the trust to be treated as a grantor trust under section 677. Treas.Reg. §1.674(b)-1(b)(6)(i). Note that the exceptions under section 674(b)(6) do not apply if the power to accumulate income is combined with a power in any person to add beneficiaries to the trust, other than after-born or after-adopted children. Section 674(b)(6).

vii. *Power To Withhold Income During Disability Of Beneficiary*. If a grantor or a nonadverse party or both, without the consent of an adverse party, reserve the power to withhold income from a beneficiary during any legal disability or until the beneficiary reaches the age of 21, the trust will not be treated as a grantor trust. Section 674(b)(7)(A) and (B). This power is different from the power in section 674(b)(6) in that such accumulated income may be distributed to other beneficiaries. Treas. Reg. §1.674(b)-1(b)(7). Like Section 674(b)(6), however, the exception does not apply if the power to withhold income is combined with a power in any person to add beneficiaries to the trust, other than after-born or after-adopted children. Section 674(b)(7).

viii. *Power To Allocate Between Principal and Income*. The power to allocate receipts and disbursements between principal and income, no matter how broadly stated, does not cause a trust to be treated as a grantor trust. Section 674(b)(8).

d. There is another exception to the application of Section 674(a) in the case of an "independent" trustee. If a trustee or trustees, "none of whom is the grantor, and no more than half of whom are related or subordinate parties who are subservient to the wishes of the grantor" may "distribute, apportion, or accumulate income" or distribute principal "to or for a beneficiary or beneficiaries, or to, for, or within a class of beneficiaries," the trust will not be treated as a grantor trust. Section 674(c)(1) and (2). This exception does not apply, however, if the power to withhold income is combined with a power in any person to add beneficiaries to the trust, other than after-born or after-adopted children. Section 674(c).

e. If a nonadverse trustee has the power to distribute or accumulate income subject to a reasonably definite standard, the trust will not be treated as a grantor trust. Such nonadverse trustee may not be the grantor or a spouse living with the grantor. Again the exception does not apply if the power to withhold income is combined with a power in any person to add beneficiaries to the trust, other than after-born or after-adopted children. Section 674(d).

f. Often a grantor will retain the right to remove and replace trustees of the trust. If the power to remove and replace trustees is unrestricted, the grantor will be deemed to hold all of the trustees' powers. Treas.Reg. §1.674(d)-2. Thus the exception in section 674(d) noted above could not apply, and the trust would be treated as a grantor trust. If, however, the choice of a replacement trustee is

limited so that the replacement trustee could not convert the trust to a grantor trust, then the trust will not be a grantor trust because of this power. Treas.Reg. §1.674(d)-2(a).

6. *Section 675: Administrative Powers.* Under section 675 a trust is treated as a grantor trust if certain administrative powers are present. Each power must be exercisable by the grantor or a nonadverse party without the consent of an adverse party.

   a. *Power To Deal For Less Than Adequate And Full Consideration.* When the grantor or a nonadverse party can deal with the trust principal for less than full and adequate consideration, without the consent of an adverse party, the trust will be treated as a grantor trust. Section 675(1). This power could allow a grantor to remove assets from the trust for such a small amount of consideration that effectively the grantor could terminate the trust. The retention of a power to revoke the trust causes the trust assets to be included in the grantor's gross estate for federal estate tax purposes. Section 2038(a)(1). Therefore this power generally should not be included in a trust that is not intended to be included in a grantor's estate for federal estate tax purposes.

   b. *Power To Borrow Trust Property Without Adequate Interest Or Security.* A power in the trust agreement that allows a grantor to borrow the trust principal or trust income without adequate interest or without adequate security will cause the trust (or some portion thereof) to be treated as a grantor trust for federal income tax purposes. Section 675(2). The trust agreement must be specific as to the grantor's authority to borrow, rather than just a general lending power to make loans to any person without adequate interest or without adequate security. Treas.Reg. §1.675-1(b)(2).

      i. When using this power, most practitioners will draft to require adequate interest. This relates to issues on intrafamily loans. When the interest on an intrafamily loan is below the acceptable interest rate, which is generally the applicable federal rate determined under section 1274(d), the lender is treated as having made a gift of the difference between the interest the lender should have received at the higher interest rate and the interest the lender is actually receiving. Therefore it is best to avoid an interest rate that is below at least the applicable federal rate.

   c. *Grantor Borrows Trust Property Without Adequate Interest Or Security.* Even if the trust agreement does not provide that the grantor has the power to borrow trust principal or trust income without adequate interest or without adequate security, if the grantor actually borrows trust principal or income without adequate interest or without adequate security and does not repay the loan and interest thereon before the beginning of the next taxable year, the trust will be treated as a grantor trust. Section 675(3).

      i. The trust also will be treated as a grantor trust if there is indirect borrowing by the grantor or grantor's spouse. For example, in *Holdeen Estate v. Comm'r,* trustees of a trust bought mortgage notes secured by property owned by the grantor. The grantor did not repay the mortgage notes on a timely basis. Accordingly the Tax Court held that the grantor indirectly borrowed the trust assets and was treated as the grantor over such portion of the trust. 34 T.C.M. (CCH) 129 (1975). The Tax Court also held that a trust was a grantor trust when the trust made a loan to a partnership in which the grantor was a general partner. *Bennett v. Comm'r*, 79 T.C. 470 (1982).

ii. Note that the grantor may not deduct the interest that the grantor pays on the loan from the trust. The Internal Revenue Service ("Service") has stated that such payment of interest is really just a gift to the beneficiaries of the trust and does not qualify for an interest deduction. Rev.Rul. 86-106, 1986-2 C.B. 28. The payment of the interest, however, is not a gift for federal gift tax purposes. Furthermore, the Service has made it clear that transactions between the grantor and the grantor trust are disregarded for federal income tax purposes. Treas.Reg. §1.1001-2(c), Ex. 5; Rev. Rul. 85-13, 1985-1 C.B. 184.

d. *Powers To Vote Stock, Control Investments, Or Substitute Property.* The final group of administrative powers that cause a trust to be treated as a grantor trust must be exercisable in a nonfiduciary capacity by the grantor or a nonadverse party without the approval or consent of a person in a fiduciary capacity. Section 675(4); Treas.Reg. §1.675-1(b)(4). A power is deemed to be exercisable in a fiduciary capacity if it is exercisable primarily in the interest of the beneficiaries of the trust. Treas.Reg. §1.675-1(b)(4). When a trustee holds any power, such power is presumed to be held in a fiduciary capacity unless it can be shown by clear and convincing evidence, under a facts and circumstances test, that the power is not exercisable primarily in the interest of the trust beneficiaries. *Id.*

i. This group includes the following powers.

(1) The power to "vote or direct the voting of 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." Section 675(4)(A).

(2) The power to "control the investment of the trust funds either by direct investments or reinvestments, or by vetoing proposed investments or reinvestments, to the extent that the trust funds consist of stocks or securities of corporations in which the holdings of the grantor and the trust are significant from the viewpoint of voting control." Section 675(4)(B).

(3) The power to "reacquire the trust corpus by substituting other property of an equivalent value." Section 675(4)(C).

ii. Neither the Code nor Treasury Regulations define the phrase "significant from the viewpoint of voting control." Therefore if the grantor and the trust own stock in the same corporation, the trust provisions should be considered carefully so that a grantor trust is not inadvertently created if the trust agreement is going to give the grantor or a nonadverse party some ability to either vote the stock or determine how the stock and other trust assets should be invested.

iii. The power to reacquire trust assets has been a significant topic of conversation among practitioners. In 1975 in *Estate of Jordahl v. Comm'r,* the Tax Court held that the power of substitution did not cause trust assets to be includable in the grantor's estate under section 2038 because the grantor was bound by fiduciary standards and thus could not alter, amend, or revoke the trust. 65 T.C. 92 (1975). In *Jordhal* the grantor was a fiduciary. Thus the question arose whether the substitution power in section 675(4), which must be exercised in a nonfiduciary capacity, would cause inclusion of the trust assets in the grantor's estate.

iv. In 2008 the Service issued Revenue Ruling 2008-22, in which it held that when a grantor has a power to substitute property held in trust and such power is held in a nonfiduciary capacity,

the trust property will not be includable in the grantor's gross estate under sections 2036 or 2038 so long as the trustee has a fiduciary obligation to ensure that the grantor complies with the trust terms. Rev.Rul. 2008-22, 2008-1 C.B. 796. Such fiduciary obligation can be provided either in the trust agreement or under local law. To ensure the grantor's compliance, the trustee must determine that the properties acquired and substituted by the grantor are in fact of equivalent value. Finally, the trustee must determine that the power cannot be exercised in a manner that would shift benefits among the beneficiaries of the trust. The Revenue Ruling states that

> [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; 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.

v. Revenue Ruling 2008-22 has given practitioners more comfort in using the power of substitution to create a grantor trust. There are, however, still certain issues that may limit its use, which are discussed further below.

7. *Section 676: Power To Revoke*

a. If the grantor or a nonadverse party or both has the power to revoke a trust and revest title to the asset in the grantor, the trust will be treated as a grantor trust. Section 676(a). The power to revest title of the trust assets in the grantor includes a power to revoke, terminate, alter, amend, or appoint. Treas.Reg. §1.676(a)-1. If, however, such power is deferred and cannot be exercised until after the exercise of a certain event, then the trust may not be treated as a grantor trust. Section 676(b). This will be the case if the trust would not be treated as a grantor trust under section 673 if the grantor had retained a reversionary interest. *Id.*

b. Of course if a grantor retains the right to revoke the trust, the trust property will be included in the grantor's gross estate for federal estate tax purposes. Section 2038(a)(1). Some states will deem a trust revocable if there is no express statement in the trust agreement that the trust is irrevocable. Accordingly, it is important to review state law if it is not intended that the trust be treated as a grantor trust and that the grantor intends for the trust property to be included in his or her estate.

8. *Section 677: Income For Benefit Of Grantor*

a. Several powers will cause a grantor to be treated as the owner of the income of the trust for federal income tax purposes. These powers arise when the income either can be used or actually is used either directly or indirectly for the benefit of the grantor or the grantor's spouse. As with most of the other powers, for the trust to be treated as a grantor trust such powers must be exercisable by the grantor or a nonadverse party or both without the consent or approval of any adverse party. Section 677(a). The powers include the following:

i. Discretion to distribute or the actual distribution of the trust income to the grantor or the grantor's spouse. Section 677(a)(1).

ii. Discretion to hold or accumulate or the actual holding and accumulation of trust income for future distribution to the grantor or the grantor's spouse. Section 677(a)(2).

iii. Discretion to apply or the application of the trust income to pay premiums on insurance on the life of the grantor or the grantor's spouse. Section 677(a)(3).

b. When a grantor is deemed for federal income tax purposes to own only the income portion of the trust, the grantor will only be taxable on the ordinary income items, and the trust will be taxed on capital gains. Treas.Reg. §1.677(a)-1(e) and (g). If the capital gain items can be held or accumulated for future distribution to the grantor or the grantor's spouse, however, then the capital gains also would be taxable to the grantor. Treas. Reg. Section 1.677(a)-1(f) and (g).

c. If a trustee has the discretion to distribute or accumulate the trust income to discharge a legal obligation of the grantor, then the trust will be treated as a grantor trust even though neither the grantor nor the grantor's spouse is a beneficiary of the trust. Section 677(b). This is not the case with respect to the grantor's legal obligation to support a minor child, unless the income is actually used to discharge such obligation. *Id.*

d. With respect to payment of insurance premiums, if a trust is not intended to be treated as a grantor trust, it is important that trust income never be used to pay insurance premiums. In Private Letter Ruling 88-39008, the trust agreement specifically prohibited the use of trust income to pay insurance premiums. Five years after the trust was created, however, the trustees purchased second-to-die policies on the grantors' lives with a single premium payment. The Service ruled that the premium payment caused the trust to be treated as a grantor trust in the year of the payment to the extent that trust income was used to pay the premium.

9. *Section 678: Grantor Trust To Someone Other Than Grantor*

a. A trust can be deemed to be a grantor trust as to an individual other than the grantor when an individual has power to appoint trust principal or income to himself or herself or had such a power that has been released but, after the release, such individual has control that, if the grantor, would cause the trust to be treated as a grantor trust. Section 678(a)(1) and (2). This situation can arise with Crummey powers granted to beneficiaries to qualify contributions to the trust for the federal gift tax annual exclusion because the beneficiaries are given the right to withdraw some portion or or all of the amount contributed to the trust.

b. Another situation is when trustees may use the trust property to discharge a beneficiary's legal obligation. Treas.Reg. §1.678(a)-1(b). As with section 677(b), however, with respect to the discharge of a support obligation, the beneficiary will only be treated as the grantor when funds are actually used to discharge such obligation. Section 678(c).

c. If a grantor is treated as the owner of the trust income for federal income tax purposes, no other person will be treated as the grantor under section 678(a). Section 678(b). Notice that this only applies when the trust is a grantor trust to the grantor as to income. If the trust is a grantor trust to the grantor only as to principal, then the beneficiary will be the owner for federal income tax purposes as to income.

10. *Section 679: Foreign Trusts With U.S. Beneficiaries*

a. Generally if a U.S. person establishes a foreign trust with one or more U.S. beneficiaries, the trust will be treated as a grantor trust. Section 679(a)(1). The trust will be a grantor trust in this situation

regardless of the terms of the trust or whether the grantor or any other person has retained any of the grantor trust powers previously discussed.

b. There are two exceptions when such a trust will not be treated as a grantor trust. The first is with respect to a testamentary trust. Section 679(a)(2)(A). Thus if a U.S. person leaves assets under his or her will to a foreign trust with U.S. beneficiaries, the trust will not be treated as a grantor trust as to the decedent's estate. Second, when property is sold by a U.S. person to a foreign trust with U.S. beneficiaries for consideration at least equal to its fair market value, the trust will not be treated as a grantor trust as to such person. Section 679(a)(2)(B). Consideration, however, does not include any obligation issued or guaranteed by the trust, the grantor, any beneficiary, any deemed owner of the trust, or any person "related" to any grantor, owner, or beneficiary of the trust. Section 679(a)(3). A person is considered "related" if the relationship would result in a disallowance of losses under section 267 or 707(b). Section 643(i)(2)(B)(i). Under section 267, a loss is disallowed if the transaction creating the loss was between

> members of a family [that is, brothers and sisters, spouse, ancestors and lineal descendants of the party at issue], an individual and a corporation more than 50 percent in value of the outstanding stock of which is owned, directly or indirectly, by or for such individual, two corporations which are members of the same controlled group, a grantor and a fiduciary of any trust, a fiduciary of a trust and a fiduciary of another trust, if the same person is a grantor of both trusts, a fiduciary of a trust and a beneficiary of such trust, a fiduciary of a trust and a beneficiary of another trust, if the same person is a grantor of both trusts, a fiduciary of a trust and a corporation more than 50 percent in value of the outstanding stock of which is owned, directly or indirectly, by or for the trust or by or for a person who is a grantor of the trust, a person and an organization to which Section 501…applies and which is controlled directly or indirectly by such person or (if such person is an individual) by members of the family of such individual, a corporation and a partnership if the same persons own more than 50 percent in value of the outstanding stock of the corporation, and more than 50 percent of the capital interest, or the profits interest, in the partnership, an S corporation and another S corporation if the same persons own more than 50 percent in value of the outstanding stock of each corporation,... [or] or except in the case of a sale or exchange in satisfaction of a pecuniary bequest, an executor of an estate and a beneficiary of such estate."

Section 267(b) and (c).

B. Most Often Used Powers To Create Grantor Trusts

1. The four powers most often used to create a grantor trust are

   a. Power to add charitable beneficiaries under section 674;

   b. Power to make loans to the grantor without adequate security under section 675(2);

   c. Power of substitution under section 675(4); and

   d. Power to use income to pay premiums on insurance on the life of the grantor or the grantor's spouse under section 677(a)(3).

2. Generally these powers are considered "safe" powers, as they should not cause the trust property to be included in the grantor's estate for federal estate tax purposes. There are, however, still arguments that certain of these powers could cause estate inclusion. There are, of course, other reasons why grantors may not be as comfortable with even these powers.

3. Many grantors do not want to give another person the authority to make distributions of trust assets to charity. While it would seem that grantors should be charitable, not all of them are. Thus allowing

a third party to potentially divert assets intended for the grantor's family to charity may not sit well with all grantors. There is always a threat of removal when a proper trustee is given this power and the grantor retains the authority to remove and replace the trustee, but the threat may not be enough and may be exercised too late.

4. Some practitioners believe that the ability of a grantor to borrow trust assets without adequate interest or without adequate security is, in effect, a retained interest under sections 2036 and 2038. There is no authority on this point at this time. It seems that more practitioners are concerned with not having adequate interest and only permit a loan to be made to the grantor with adequate security.

5. The power of substitution has been blessed by the Service in Revenue Ruling 2008-22 more or less. As explained above, a power to substitute trust property that is held in a nonfiduciary capacity will not cause the trust property to be includable in the grantor's gross estate under sections 2036 or 2038 so long as the trustee has a fiduciary obligation to ensure that the grantor complies with the trust terms. Rev.Rul. 2008-22, 2008-1 C.B. 796. Of course, this Revenue Ruling is not black and white, and it leaves open possibilities for situations when such power of substitution, if not properly drafted, would cause inclusion in the grantor's estate. Furthermore, the question of whether a power is exercised or exercisable in a nonfiduciary capacity is determined on facts and circumstances. Treas.Reg. §1.675-1(b)(4).

6. In addition, there is a question of whether a grantor should have the ability to remove an insurance policy from the trust. Some practitioners raise concerns that this could be deemed an incident of ownership over the policy causing inclusion under section 2042(2). One solution would be to give the power to a nonadverse party who would not have the inclusion issue. But again that raises trust questions with the grantor and who could be given such a power. There should, however, be less concern for abuse as the nonadverse party would be required to substitute assets with an equivalent value. If it is an insurance policy, though, and the insured is still alive, what is its value for this purpose? It is not likely the death benefit.

7. There are no estate tax concerns with the power under section 677(a)(3) to pay insurance premiums from income. The issue has been raised, however, as to whether it is enough just to include the power in the trust when the trust does not own any insurance on either the grantor or the grantor's spouse. Section 677(a)(3) seems clear as it states that the discretion to use income to pay insurance premiums is sufficient to create a grantor trust.

8. Probably the most significant issue is the choice of trustee. Each of the powers above must be exercised by the grantor or a nonadverse party without the consent of an adverse party. An "adverse party" is a person with a substantial beneficial interest in the trust that will be adversely affected by the exercise or nonexercise of a power possessed by such party. Section 672(a). A "nonadverse party" is anyone who is not an adverse party. Section 672(b). It can be difficult for a grantor to find someone to serve as trustee or hold the power who does not have a substantial beneficial interest in the trust.

C. Treatment Of Gifts To Grantor Trusts In 2010

1. Effective January 1, 2010, section 2511(c) provides that "a transfer in trust shall be treated as a transfer of property by gift, unless the trust is treated as wholly owned by the donor or the donor's spouse"

under the grantor trust rules. The situation that Congress was trying to address with this provision is when a transfer in trust is incomplete for gift tax purposes but complete for income tax purposes, allowing taxable income to be shifted without incurring a gift tax. This is often referred to as a DING trust (defective intentional non-grantor trust). Thus the rule is now that a gift to a nongrantor trust is treated as a completed gift for gift tax purposes.

2. What this means is if an estate planner wishes for a transfer in trust to be an incomplete gift, the trust must be a wholly owned grantor trust. Therefore, the provisions used in the trust must be chosen carefully to ensure that the grantor is treated as the owner of both the income and the principal of the trust for income tax purposes.

3. But what about the situation when a grantor wishes to create a grantor trust and wants the gifts to the trust to be complete for federal gift tax purposes? Does the inverse of the statute hold true: if a trust is a grantor trust, are transfers not completed gifts for federal gift tax purposes? What then does this mean for insurance trusts that are drafted as grantor trusts and to which gifts are made intending to qualify for the gift tax annual exclusion?

4. Congress clarified section 2511(c) in 2002 by deleting the phrase "taxable gift under section 2503" and replacing it with "transfer of property by gift." In the Technical Explanation to the Job Creation and Worker Assistance Act of 2002, Pub.L.No. 107-147, Section 411(g)(1), 116 Stat. 21 (2002), Congress stated:

> Transfers in trust. — The provision clarifies that the effect of section 511(e) of the [Economic Growth and Tax Relief Reconciliation Act of 2001] (effective for gifts made after 2009) is to treat certain transfers in trust as transfers of property by gift. The result of the clarification is that the gift tax annual exclusion and the marital and charitable deductions may apply to such transfers. Under the provision as clarified, certain amounts transferred in trust will be treated as transfers of property by gift, despite the fact that such transfers would be regarded as incomplete gifts or would not be treated as transferred under the law applicable to gifts made prior to 2010. For example, if in 2010 an individual transfers property in trust to pay the income to one person for life, remainder to such persons and in such portions as the settlor may decide, then the entire value of the property will be treated as being transferred by gift under the provision, even though the transfer of the remainder interest in the trust would not be treated as a completed gift under current Treas. Reg. sec. 25.2511-2(c).

5. Another issue raised by this new provision is what happens to grantor trusts that become nongrantor trusts during the period in which this provision is in effect. It would seem that, if an incomplete transfer was made to a grantor trust, the transfer will be a completed gift when the trust becomes a nongrantor trust. Thus DING trusts should be reviewed carefully to ensure that any such consequences will not unexpectedly come into existence.

D. Tax Reimbursement Clauses

1. While not a new development, tax reimbursement clauses are an important consideration when working with irrevocable grantor trusts. Before the Service's ruling in 2004, there was a question of whether including the ability to reimburse the grantor for the grantor's payment of the grantor trust's income tax liability caused the trust property to be included in the grantor's estate for federal estate tax purposes. Revenue Ruling 2004-64, 2004-2 C.B. 7, clarified the circumstances in which such a clause would cause inclusion in the grantor's estate.

2. In Revenue Ruling 2004-64, the grantor established an irrevocable trust for the benefit of his descendants. Only persons who were not related or subordinate to the grantor within the meaning of section 672(c) could serve as trustees of the trust. The grantor did not retain any interest in the trust that would cause any transfer to be an incomplete gift to the trust or would cause the trust property to be included in the grantor's estate. The grantor, however, did retain powers sufficient to cause the trust to be treated as a grantor trust under sections 671 to 678.

3. The Ruling analyzes the gift and estate tax consequences of the grantor's payment of federal income taxes on the income generated by the trust assets in three situations.

    a. *Situation 1*. Neither the trust instrument nor the applicable state law requires or permits the trustee to reimburse the grantor for the income taxes the grantor pays on the income generated by the trust.

        i. In Situation 1 the Service ruled that the payment of income tax liability by the grantor is not a gift to the trust. Furthermore, no portion of the trust property will be included in the grantor's estate as a result of the payment because the grantor did not retain a right to have the trust property distributed to discharge a legal obligation of the grantor.

    b. *Situation 2*. The trust instrument requires a trustee to reimburse the grantor from trust assets for the income taxes the grantor pays on the income generated by the trust.

        i. In Situation 2, because the trustee was required to reimburse the grantor for payment of income tax liability, the Service ruled that the full value of the trust assets were includable in the grantor's estate upon death. The result will be the same whether such requirement is set forth in the trust instrument or under applicable state law. The Service stated that the grantor, however, will not be making a gift to the trust when paying income tax liability.

    c. *Situation 3*. The trust instrument gives a trustee discretion to reimburse the taxpayer for the income taxes the taxpayer pays on the income generated by the trust.

        i. In Situation 3 the Service stated that the payment of income tax by the grantor will not be treated as a gift, and because the right of reimbursement is discretionary the trust property will not be included in the grantor's estate. The Service, however, stated that the discretion to reimburse the grantor combined with other facts, such as an understanding or pre-existing arrangement between the grantor and the trustee regarding the trustee's exercise of this discretion, a power retained by the taxpayer to remove the trustee and name the grantor as a trustee, or a provision under applicable state law subjecting the trust assets to the grantor's creditors, may cause the trust assets to be included in the grantor's estate.

    d. Based on this ruling, should everyone be including discretionary tax reimbursement clauses in irrevocable grantor trusts? Of course, it depends. Generally one of the primary benefits of having a grantor pay the income taxes of the grantor trust is that it allows the trust assets to grow without reduction for income taxes at no transfer tax cost to the grantor. No one can predict the future, however, and there could come a time when the grantor does not have sufficient assets to pay the income tax generated by the grantor trust. The inclusion of the reimbursement clause will allow the trustee to address this situation should it arise.

i. Probably the most important consideration in using the clause is to know your client. While the mere inclusion of a discretionary reimbursement clause will not automatically cause inclusion of trust assets in the grantor's estate, if the grantor and the trustee have some understanding as to when that discretion will be exercised, there is going to be a problem. The burden of proof is on the taxpayer to show there was no understanding.

E. Toggling Grantor Trust Status

1. Another question that arises with a grantor trust is whether once it is a grantor trust will it always be a grantor trust? Many grantors are comfortable with the idea of paying the income tax liability of the trust, as it is a way to make a "free gift" to the trust beneficiaries and allow the trust assets to continue to grow unburdened by income tax obligations. More often than not, some years after the creation of the trust, the grantor no longer wishes to be burdened with the income tax liability of the trust and wants the grantor trust status to end. But what are the tax consequences when a grantor's trust status ends during the grantor's lifetime? How is the power exercised to turn off grantor trust status? What if the grantor wants to turn grantor trust status back on? Could toggling be viewed as an abuse?

2. *Income Tax Consequences Of Turning Off Grantor Trust Status*

   a. When grantor trust status terminates during the grantor's lifetime, the grantor is deemed to have transferred to the trust all of the assets in the trust and all of the liabilities of the trust. *Madorin v. Comm'r*, 84 T.C. 667 (1985); Treas.Reg. §1.1001-2(c), Ex. (5); Rev.Rul. 77-402, 1977-2 C.B. 222. If the liabilities deemed transferred to the trust exceed the basis of the assets deemed transferred to the trust, the grantor will recognize gain on the difference. Treas.Reg. §1.1001-2(a)(1). This section provides that the "amount realized from a sale or other disposition of property includes the amount of liabilities from which the transferor is discharged as a result of the sale or disposition." If, however, the liability was incurred by reason of acquisition of the property, the liability will not be included in the amount realized. Treas.Reg. §1.1001-2(a)(3). Furthermore, because transactions between the grantor and the grantor trust are disregarded for federal income tax purposes, any liabilities between the grantor and the grantor trust should be disregarded. *See* Rev.Rul. 85-13, 1985-1 C.B. 184.

   b. The Treasury Regulations illustrate the tax consequences of turning off grantor trust status in Section 1.1001-2(c), Example (5):

   In 1975, C, an individual, creates T, an irrevocable trust. Due to certain powers expressly retained by C, T is a "grantor trust" for [Federal income tax purposes] and therefore C is treated as the owner of the entire trust. T purchases an interest in P, a partnership. C, as the owner of T, deducts the distributive share of partnership losses attributable to the partnership interest held by T. In 1978, when the adjusted basis of the partnership interest held by T is $1,200, C renounces the powers previously and expressly retained that initially resulted in T being classified as a grantor trust. Consequently, T ceases to be a grantor trust and C is no longer considered to be the owner of the trust. At the time of the renunciation all of P's liabilities are liabilities on which none of the partners have assumed any personal liability and the proportionate share of which of the interest held by T is $11,000. Since prior to the renunciation C was the owner of all the entire trust, C was considered the owner of all the trust property for Federal income tax purposes, including the partnership interest. Since C was considered to be the owner of the partnership interest, C not T, was considered to be the partner in P during the time T was a "grantor trust." However, at the time C renounced the powers that gave rise to T's classification as a grantor trust, T no longer qualified as a grantor trust with the result that C was no longer considered to be the owner of the trust and trust property for Federal income tax purposes. Consequently, at that time,

C is considered to have transferred ownership of the interest in P to T, now a separate taxable entity, independent of its grantor C. On the transfer, C's share of partnership liabilities ($11,000) is treated as money received. Accordingly, C's amount realized is $11,000 and C's gain realized is $9,800 ($11,000-$1,200).

3. *Exercising Power To Turn Off Grantor Trust Status And Turn It Back On*

   a. The trust agreement generally should be drafted in a manner that will give a grantor the flexibility to turn off grantor trust status. Certain grantor trust powers are personal to the grantor and likely require that the grantor be the one to relinquish them. It is important, however, to be careful not to draft the trust in a manner that gives the grantor the right to relinquish a power but then subsequently reacquire it. Such ability likely will be construed as a power to amend the trust, which will cause the trust to be treated as a grantor trust anyway. Treas.Reg. §1.675-1(a). Thus it is important to give the power to reinstate a power to a third party.

   b. There is no requirement that the person who holds the power to relinquish or reinstate grantor trust powers must be a nonadverse party. Therefore even the grantor's spouse may be given the authority to relinquish such powers in most circumstances.

4. *Is Toggling An Abuse?*

   a. In 2007 the Service issued Notice 2007-73, identifying a toggling grantor trust transaction as a reportable transaction of interest. Notice 2007-73, 2007-2 C.B. 545. The Service has identified certain transactions as "transactions of interest." These generally are transactions that have the potential for tax avoidance or evasion but for which the Service lacks sufficient information to classify as tax avoidance transactions. When a person enters into a transaction of interest, such person must disclose the transaction to the Service in accordance with Treas. Reg. §1.6011-4. This Notice applies to such transactions and those that are substantially similar entered into on or after November 2, 2006.

   b. In the Notice the Service identified two variations on a particular transaction relating to the toggle power in the grantor trust that it believes constitutes a transaction of interest. Both transactions typically occur within a short period of time during the taxable year, usually within 30 days, and in each case the grantor claims that the termination and subsequent reestablishment of grantor trust status result in a tax consequence that could not be achieved without the toggling on and off of grantor trust status. The Service noted that the transactions do not include a situation when just the grantor trust status is terminated and there is not also a subsequent reinstatement of grantor trust status.

   c. *Variation One*. In the first variation, the grantor purchases four options, the values of which are expected to move inversely in relation to at least one of the other options so that there will be two options with a gain and two options with a loss that substantially offsets the gain. The grantor then transfers the four options and a small amount of cash to a trust. The grantor retains a noncontingent reversionary interest in the trust, giving another beneficiary a short-term unitrust interest. The remainder interest is structured to have a value, as determined under section 7520, that equals the fair market value of the options. The grantor also retains a power of substitution in accordance with section 675(4) that will become effective on a specified date in the future. The reversionary

interest and power of substitution cause the trust to be treated as a grantor trust for federal income tax purposes.

i. After the trust is funded, the grantor sells the remainder interest to an unrelated person for the fair market value of the remainder interest, which is equal to the fair market value of the options. The grantor claims that the basis in the remainder interest is determined by allocating a portion of all of the trust assets to the remainder interest, which results in no gain recognized in the sale of the remainder interest. The buyer gives the grantor a note, cash, or other consideration for the remainder interest. The grantor claims that the grantor trust status has terminated as a result of the sale of the remainder interest.

ii. Once the substitution power becomes effective, the grantor claims that the trust becomes a grantor trust again. At that time, the loss options are closed out and the grantor recognizes the loss. The grantor calculates the loss based on the difference between the amount realized and the original basis in the loss options, even though the grantor already used a portion of the basis to eliminate the grantor's gain on sale of the remainder interest.

ii. The buyer then purchases the unitrust interest from the beneficiary for the actuarial value of that interest, which equals or approximates the amount of cash the grantor contributed to the trust. The buyer now owns the unitrust interest and the remainder interest in the trust, resulting in the effective termination of the trust by operation of law. The buyer's basis in the gain options and the cash is claimed to be equal to the amount the buyer paid for the two separate interests. The grantor does not treat the termination of the trust as a taxable disposition by the grantor of the assets in the trust.

iv. The buyer then sells the gain options and recognizes gain only to the extent that the amount realized exceeds the basis the buyer allocated to the gain options. Such gain ends up to be minimal as a result of the structure of the transaction. If the buyer purchased the remainder interest with a note, the buyer uses the proceeds from the gain options to repay the note.

d. *Variation Two*. The facts in the second variation are the same, except the grantor contributes cash or marketable securities to the trust with a basis equal to fair market value. Before the date on which the substitution power becomes effective, the grantor sells the remainder interest in the trust to a buyer for an amount equal to its fair market value. The grantor does not recognize any gain (or very little gain or a loss). Again the grantor claims the sale terminates the grantor trust status of the trust. After the substitution power becomes effective, the grantor substitutes appreciated property for the liquid assets owned by the trust. The fair market value of the appreciated property equals the fair market value of the liquid assets. Then, the grantor claims that, once the substitution power becomes effective, the grantor trust status is restarted. Thus the grantor does not recognize gain on the substitution.

i. Then the buyer purchases the unitrust interest from the beneficiary, and the trust terminates by operation of law. The grantor does not treat the termination as a disposition. The buyer takes a basis in the trust assets equal to the amount the buyer paid for the interests in the trust.

F. What Happens When The Grantor Dies?

1. One looming question is what happens to a grantor trust when the grantor dies? There are several theories and substantial debate on the income tax consequences on the termination of grantor trust status as a result of the grantor's death. There seems to be agreement that the termination of the trust is a transfer of the assets and liabilities by the grantor to the trust. *Madorin v. Comm'r*, 84 T.C. 667 (1985); Treas.Reg. §1.1001-2(c), Ex. (5); Rev.Rul. 77-402, 1977-2 C.B. 222. But the debate lies in the type and timing of the transfer. The Code does not address this.

2. In Chief Counsel Advice 2009-23024 (Dec. 31, 2008)), discussed below, the Office of the Chief Counsel addressed a transaction when a nongrantor trust was converted to a grantor trust. The Chief Counsel discussed authorities regarding termination of a grantor trust during the grantor's lifetime, including *Madorin,* Revenue Ruling 77-402 and Treas. Reg. §1.1001-2, Example 5. In that ruling, the Office of the Chief Counsel stated: "We would also note that the rule set forth in these authorities is narrow, insofar as it only affects inter vivos lapses of grantor trust status, not that caused by the death of the owner *which is generally not treated as an income tax event* [emphasis added]." While there is no authority for this, it certainly sets forth a possible position of the Service on the issue of what happens when grantor trust status terminates on the death of the grantor.

3. *No Gain And Possible Step-Up*

   a. Some commentators view the termination of grantor trust status upon the death of the grantor as a testamentary transfer. *See* Jonathan G. Blattmachr, Mitchell M. Gans, and Hugh H. Jacobson, *Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor's Death*, 97 J. Tax'n 149 (2002). This theory recognizes the deemed transfer of all of the assets and all of the liabilities of the trust by the grantor to the trust on the grantor's death but states that section 1001 does not apply.

   b. Section 1001(a) defines gain on the sale or other disposition of property as the excess of the amount realized over the adjusted basis of the property. Amount realized is the sum of the cash received plus the fair market value of any other property received. Section 1001(b). When a donor gives property to the donee, the donor does not receive any property in return for the gift, resulting in a zero amount realized. The same is true on a bequest: the decedent does not receive any consideration for the bequest, thus no gain is realized. The commentators find support for this theory in *Crane v. Comm'r*, 331 U.S. 1 (1947).

   c. In *Crane* the taxpayer inherited a building and lot subject to a mortgage with a principal value of $255,000 and overdue interest of $7,042. The property was appraised as of the decedent's date of death at $262,042. Seven years later, Crane sold the property for $3,000, subject to the mortgage, and paid $500 in sales expenses. Crane reported a taxable gain of $1,250 stating that the basis of the property was zero and half of the net proceeds were reportable as income because the property was a capital asset. The Service determined that Crane realized a gain of $23,767. The Supreme Court held that Crane realized $257,500 on the sale of the property. The Court further stated that Crane's basis in the property was equal to its appraised value at the time of inheritance. In the disposition of the property, the amount realized is not just the cash or other property Crane received but also the benefit of having been relieved of the debt associated with the property. Therefore the amount realized was equal to the $2,500 of cash Crane received plus the $255,000 mortgage.

d. The Service has acquiesced in this logic in issuing Revenue Ruling 73-183. Rev.Rul. 73-183, 1973-1 C.B. 364. In this ruling, the issue was whether the decedent's final income tax return should reflect a loss on the transfer of securities from the decedent to the executor of the decedent's estate at the time of the decedent's death. During the decedent's lifetime, the decedent purchased stock for $30 per share. On the decedent's date of death, the stock was valued at $20 per share. The Service stated that "[t]he mere passing of property to an executor or administrator on the death of the decedent does not constitute a taxable realization of income even though the property may have appreciated in value since the decedent acquired it." It continued that the "transfer of the stock of the deceased taxpayer to the executor of his estate did not result in a sale or other disposition of such stock within the meaning of Section 1001(a)." Accordingly, the decedent could not recognize the loss on the decedent's final income tax return. Even if the stock was worth more at the decedent's date of death, there also would not be a gain recognized.

e. This theory also relies on the Service's position set forth in the Treasury Regulations under Section 684. This section provides that when a U.S. person transfers property to a foreign estate or trust, the transfer is treated as a sale or exchange. Section 684(a). The transferor is required to recognize gain on such transfer, the excess of the fair market value of the property transferred over the transferor's adjusted basis of such property. *Id.* This rule, however, does not apply if the trust is treated as a grantor trust for federal income tax purposes. Section 684(b).

f. The Code seems to track section 1001. The Regulations, however, deviate and set up a timing fiction. The Regulations state that when a foreign trust ceases to be treated as a grantor trust the grantor will be deemed to have transferred the trust assets immediately before, but on the same date that, the trust is no longer treated as a grantor trust. Treas.Reg. §1.684-2(e). The Regulations provide the following example on the death of the grantor:

> On January 1, 2001, A transfers property, which has a fair market value of 1000X and an adjusted basis of 400X, to [a foreign trust ("FT")]. At the time of the transfer, FT has a U.S. beneficiary within the meaning of section 1.679-2, and A is treated as owning FT under section 679. Under section 1.684-3(a), section 1.684-1 does not cause A to recognize gain at the time of the transfer.....
>
> On July 1, 2003, A dies, and as of that date no other person is treated as the owner of FT. On that date, the fair market value of the property is 1200X, and its adjusted basis equals 350X. Under paragraph (e)(1) of this section, A is treated as having transferred the property to FT immediately before his death, and generally is required to recognize 850X of gain at that time under section 1.684-1. However, an exception may apply under section 1.684-3(c). Treas. Reg. Section 1.684-2(e)(2).

g. The commentators suggest that this portion of the Regulations shows that the Service is abandoning the "no gain at death" rule. There is an exception, however, when no gain will be recognized if the basis of the assets in the hands of the trustee will be determined under section 1014. Treas. Reg. §1.684-3(c).

h. The final question addressed under this theory is what is the basis of the assets in the trust following the death of the grantor? There are three alternatives: (1) if the transfer is viewed as a bequest or devise, then section 1014 applies to cause the basis to equal the date of death value; (2) if the transfer is viewed as a sale by the grantor to the trust, the trust's basis will equal the purchase price under section 1012; or (3) if the transfer is viewed as a gift by the descendent then the basis will be the same as the grantor's basis under section 1015. The commentators under this theory believe

there is a compelling argument that section 1014 applies, and the assets in the grantor trust should be equal to the date of death value of the assets.

4. *No Gain But No Step-Up*

   a. Another theory takes the position that there is no gain recognized at the grantor's death but no step-up in basis. *See* Elliott Manning and Jerome M. Hesch, *Deferred Payment Sales to Grantor Trusts, GRATs and Net Gifts: Income and Transfer Tax Elements*, 24 Tax Mgmt., Est., Gifts & Tr. J. 3 (1999). The commentators take the position that, because the cessation of grantor trust status and the resulting deemed transfer occur because of the death of the grantor, the principles that apply to a transfer to the estate should apply. The Service has ruled that the transfer of property from a decedent to his or her estate is not a recognition event. Rev.Rul. 73-183, 1973-1 C.B 364. Further, items of income in respect of a decedent (IRD) are not realized at death. Rather they are not entitled to a step-up in basis under Section 1014(a).

   b. The commentators also disagree that a mortgage on the property deemed transferred at the decedent's death should be treated as an amount realized, thus potentially causing the recognition of gain when the amount realized equals the basis of the assets. They state that there is no other recognition of unrealized changes in the value of an asset, so a liability should not have any consequence either. For example, an estate that owns a tax shelter investment does not have an income tax consequence because of the death of a decedent.

   c. The fact that the entity is a grantor trust and not an estate does not change the commentators' analysis. They state that the grantor trust status before the grantor's death is ambiguous. A grantor trust is not a fully disregarded entity, because section 671 and Treas. Reg. §§1.671-2 and 1.671-3(a) provide that a grantor is taxed as the owner of certain items as if the trust does not exist, thereby implying that the trust does have some status, even if the grantor is treated as the owner of the entire trust. Furthermore, Treas. Reg. §1.671-4 sets forth reporting obligations for a grantor trust, providing that some items are not reportable on the trust's Form 1041 but on an attached statement. Moreover, until the Subchapter S provisions were amended to permit grantor trusts to be owners of S corporation stock, the transfer of S corporation stock to a revocable trust terminated the S election. *American Nurseryman Publishing Co. v. Comm'r*, 75 T.C. 271 (1980); *W &W Fertilizer Corp. v. Comm'r*, 527 F.2d 621 (Ct.Cl. 1975), *cert. denied,* 425 U.S. 974(1976). But then rulings like Revenue Ruling 85-13 demonstrate more inclination that a grantor trust is a disregarded entity.

   d. On the timing issue of when grantor trust status terminates, the commentators believe it does not matter. They believe that it is a question of realization at death and nothing more and, as noted above, that there is no realization at death. They reason that the trust continues to hold the property with a transferred basis, increased by any obligation in accordance with the *Crane* case.

5. *Gain To Extent Liabilities Exceed Basis And No Step-Up*

   a. Many commentators follow the same rules for termination of grantor trust status at death that apply during lifetime. *See* Deborah V. Dunn and David A. Handler, *Tax Consequences of Outstanding Trust Liabilities When Grantor Trust Status Terminates*," 95 J. Tax'n 49 (2001). That is, the grantor will

recognize gain to the extent that the liabilities of the trust exceed the grantor's basis in the trust assets.

b. The idea is that, upon the death of the grantor, the assets of the trust are no longer treated as being owned by the grantor, and the liabilities of the trust are no longer treated as being owed by the grantor. Now the trust is treated as a separate taxpaying entity and treated as the owner of the trust assets and the obligor of the trust's liabilities. As with termination of grantor trust status during the life of the grantor, the grantor is deemed to have transferred the assets in the trust and the liabilities of the trust to the trust. *Madorin v. Comm'r*, 84 T.C. 667 (1985); Treas.Reg. §1.1001-2(c), Ex. 5; Rev. Rul. 77-402, 1977-2 C.B. 222. If there are any outstanding liabilities, the grantor must recognize gain to the extent that the liabilities exceed the grantor's basis in the trust assets. Any liability that was incurred to acquire the property and not taken into account in determining the trust's basis in the property is not included in the determination of the recognized gain. Treas.Reg. §1.1001-2(c).

c. The real debate though regarding treatment upon death of a grantor comes with respect to the timing of the transfer and whether there is a step-up in basis of the assets. The two issues are intertwined. So, which is it?

d. If the transfer is deemed to take place immediately *before* the grantor's death, the commentators state that the assets should not receive a step-up in basis under section 1014(a) because they were not owned by the grantor at the time of the grantor's death. As noted above, if there are liabilities in excess of basis, the grantor will recognize gain on the deemed transfer to the extent of the excess. Finally, if liability is owed to the grantor and the sale is reported on the installment method, the beneficiaries of the grantor's estate who inherit the note will report the gain as income in respect of a decedent as payments are made under section 691, reduced by the estate tax attributable to the inclusion of the note in the grantor's estate. Section 691(c).

e. If the transfer is deemed to take place immediately *after* the grantor's death, the grantor's estate will recognize gain on the transfer to the extent that the liabilities exceed the estate's basis in the assets. The extent of the liabilities depends on whether the assets in the trust receive a step-up in basis upon the grantor's death. If there is a step-up in basis allowed under section 1014, then the trust's basis in the assets will be stepped up to their fair market value as of the date of the grantor's death. Following such adjustment, if the liabilities exceed the trust's new basis in the assets, then there will be gain recognition to the grantor's estate. If, however, section 1014 does not apply, then the same rules apply as if the transfer is deemed to take place before the grantor's death.

f. Accordingly, the timing of the deemed transfer only makes a difference if there is authority for a step-up in basis upon the grantor's death. The commentators under this theory do not believe that a step-up is possible. Section 1014(a) provides that the "basis of property in the hands of a person acquiring the property from a decedent or to whom the property passed from a decedent shall, if not sold, exchanged, or otherwise disposed of before the decedent's death by such person, be the fair market value of the property at the date of the decedent's death…." The following situations demonstrate how property is considered to have been acquired from a decedent or to have passed from a decedent:

i. Property acquired by bequest, devise, or inheritance or by the decedent's estate from the decedent. Section 1014(b)(1).

ii. Property transferred to a trust by the decedent during his or her lifetime in which the decedent retained an income interest and the right to revoke the trust. Section 1014(b)(2).

iii. Property transferred to a trust by the decedent in which the decedent retained the right to "pay the income for life to or on the order or direction of the decedent" and the right to alter, amend, or terminate the trust. Section 1014(b)(3).

iv. Property passing without full and adequate consideration under a general power of appointment exercised by the decedent's will. Section 1014(b)(4).

g. For property to pass by bequest, devise, or inheritance would require the property to pass pursuant to the decedent's will or by intestacy. This does not occur because the grantor trust was created during the grantor's lifetime, and in most cases the grantor does not retain any powers over the trust that would cause the property to pass under the decedent's will or by intestacy or otherwise be included in the grantor's estate for federal estate tax purposes. This also eliminates the application of the other three examples noted above.

h. Furthermore, the Regulations expand on the first example to state that property is deemed to have been acquired from a decedent or passed from a decedent if the property is "acquired by bequest, devise, or inheritance, or by the decedent's estate from the decedent, whether the property was acquired under the decedent's will or under the law governing the descent and distribution of the property of decedents." Treas.Reg. §1.1014-2(a)(1). The commentators view this additional language as meaning that the step-up occurs when property is acquired from the decedent's estate, not merely a deemed acquisition for income tax purposes. It follows that, if such language were not interpreted in this manner, then all property held in any grantor trust should receive a step-up in basis upon the grantor's death. In addition, the other three examples noted above from section 1014(b) would not be necessary to distinguish certain types of trusts from the typical grantor trust when the grantor does not retain rights that cause estate tax inclusion.

i. The timing of the transfer has another important consequence: the deductibility of the income taxes paid on the recognized gain. If the transfer is deemed to have occurred immediately before the grantor's death, the income taxes should be deductible under Section 2053 as an expense of the grantor's estate, because such income tax will be paid by the estate when it files the grantor's final income tax return. Treas.Reg. §20.2053-6(f). This, however, will not be the case if the liability is from the trust to the grantor and it is reported on the installment method, because the gain is income in respect of a decedent to the beneficiary of the note. Section 691(a).

j. If the transfer is deemed to have occurred immediately after the grantor's death, the income tax will not be deductible under section 2053. The income tax will be a liability of the estate, not of the decedent, and reported on the estate's income tax return.

G. Recent Rulings Regarding Grantor Trusts

1. *Private Letter Ruling 2009-49012 (Aug. 17, 2009): Withdrawal Rights Cause Trust To Be Grantor Trust As To Beneficiary*

   a. G created a trust for the benefit of B. B was designated the Investment Trustee, A was designated the Distribution Trustee, and a Trust Company was designated as the Administrative Trustee. A does not have any beneficial interest in the trust. The Distribution Trustee has the discretion to distribute the income or principal or both of the trust to B. B has a lifetime power to appoint the net income or principal or both of the trust to B or for B's benefit for B's health, education, maintenance, and support. B also has the power to withdraw amounts contributed to the trust each year to qualify such contributions for the gift tax annual exclusion. Such withdrawal right is limited to the greater of $5,000 or five percent of the value of the principal of the trust. Upon B's death, the property remaining in the trust will be distributed among those individuals (other than B, B's estate, G, G's estate, B's creditors, the creditors of B's estate, G's creditors, or the creditors of G's estate) or charitable organizations as B appoints in B's will. Any property not so appointed will be distributed among those charitable organizations as selected by the Distribution Trustee.

   b. G is not a beneficiary of the trust and has no interest in the trust. No income or principal may be paid or applied for the benefit of G or G's spouse or to pay premiums on an insurance policy on the life of G or G's spouse. Neither G nor G's spouse may serve as a trustee of the trust, and no more than half of the trustees of the trust may be related or subordinate parties to G within the meaning of section 672(c). The trust agreement specifically provides that G does not intend to be treated as the owner of the trust for income tax purposes. Furthermore, neither G nor any other nonadverse party (as defined in section 672(b)) has any power to purchase, exchange, or otherwise deal with or dispose of the trust property for less than adequate consideration or borrow any trust property without adequate interest or security.

   c. Finally, the trust agreement provides that no person, other than a U.S. person, shall have the authority to control any substantial decision (within the meaning of section 7701(a)(30)(E)) of the trust or any trust created thereunder. Only U.S. courts will exercise primary supervision over the administration of the trust.

   d. The Service reviewed specifically sections 675 and 677(a) with respect to whether the trust would be treated as a grantor trust with respect to G and held that neither section applied. The Service did, however, rule that the withdrawal rights granted to B caused the trust to be treated as a grantor trust as to B under section 678(a).

2. *Private Letter Ruling 2009-44002 (July 15, 2009): Power of Substitution Does Not Cause Estate Tax Inclusion*

   a. G created an irrevocable trust for the benefit of G, G's spouse, and G's descendants. A Trust Company was appointed to serve as the initial trustee. The Trust Company is not a related or subordinate party within the meaning of section 672(c). The trustee has discretion to distribute the income or principal or both of the trust to any of G, G's spouse, and G's descendants. The trustee, however, may not pay G or G's executors any income or principal in discharge of G's income tax liability. Upon the death of the latter of G and G's spouse to survive, the remaining trust property

will be distributed among G's then-living descendants. If none of G's descendants is then living, such property will be distributed to charity. No portion of the trust property may be distributed to G, G's estate, G's creditors, or the creditors of G's estate upon the termination of the trust.

b. The trust also provides for restrictions on who may serve as the trustee of the trust. The following persons may not serve as the trustee: G, G's spouse or former spouse, an individual who is a beneficiary of the trust or any trust created thereunder, the spouse or former spouse of any such beneficiary, or anyone who is related or subordinate to G within the meaning of section 672(c). G also may not remove any trustee.

c. G has the power, exercisable in a nonfiduciary capacity, without the approval or consent of any person in a fiduciary capacity, to acquire property held in the trust by substituting other property of an equivalent value. Such power must be exercised by certifying in writing that the substituted property and the trust property for which it is substituted are of equivalent value. The trustee has a fiduciary obligation to ensure this as well. The power may not be exercised in a manner that can shift benefits among the beneficiaries of the trust.

d. The law of the state in which the trust is created allows for creditor protection for self-settled trusts such as this, with certain exceptions.

e. It should be noted that the Service specifically did not rule on whether the trust qualifies as a grantor trust for federal income tax purposes. The power of substitution is, however, generally used to create a grantor trust.

f. The issues raised in the Ruling are as follows:

i. *Will Contributions To The Trust Be Completed Gifts?* The first issue is whether G's status as a discretionary beneficiary of the trust causes gifts to the trust to be incomplete for federal gift tax purposes. A gift is complete when the "donor has so parted with dominion and control as to leave in him no power to change its disposition, whether for [the donor's] benefit or for the benefit of another." Treas.Reg. §25.2511-2(b). If the donor reserves the power to revest the beneficial title to the property in himself or herself, to name new beneficiaries, or to change the interests of the beneficiaries as between themselves, the gift is incomplete for federal gift tax purposes. Treas.Reg. §25.2511-2(c).

(1) In this case, G is a discretionary beneficiary of the trust. G did not retain any power to revest beneficial title in himself or herself or any right to name new beneficiaries or change the interests of the designated beneficiaries. Therefore the Service ruled that G's contributions to the trust will be completed gifts for federal gift tax purposes.

ii. *Will Any Portion Of The Trust's Assets Be Included In G's Estate?* The second issue addressed by the Ruling is whether any portion of the trust property will be includable in G's estate for federal estate tax purposes. Property transferred in trust is includable in the grantor's estate when the grantor retained for his or her lifetime the possession or enjoyment of, or the right to the income from, the transferred property. Section 2036(a)(1). If the property can be used to discharge a legal obligation of the grantor, the grantor is deemed to have retained the possession and enjoyment of the property and thus the property is includable in the grantor's estate. Treas.Reg. §20.2036-1(b)(2).

(1) The Service first addressed the power of substitution retained by G. Citing Rev. Rul. 2008-22, the Service ruled that the substitution power, by itself, will not cause the trust property to be included in G's estate.

(2) The Service then reviewed Revenue Ruling 2004-64 relating to the power to reimburse the grantor for taxes the grantor pays on the income generated by a grantor trust. In this case the trustee is prohibited from reimbursing G for any income taxes G pays. Therefore G has not retained a right to be reimbursed for income taxes, and there should be no inclusion.

(3) The Service, however, would not rule on whether the trustee's discretion to distribute income and principal to G would cause inclusion in G's estate under section 2036. The Service recognized that the discretion in the trustee alone should not cause estate tax inclusion. If there were other facts, however, such as an understanding or preexisting arrangement between G and the trustee regarding the exercise of the trustee's discretion, then the trust assets may be included in G's estate.

3. *Chief Counsel Advice 2009-23024 (Dec. 31, 2008): Conversion Of Nongrantor Trust To Grantor Trust*

a. The taxpayer (A), A's three children (B, C, and D), and A's spouse formed a limited liability company, contributing a nominal amount of cash. A, B, C, and D also transferred shares in a Subchapter S corporation to the LLC. A, B, C, and D each then established an irrevocable trust funded with $100,000 for the benefit of each grantor's then-living issue. The trusts were nongrantor trusts for federal income tax purposes. The trustees of each trust were A's spouse, an independent individual trustee, and an independent corporate trustee. Each trust terminated on the death of its grantor, at which time the remaining trust property was to be distributed, subject to further trust provisions, to the grantor's then-living issue, or, if none, the living issue of the grantor's mother.

b. Each of A, B, C, and D sold his or her respective interest in the LLC to the trust he or she created in exchange for an unsecured private annuity. The amount of the annuity varied depending on the age of the transferor. The LLC then made an election under section 754 to adjust the basis of the LLC property as a result of the sale, allowing the basis of stock in the S corporation to be stepped up to its fair market value as of the date of the sale. The LLC then sold all of its shares in the S corporation pursuant to its initial public offering for an amount almost equal to its new basis in the shares. The LLC then distributed an amount equal to the annuity payments to A, B, C, and D, and A, B, C, and D reported such amount as income on their income tax returns. They did not, however, report the gain from the sale of the LLC interests to the trusts. In Year 2, A, B, C, and D again reported the annuity amounts as income on their income tax returns.

c. The independent corporate trustee was removed by a trust adviser who was not related or subordinate to the grantor of each trust within the meaning of section 672(c). The trust adviser appointed in place of the independent corporate trustee an individual who was an employee of a corporation in which the stock holdings of A, B, C, and D are significant from the viewpoint of voting control or a subordinate employee of a corporation in which A, B, C, and D are executives. The exercise of certain powers by the new trustee would cause the trusts to be treated as grantor trusts under section 674(a) and (c). From that point forward, each grantor stopped reporting the annuity amounts received as income on his or her income tax return.

d. The first issue that arose was whether the conversion of the trust from a nongrantor trust to a grantor trust caused recognition of gain on the transfer. The examining agent argued that the same rules that apply to the conversion from a grantor trust to a nongrantor trust apply in this case by asserting that ownership of a trust's assets changes hands when its separate existence for tax purposes disappears on becoming a grantor trust. The agent cited authorities that discuss tax consequences of the conversion of a grantor trust to a nongrantor trust.

i. Revenue Ruling 77-402 holds that when a grantor trust owns a partnership interest subject to liabilities and the grantor renounces all grantor trust powers, the grantor is treated as having transferred the interest to the trust and will recognize gain or loss on the transfer. Rev.Rul. 77-402, 1977-2 C.B. 222.

ii. Treasury Regulation §1.1001-2(c), Example 5, provides an example of termination of grantor trust status when a trust owns a partnership interest and its share of partnership liabilities is treated as money received on the termination.

iii. *Madorin v. Comm'r* upholds Example 5 in Treasury Regulation §1.1001-2(c). 84 T.C. 667 (1985).

e. The Chief Counsel stated that such authority deals with the opposite situation to that at hand. Furthermore, even if the authorities were to apply to the conversion of a nongrantor trust to a grantor trust, they do not support the position that the new deemed owner of the trust assets will have taxable income on receipt of the assets. While this particular transaction may be abusive, the result would have an adverse effect on nonabusive situations. The Chief Counsel listed such examples as the appointment of a related or subordinate trustee that causes a trust to be treated as a grantor trust under section 674, borrowing of trust corpus by the grantor under section 675(3), or the payment of the grantor's legal support obligations under section 677(b). There is no authority stating that any of these events results in taxable income to the deemed transferee. Revenue Ruling 85-13 held that the grantor became the owner of a trust when the grantor indirectly borrowed assets from the trust. Rev.Rul. 85-13, 1985 C.B. 184. The grantor could not then engage in a transaction with the trust that would be respected for income tax purposes. It did not, however, conclude that the grantor realized the amount of the indirect borrowing as income under section 61. Accordingly the Office of the Chief Counsel stated that the Service should not take the position that the conversion of a nongrantor trust to a grantor trust results in taxable income to the grantor.

f. The second issue addressed by the Advice was whether the grantors of the trusts are considered to have indirectly borrowed the trust property by selling partnership interests to the trusts in exchange for unsecured annuities. A trust is treated as a grantor trust when the grantor has directly or indirectly borrowed trust income or principal and has not completely repaid the loan before the beginning of the taxable year, unless such loan is made with adequate interest and adequate security by a trustee other than the grantor or a party who is related or subordinate to a grantor within the meaning of section 672(c). Section 675(3). In Revenue Ruling 85-13, the grantor created a nongrantor trust funded with stock for the benefit of his child. The grantor trust transferred appreciated stock to the grantor in exchange for an unsecured promissory note for the full value of the stock. The grantor then sold the stock to an unrelated party. The Ruling holds that the sale

is the equivalent of a borrowing from the trust, in that the result is the same as the grantor having contributed cash to the trust and then borrowing back the cash in exchange for an unsecured note. Thus the grantor is treated as the owner of the trust assets under section 675(3), and the sale between the grantor and the grantor trust is disregarded for federal income tax purposes.

g. The Chief Counsel stated that it does not agree that the facts in this case are substantially similar to the facts in Revenue Ruling 85-13. In that ruling, the economic benefit is to the grantor. In this case the grantors are giving up property in return for an unsecured promise by the trust to pay. Furthermore, the Chief Counsel cited Revenue Ruling 69-74, which treats the exchange of appreciated property for a private annuity as a sale rather than a borrowing. Rev.Rul. 69-74, 1969-1 C.B. 43. Accordingly the Chief Counsel concluded that the grantors are not considered to have indirectly borrowed the trust property, and the trusts did not become grantor trusts when the grantors sold the LLC interests to the trusts.

4. *Private Letter Ruling 2009-20031 (Jan. 26, 2009): Distribution Of Appreciated Securities By Grantor CLAT*

a. G created a charitable lead annuity trust (CLAT) that was treated as a grantor trust for federal income tax purposes. G transferred an interest in a family-owned limited liability company to the CLAT. The CLAT was required to make a fixed annuity payment to a private foundation equal to a percentage of the initial value of the assets transferred to the CLAT each year for a period of 20 years. The trustees wanted to distribute appreciated securities to the foundation rather than from the CLAT's income, and the question was whether such payment will trigger a gain or loss to the grantor or to the CLAT.

b. In *Kenan v. Comm'r* the trustees of a testamentary trust were directed to pay the beneficiary $5 million when the beneficiary reached the age of 40. 114 F.2d 217 (2d Cir. 1940). The trustees could make the distribution all in cash or all in securities and decided to make the distribution in part cash and part securities. The Second Circuit held that transfer of the securities in satisfaction of the distribution was treated as a sale of the securities by the trust and a distribution of the sales proceeds to the beneficiary. Thus the trust recognized gain on the transfer of the securities.

c. The Service then cited Revenue Ruling 83-75, stating that it adopted the reasoning in *Kenan* when a distribution by a nongrantor trust of appreciated securities to satisfy its obligation to pay a fixed annuity to charity resulted in a taxable gain to the trust. Rev.Rul. 83-75, 1983-1 C.B. 114. Although the trustee had the authority to pay the annuity to qualified charities of the trustee's choice, the Service stated that the distribution was a taxable exchange because it was made in satisfaction of a right to receive a specified dollar amount.

d. Revenue Procedure 2007-45 sets forth sample provisions and other information regarding inter vivos grantor charitable lead annuity trusts. Rev.Proc. 2007-45, 2007-2 C.B. 89. One such provision provides that the donor may claim a federal income tax charitable contribution deduction in the year the assets are transferred to the trust but will then be taxed on all income earned by the trust without reduction for the annuity payment made to the charity each year. Rev.Proc. 2007-45, 2007-2 C.B. 89, §8.01(2). If the trustee distributes appreciated property to satisfy the annuity payment, the donor will realize capital gain on the assets distributed. *Id.*

e. G cited to Revenue Ruling 55-410. Rev.Rul. 55-410, 1955-1 C.B. 297. In that ruling, the Service found that the satisfaction of a pledge to charity with appreciated (or depreciated) property does not result in realization of gain or loss. The Service stated that this ruling does not apply to the distribution to satisfy an annuity payment by a CLAT. With the CLAT, the charity has a claim against the trust assets that is satisfied by the transfer of the appreciated property. In Revenue Ruling 55-410, the Service found that the pledge was not a debt because the individual making the pledge is not entitled to the income tax deduction until the pledge is satisfied. Accordingly, the Service ruled that G will recognize gain on the transfer of appreciated securities in satisfaction of the annuity payments.

5. *Private Letter Rulings 2008-48006, 2008-48015, 2008-48016, and 2008-48017 (Aug.4, 2008): Service Cannot Determine Whether Substitution Power Exercisable In Fiduciary Or Nonfiduciary Capacity Until Examination Of Federal Income Tax Returns Of Parties*

   a. In each ruling A created and funded an irrevocable trust for the benefit of A's children. A and all of the beneficiaries of the trust intended to modify the trust, in accordance with state law, to provide that A will have the power, solely in a nonfiduciary capacity and without the approval of any person in a fiduciary capacity, to reacquire any property owned by the trust by substituting property of equivalent value. The issue is whether the addition of such power will cause the trust to be treated as a grantor trust as to A for federal income tax purposes.

   b. A grantor is treated as the owner of a trust for federal income tax purposes when the grantor has the power to reacquire the trust principal by substituting other property of an equivalent value so long as such power is exercisable in a nonfiduciary capacity without the approval or consent of any person in a fiduciary capacity. Section 675(4)(C). If the terms of the trust agreement or the circumstances surrounding its administration demonstrate that "administrative control is exercisable primarily for the benefit of the grantor rather than the beneficiaries of the trust," a power of substitution can be deemed to be exercisable primarily for the benefit of the grantor. Treas. Reg. §§1.675-1(a); 1.675-1(b)(4)(iii). With respect to the power of substitution, whether the power is exercisable in a fiduciary or a nonfiduciary capacity depends on the terms of the trust and the circumstances surrounding its creation and administration. *Id.*

   c. The Service concluded that the circumstances surrounding the administration of the trust will determine whether the power of substitution in this case is exercisable in a fiduciary or nonfiduciary capacity. As this is a question of fact, the Service stated that it cannot make a determination until the federal income tax returns of the parties involved have been examined. If they determine that the power is exercisable in a nonfidicuary capacity, then A will be treated as the owner of the trust for federal income tax purposes.

6. *Private Letter Ruling 2008-42007 (June 24, 2008): Exercise Of Substitution Power Is Not Gift*

   a. G created a trust for the benefit of G's spouse and G's issue. During G's lifetime, the trustees may distribute as much of the trust property to G's spouse as the trustees determine for any reason not prohibited by the trust agreement. Following G's death, the trustees may distribute as much of the trust property to G's spouse as the trustees determine for the health, maintenance, and support of G's spouse. G's spouse also has an inter vivos limited power of appointment to have trust property

distributed to G's issue, so long as such distribution does not discharge G's obligation to support the recipient. G's spouse also has a testamentary limited power appointment over the trust property. Any property not so appointed by G's spouse's will upon her death will be distributed to G's issue per stirpes.

b. G's spouse has a Crummey withdrawal right, limited by the "five or five" power of sections 2514(e) and 2041(b)(2). G has retained a power of substitution that may be exercised only in a fiduciary capacity. The trust agreement defines "fiduciary capacity" as an "action that is undertaken in good faith and in the best interests of the Trust and its beneficiaries subject to fiduciary standards imposed under applicable state law."

c. G would like to exercise his power of substitution by transferring shares of Company 1 stock that G owns in exchange for shares of Company 2 stock that the trust owns. G will transfer to or withdraw from the trust any amount of cash necessary to make the substitution of equivalent value. Neither of the trustees is a descendant of G nor are otherwise related or subordinate to G within the meaning of section 672(c). If there is a vacancy in the office of trustee, it must be filled by a person who is not related or subordinate to G within the meaning of section 672(c). The stock of both Company 1 and Company 2 is publicly traded.

d. Five issues were addressed by the ruling.

i. The first issue was whether the retention of the power of substitution will cause the trust property to be included in G's estate for federal estate tax purposes under sections 2033, 2036(a), 2038, or 2039. In *Estate of Jordahl*, the Tax Court held that the decedent's reserved power to substitute property was not a power to alter, amend, or revoke the trust within the meaning of section 2038(a)(2) because the power was exercisable only in good faith and subject to fiduciary standards, and the substituted property must have been equal in value to the assets replaced. *Estate of Jordahl v. Comm'r*, 65 T.C. 92 (1975), *acq.*, 1977-2 C.B. 1. This, the Tax Court believed, provided that the decedent could not exercise the power to deplete the trust to shift the benefits among the beneficiaries. This idea was furthered by the Service in Revenue Ruling 2008-22, in which the Service stated that a power of substitution exercisable in a nonfiduciary capacity will not cause inclusion of the trust assets in the grantor's estate. Rev.Rul. 2008-22, 2008-16 I.R.B. 796.

(1) In this case, G's power to substitute assets may be exercised only in a fiduciary capacity, and G must substitute assets of equivalent value. Accordingly the Service ruled that the power will not cause the trust assets to be included in G's estate under sections 2033, 2036(a), 2038, or 2039.

ii. The second and third issues were combined. The second issue is whether G's exercise of the power of substitution will constitute a gift if the total value of the assets transferred to the trust equals the total value of the assets transferred from the trust. The third issue is whether the gift tax value of the stock being exchanged will be determined by valuing each stock at the mean between its highest and lowest quoted selling price on the date of the substitution in accordance with Treas. Reg. §25.2512-2(b)(1).

(1) The Service reviewed the provisions of section 2512. Section 2512(a) provides that, when a gift is made in property, the value of the property as of the date of the gift is considered the amount of the gift. If property is transferred for less than "adequate and full consideration in money or money's worth, then the amount by which the value of the property exceeded the value of the consideration shall be deemed a gift…." Section 2512(b). If, however, the transfer is bona fide, at arm's length, and free from any donative intent, then such transfer will be deemed to have been for full and adequate consideration. Treas.Reg. §25.2512-8. The value of property for gift tax purposes is the "price at which such property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell, and both having reasonable knowledge of relevant facts." Treas.Reg. §25.2512-1. When dealing with publicly traded stock, the value of the stock is equal to the mean between the highest and lowest quoted selling prices on the date of the gift. Treas.Reg. §25.2512-2(b)(1).

(2) In this case, the stock being exchanged will be valued in accordance with the rules of Treas. Reg. §25.2512-2(b)(1). G has represented that if the value of the stocks is not equal then G will transfer to the trust or the trust will transfer to G cash to make up the difference. Accordingly the Service concluded that G's exercise of the power of substitution will not constitute a gift as long as the total fair market value of the assets transferred to the trust equals the total fair market value of the assets transferred from the trust.

iii. The last issues are whether the trust is a grantor trust and whether G or the trust will recognize any income or loss by reason of the exercise of the power of substitution. Section 677(a)(1) provides that a trust will be treated as a grantor trust if the income of the trust may be distributed to the grantor spouse by the grantor or a nonadverse party without the consent of an adverse party. In Revenue Ruling 85-13 the Service ruled that if the trust is a grantor trust, transactions between the grantor and the grantor trust will be disregarded for federal income tax purposes. Rev.Rul. 85-13, 1985-1 C.B. 184. In this case, the trustees are nonadverse parties within the meaning of section 672(b). The trustees may distribute the income of the trust to G's spouse for any purpose while G is living. Thus the trust is a grantor trust under section 677(a)(1). As a result, the Service ruled that the exercise of the power of substitution will not result in the recognition of gain or loss by either G or the trust.

(1) Note that the Service did not comment on whether the power of substitution caused the trust to be treated as a grantor trust. This likely is because of the fact that it must be exercised in a fiduciary capacity. But in any event, it is interesting that this power was not even raised as a possible power to cause grantor trust status.

7. *Private Letter Ruling 2008-22008 (Feb. 6, 2008): Addition of Reimbursement Clause Should Not Cause Estate Tax Inclusion*

a. G created an irrevocable trust naming G's spouse as the initial trustee of the trust. Until the earlier of G's death or G's spouse's death, the trustee must distribute all of the income or principal or both of the trust to G's spouse as the trustee determines in the trustee's sole discretion but with the consent of an adverse party as defined in section 672(a). The trustee is prohibited from reimbursing G for his or her payment on the income tax attributable to the trust while it is a grantor trust,

and G expressly waived any right of reimbursement. The trustee wanted to modify the trust to provide that the trustee would be authorized, but not directed, to distribute to G funds sufficient to cover the income tax liability incurred by G attributable to the grantor trust status of the trust. Any exercise of such power would be required to be approved by a "reimbursement committee," which must consist of members who are not related or subordinate to G within the meaning of section 672(c), and at least one child beneficiary who qualifies as an adverse party under section 672(a).

b. The Service concluded that the addition of the reimbursement provision will not cause the trust assets to be included in G's estate for federal estate tax purposes. In accordance with Revenue Ruling 2004-64, the power to reimburse is not mandatory and must be approved by the reimbursement committee. Assuming there is no express or implied understanding between G and the members of the reimbursement committee and the trustee, the trustee's discretion to exercise the right to reimburse G alone will not cause the trust property to be includable in G's estate. Furthermore, the Service noted that the inclusion of the reimbursement provision should not jeopardize grantor trust status.

8. *Notice 2008-63: Proposed Guidance For Treatment of Private Trust Companies Used As Trustees By Family Members*

a. In July 2008 the Service issued Notice 2008-63 in which it set forth a proposed Revenue Ruling on the income, gift, estate, and generation-skipping transfer tax consequences of the use of a private trust company by families to serve as the trustee of a trust of which the family members are the grantors and beneficiaries. Notice 2008-63, 2008-2 C.B. 261. The facts of the proposed Revenue Ruling are as follows:

A and B, husband and wife, have three children, C, D and E. Each child is married and has children. A and B established irrevocable trusts with each of their children and grandchildren as the primary beneficiary of the relevant trust. C, D and E also established irrevocable trusts for their own descendants. Contributions are made to each trust only by the individual who created such trust. Each trust agreement provides that the Trustee has the discretion to distribute income and/or principal to the primary beneficiary. The primary beneficiary has a testamentary limited power of appointment over the trust property that can be exercised in favor of any of A and B's descendants (other than the primary beneficiary) and any charitable organization. The grantor has the power to appoint a successor Trustee, other than such grantor, if the current Trustee ceases to serve.

b. The Notice then sets forth two situations:

Situation 1: In Situation 1, each trust is governed by the laws of a state that has enacted a private trust company statute. Under such statute, each private trust company must create a "Discretionary Distribution Committee" (DDC) and delegate to the DDC the exclusive authority to make all decisions regarding discretionary distributions from each trust for which it serves as a Trustee. Any person may serve on the DDC, but no member of the DDC may participate in decisions relating to any trust of which such member or his or her spouse is a grantor or a beneficiary or with respect to a beneficiary to whom such member or such member's spouse owes a legal obligation of support. Only officers and managers of the private trust company may participate in decisions regarding the hiring, discharge, promotion and compensation of personnel of the private trust company. Nothing in the statute or the governing documents of the private trust company may override a more restrictive provision in the trust agreement. No family member may enter into any reciprocal agreement regarding discretionary distributions from any trust for which the private trust company is serving as a Trustee.

In 2008, A and B's family formed a private trust company in accordance with applicable state law. A DDC will make all decisions regarding discretionary distributions in accordance with the statute. There are no restrictions on who may serve on the DDC. A, C and D are officers and serve on the board of directors, as well as members of the DDC. B and E own shares of the company, but have no other role. E is a manager and an employee of the private trust company.

A financial institution has served as the Trustee of all of the trusts. The only relationship that any grantor has with the Trustee is that of a customer or client. Following the formation of the private trust company, the financial institution resigned as Trustee and the private trust company was appointed as successor Trustee. A also created new trusts for each of A's children and their descendants, naming the private trust company as the initial Trustee.

Situation 2: In Situation 2, the state law governing each trust does not have a statute that governs private trust companies. The facts are the same as above. The private trust company's documents set forth the provisions regarding the DDC. Specifically, the DDC has the exclusive authority to make all decisions regarding discretionary distributions, which are defined as permissible distributions not mandated in the trust agreement or by applicable law. There are no restrictions on who may serve on the DDC, but no member of the DDC may participate in decisions relating to any trust of which such member or his or her spouse is a grantor or a beneficiary or with respect to a beneficiary to whom such member or such member's spouse owes a legal obligation of support. The company's governing documents provide that only officers and managers of the private trust company may participate in decisions regarding the hiring, discharge, promotion and compensation of personnel of the private trust company. Nothing in the private trust company's governing documents may override a more restrictive provision in the trust agreement. No family member may enter into any reciprocal agreement regarding discretionary distributions from any trust for which the private trust company is serving as a Trustee.

The private trust company's governing documents also provide for the creation of an "Amendment Committee." The Amendment Committee has the authority to amend the company's governing documents relating to the creation, function or members of the DDC or Amendment Committee, the provisions delegating exclusive authority regarding personnel decisions to the officers and managers and the prohibition of reciprocal agreements between family members. The Amendment Committee must be made of individuals, a majority of whom must not be members of the family or persons related or subordinate to any shareholder of the private trust company, within the meaning of Section 672(c). A is one of the initial members of the Amendment Committee, with F and G, neither of whom are members of the family, employed by the private trust company or related or subordinate to any members of the family within the meaning of Section 672(c).

A, C and D are officers of the private trust company and serve on the DDC. A, C, D, F and G serve on the Board of Directors. B and E own shares of the private trust company but are not on the DDC or officers or directors of the private trust company. E is a manager and employee of the company.

A financial institution has served as the Trustee of all of the trusts. The only relationship that any grantor has with the Trustee is that of a customer or client. Following the formation of the private trust company, the financial institution resigned as Trustee and the private trust company was appointed as successor Trustee. A also created new trusts for each of A's children and their descendants, naming the private trust company as the initial Trustee.

c. Five issues were raised in the Notice. Each issue and its resolution are described below.

i. *If Private Trust Company Serves As Trustee, Will Any Portion Of Trust Assets Be Included In Grantor's Gross Estate Under Sections 2036(A) Or 2038(A)?* When a decedent made a transfer during lifetime under which the decedent retained for his or her life the possession or enjoyment of, or the right to the income from, the property transferred, or the right to designate the persons who are to possess or enjoy the property or the income therefrom, such property will be includable in the decedent's estate for federal estate tax purposes. Section 2036(a). Also, if the decedent transfers property to a trust but retains the right to alter, amend, revoke, or terminate such trust, the property will be includable in the decedent's estate for federal estate tax purposes. Section 2038(a). Such right includes the discretionary authority to distribute or withhold income. *See* Rev.Rul. 70-348, 1970-2 C.B. 193.

(1) In Situation 1, the private trust company is the trustee. Discretionary distributions are made solely by the DDC. No family member may participate in making such distributions when such family member or his or her spouse is the grantor, a beneficiary, or has a legal obligation to support a beneficiary. Furthermore, the applicable state statute prohibits any

shareholders of the private trust company from changing any provisions regarding the DDC. Accordingly, the Service ruled that no portion of the trust assets be included in the grantor's gross estate under sections 2036(a) or 2038(a) under Situation 1.

(2) The Service held the same in Situation 2 but noted that Situation 2 is different from Situation 1 because there is no state law restricting the ability of the shareholders of the private trust company from changing the applicable provisions of the DDC. This issue, however, was resolved by the appointment of the Amendment Committee.

ii. *If Private Trust Company Is Serving As Trustee, Will Trust Assets Be Included In Beneficiary's Gross Estate Under Section 2041?* When a beneficiary has a general power of appointment over trust property, such property is includable in the beneficiary's estate for federal estate tax purposes. Section 2041(a)(2). A general power of appointment is a power to appoint property in favor of the decedent, the decedent's estate, the decedent's creditors, or the creditors of the decedent's estate, unless limited by an ascertainable standard. Section 2041(b)(1). A donee may have a general power of appointment if he or she has the power to remove or discharge a trustee and appoint himself or herself as a trustee. Treas.Reg. §20.2041-1(b)(1).

(1) In Situation 1, the trustee has the discretion to distribute the income or principal or both to a beneficiary of the trust. With the private trust company serving as the trustee, state law provides that such discretionary authority is delegated exclusively to the DDC. No member of the DDC may participate in making such distributions when such member or his or her spouse is the grantor, a beneficiary, or has a legal obligation to support a beneficiary. Furthermore, family members cannot enter into reciprocal arrangements that affect distribution decisions. Accordingly, the Service ruled that C and D as beneficiaries of the trusts and officers, directors, and members of the DDC do not have a general power of appointment under section 2041. Additionally, neither E nor any other beneficiary will be deemed to have a general power of appointment solely for participating in the daily activities of the private trust company relating to investments and the retention of professional advisors. The result under Situation 2 is the same but because of the powers of the Amendment Committee.

iii. *If Private Trust Company Is Trustee And Has Discretionary Power To Distribute Income Or Principal To Grantor's Child Or Descendants, Will Grantor's Transfer To Trust Be A Completed Gift?* When the donor has completely parted with all dominion and control over property transferred, the gift is complete. Treas.Reg. §25.2511-2(b). If, however, the donor reserves any power over the disposition of such property, such gift will be incomplete. *Id.* This is true, even if such power must be exercised in conjunction with another person, if such person does not have a substantial adverse interest in the disposition of the property or its income. Treas. Reg. §25.2511-2(e).

(1) In both Situation 1 and Situation 2, the grantor may serve on the DDC. Both the statute and the governing documents, however, provide that no member of the DDC may participate in making any discretionary distributions when such member or his or her spouse is the grantor, a beneficiary, or has a legal obligation to support a beneficiary. Furthermore, in both situations, family members are prohibited from making reciprocal agreements to make discretionary distributions. Therefore A's transfer will be considered a completed gift.

iv. *Does Private Trust Company's Appointment As Trustee Affect GST Exempt Status Of The Trust Or Change Its Inclusion Ratio?* Generally the modification of a trust agreement by judicial reformation or under applicable state law will not cause a GST exempt trust to become subject to the GST tax if the modification does not shift a beneficial interest in the trust to any beneficiary who occupies a lower generation than the person or persons who held the beneficial interest before the modification and if the modification does not extend the time for vesting beyond the period provided in the original trust. Treas.Reg. §26.2601-1(b)(4)(i)(D)(1). In both situations, the only change is a change in trustee, and there is no effect on the beneficial interests in the trust. Furthermore, each trust provides that it must terminate no later than 21 years after the death of the last to die of certain individuals living at the time of the creation of the trust. Therefore no trust should lose its GST exempt status.

(1) Moreover, so long as the private trust company is operated in accordance with the applicable statute and its governing documents, no portion of the trust property should be includable in the estates of the grantors or the beneficiaries, and no beneficiary is deemed to have a general power of appointment. Therefore the inclusion ratio of the trusts should not be affected.

v. *If Private Trust Company Serves As Trustee, Will Grantor Or Any Beneficiary Be Treated As Owner Of Trust For Federal Income Tax Purposes?* In Situation 1, none of the terms of the trusts, the statute, or the private trust company's governing documents result in any administrative controls under section 675. This is a question of fact, however, that cannot be determined until the federal income tax returns are examined. Furthermore, the grantor will be deemed to be the owner of the trust for federal income tax purposes when the income is used to discharge the grantor's obligation to support a beneficiary. Section 677(b). This is the result regardless of who is serving as the trustee, so the appointment of the private trust company will not change the result.

(1) The identity of the trustee is relevant under section 674. Section 674 applies when a power is exercisable by the grantor or a nonadverse party without the consent or approval of an adverse party. Section 674(a). In both situations, however, a member of the DDC is prohibited from making any decisions with respect to any trust in which such member has an interest. Therefore there will not be an adverse party to provide consent or approval.

(2) There are some powers under sections 674(b) and (d) that can be held by any trustee without causing the trust to be treated as a grantor trust. Thus the appointment of the private trust company in those circumstances will not have any adverse impact. But if the trustee is granted the authority to distribute trust property among a group of beneficiaries, the trust will not be treated as a grantor trust if such power is exercisable, without the approval and consent of any other person, by a trustee or trustees, none of whom is the grantor and no more than half of whom are related or subordinate to the grantor. Section 674(c).

(3) The term "related or subordinate" is defined in Section 672(c). When dealing with a private trust company, such company will be considered related or subordinate when the stock holdings of the grantor and the trust in the company are significant from the viewpoint of voting control. Section 672(c)(2). Voting control is relevant when it gives the grantor or the

trust a power over distributions. The Service ruled that, in both situations, there are adequate safeguards against the exercise of such powers.

(4) A subordinate employee of a corporation in which the grantor is an executive also is considered a related or subordinate party. Neither situation requires that the trustee be a person who is not related or subordinate to the grantor. Furthermore, there is no requirement that more than half of the members of the DDC be nonadverse parties who are not related or subordinate to the grantor. Thus it is important to make sure that no member of the DDC falls into this category. Currently, however, in both situations, there are no individuals who fall into this category. Therefore the trusts will not be treated as grantor trusts as to any grantor or beneficiary.

(5) The Service requested comments to this Notice that were due on November 4, 2008. Comments were submitted by the American College of Trusts and Estates Council (ACTEC), Arnold & Porter LLP, Caplin & Drysdale Chartered, Florida Bar Tax and Real Property, Probate and Trust Law Sections, Levin, Schreder & Carey Ltd., McGuire Woods LLP, New York City Bar Committee on Estate and Gift Taxation, Sullivan & Cromwell LLP, Thomson & Knight LLP, Warner, Norcross & Judd LLP and the New York State Bar Association. The primary concerns with the Notice are that the restrictions in the rules relating to the DDCs are too tight. Some of the commentators also suggested that the Service should not be addressing the grantor trust rules because of the inconsistencies between the transfer tax rules and the grantor trust rules.

(6) The commentators also asked the Service to clarify that the safe harbor rule regarding removal and replacement of trustees set forth in Revenue Ruling 95-58, 1995-2 C.B. 191 does not apply to the removal and replacement of officers, directors, and members of the DDC. They also stated that the stock in the private trust company should not be includable in the transferor's estate if the transferor cannot vote the stock or cause the governing documents to be modified to allow voting.

(7) The final Revenue Ruling has not been issued.