GRANTOR TRUSTS:
INCOME TAX RULES OF SUBPART E

Young Lawyers Institute
American Bar Association Section of Real Property, Probate & Trust Law
April 27, 2007

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TABLE OF CONTENTS

Page

TABLE OF CONTENTS
(continued)

Page

TABLE OF CONTENTS
(continued)

Page

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I. Introduction to the Grantor Trust Rules

A. **"Subpart E"**. The grantor trust rules are found §§671–679 of the Internal Revenue Code of 1986, as amended (the "Code").[2] Code §§671-679 comprise subpart E of subchapter J of chapter 1 of the Code ("Subpart E").[3]

B. **Brief history of the grantor trust rules**

1. **Congressional purpose**. The present form of Subpart E was enacted by Congress in 1954. In enacting Subpart E, Congress intended to stem abuses resulting from income shifting by taxpayers in very high income tax brackets to beneficiaries in lower brackets in situations where high bracket taxpayers retained control or enjoyment of the property at issue. When Subpart E was enacted in 1954, incentives for high-bracket taxpayers to shift income to lower-bracket taxpayers were significant, as there were 24 individual federal income tax brackets at tax rates ranging from 20% to 91%.

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[1] The author would like to thank Alan S. Halperin, whose class on the taxation of trusts and estates at New York University Law School was instrumental to the preparation of this outline and Carlyn S. McCaffrey, for her many insights into grantor trusts and other aspects of trusts and estates law.

[2] References to "Code §" are to sections of the Internal Revenue Code. References to "sections" are to sections of this outline.

[3] This outline addresses the rules of Subpart E that are applicable to domestic grantor trusts. It does not address the special rules in Subpart E that may be relevant to foreign grantor trusts (*e.g.*, Code §§679, 672(f)).

2. **Foundational cases**. Several cases are foundational to current Subpart E.

a. ***Helvering v. Clifford***, 309 U.S. 331 (1940). *Helvering v. Clifford* concerned a taxpayer who funded a trust for the "exclusive benefit" of his wife but who retained "absolute discretion" to make distributions to his wife and extensive powers over the trust assets, including the power to vote the shares of stock transferred to the trust and the power to sell, exchange, mortgage or pledge trust assets. The trust was to terminate at the end of five years, at which time the accrued but unpaid income was to be paid to the taxpayer's wife, and the principal returned to taxpayer. The Supreme Court held that the trust's income was table to the taxpayer, as the facts demonstrated that the trust arrangement was "no more than a temporary reallocation of income within an intimate family group."[4]

i. **"Clifford Regulations."** In response to *Helvering v. Clifford*, Treasury adopted the so-called "Clifford Regulations" in 1946.[5] The Clifford Regulations formed the basis for Congressional codification of the grantor trust rules in current Subpart E in 1954.[6]

b. ***Mallinckrodt v. Nunan***, 146 F.2d 1 (8th Cir.), *cert. denied*, 324 U.S. 871 (1945). *Mallincrkrodt v. Nunan* concerned a beneficiary of a trust who was entitled to receive as much of the otherwise undistributed income of a trust created by his father as the beneficiary requested. The 8th Circuit held

[4] 309 U.S. at 336.

[5] *See* T.D. 5488, 1946-1 C.B. 19.

[6] There several ways in which the Clifford Regulations differ from current Subpart E. One of these relates to the circumstances under which a grantor's retention of a reversionary interest will cause the grantor to be taxed as the trust's owner. Under the Clifford Regulations, a grantor was treated a trust's owner if he or she retained a reversionary interest in a trust's income or corpus that would vest within 10 years of the inception of the trust. Certain regulations under Subpart E still refer to reversionary interests in excess of 10 years, concluding that such reversionary interests are insufficient to grantor trust status. See e.g., Treas. Reg. §1.673(a)-1(b); Treas. Reg. §1.673(b)-1(c) (example). Rather than ignoring these regulations entirely, any reference to a 10-year reversionary interest should be read as a reference to a reversionary interest that will take effect far enough in the future that the value of such interest, at the inception of the trust, is worth less than 5% of the value of the trust.

that the beneficiary was to be treated as owner of the trust, whether or not he actually demanded income in a given year, in view of his "position of power over the disposition of trust income." *Mallinckrodt* has been codified in Code §678, described in section III.F of this outline, below.

C. **Basic operation of Subpart E**. There are two basic steps to the operation of the grantor trust rules. Step 1 operates through Code §§673 to 679, which identify persons as "owners" of "portions" of trusts with respect to which they have certain interests or powers. Step 2 operates through Code §671, which describes the consequences of being treated as an "owner." [7] Code §672 provides definitions and rules of application relevant to steps 1 and 2.

II. Key Terms, Definitions and Concepts

A. "Grantor"

1. **Basic definition of "grantor"**. The term "grantor" is not defined in the Code. Rather, "grantor" is defined in Treas. Reg. §1.671-2(e)(1), which provides that for purposes of part I of subchapter J of chapter 1 of the Code,[8] *a grantor includes any person to the extent such person either creates a trust, or directly or indirectly makes a gratuitous transfer of property to a trust*.

   a. **"Gratuitous transfer" – definition**. For purposes of Treas. Reg. §1.671-2(e)(1), a gratuitous transfer is any transfer other than a transfer for fair market value.

   b. **Example**. A creates and funds a trust for the benefit of her children. B subsequently makes a gratuitous transfer to the trust. Under Treas. Reg. §1.671-2(e)(1), both A and B are grantors of the trust.[9] A created and made a gratuitous transfer to the trust; B made a gratuitous transfer to the trust.

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[7] These steps are described in further detail in M. Carr Ferguson, James J. Freeland, and Mark L. Ascher, *Federal Income Taxation of Estates, Trusts & Beneficiaries*, Aspen Publishers (3rd. ed.), § 10.03.

[8] Part I of subchapter J of chapter 1 of the Code includes all provisions of the Code dealing with the income taxation of estates, trusts and beneficiaries, other those provisions related to income in respect of decedents.

[9] *See* Treas. Reg. §1.671-2(e)(6) (example 1).

2. **Trust created or funded on behalf of another**. If a person creates or funds a trust on behalf of another person, both persons are treated as grantors.[10] However, under the circumstances described immediately below, a person who is a grantor of a trust will not be treated as owner, even if such person has powers described in Code §§673-679.

a. **Grantor but not owner**. A person who ***creates a trust but makes no gratuitous transfers*** to the trust is not treated as an owner of any portion of the trust under Code §§671 through 679.[11] Similarly, a person who funds a trust with an amount that is directly ***reimbursed*** to such person within a reasonable period of time and who makes no other transfers to the trust that constitute gratuitous transfers is not treated as an owner of any portion of the trust under Subpart E.[12]

i. **Rationale for treating a person as grantor but not owner**. In the preamble to Treas. Reg. §1.671-2(e), Treasury explained that treating a nominal creator as a grantor ensures that someone will be responsible for reporting the creation of a foreign trust by a U.S. person in accordance with Code §6048, even if the trust is not immediately funded.

b. **Example**. A, an attorney, creates a foreign trust, FT, on behalf of A's client, B, and transfers $100 to FT out of A's funds. A is reimbursed by B for the $100 transferred to FT. Both A and B are treated as grantors of FT under Treas. Reg. . In addition, B is treated as the owner of the entire trust under Treas. Reg. §1.671-2(e). Assuming the grantors have powers described in Code §§673-679, only B will be treated as owner. Both A and B are responsible parties for purposes of the requirements in section 6048.[13]

3. **Transfer to a trust by a partnership or corporation**. When a partnership or a corporation makes a transfer to a trust, the identity of the grantor turns on whether or not the transfer is for a business purpose of the partnership or corporation.

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[10] *See* Treas. Reg. §1.671-2(e)(1).

[11] *See id*.

[12] *See id*.

[13] *See* Treas. Reg. §1.671-2(e)(6) (example 3).

a. **Gratuitous transfer is for a business purpose of the partnership or corporation**. If a gratuitous transfer is made by a partnership or corporation to a trust and is for a business purpose of the partnership or corporation, the partnership or corporation will generally be treated as the grantor of the trust.[14]

i. **Example – gratuitous transfer to secure legal obligation**. If a partnership makes a gratuitous transfer to a trust in order to secure a legal obligation of the partnership to a third party unrelated to the partnership, the partnership will be treated as the grantor of the trust.[15]

ii. **Example – rabbi trust**. A trust or other fund established by the employer to hold assets from which nonqualified deferred compensation payments will be made. The trust or fund is generally irrevocable and does not permit the employer to use the assets for purposes other than to provide nonqualified deferred compensation, except that the terms of the trust or fund provide that the assets are subject to the claims of the employer's creditors in the case of insolvency or bankruptcy.

b. **Gratuitous transfer is not for a business purpose of the partnership or corporation**. If a partnership or corporation makes a gratuitous transfer to a trust that is not for a business purpose of the partnership or corporation but is for the personal purposes of one or more of the partners or shareholders, the gratuitous transfer will be treated as a constructive distribution to such partners or shareholders under federal tax principles, and the partners or shareholders will be treated as the grantors of the trust.[16]

i. **Example**. If a partnership makes a gratuitous transfer to a trust that is for the benefit of a child of a partner, the gratuitous transfer will be treated as a distribution to

[14] *See* Treas. Reg. §1.671-2(e)(4).

[15] *See* Treas. Reg. §1.671-2(e)(4).

[16] *See* Treas. Reg. §1.671-2(e)(4).

the partner under §731 and a subsequent gratuitous transfer by the partner to the trust.[17]

4. **Gratuitous transfer from one trust to another trust**. Under Treas. Reg. §1.671-2(e)(5), if a trust makes a gratuitous transfer of property to another trust (*e.g.*, pursuant to trust instrument or pursuant to a state "decanting statute" such as N.Y. EPTL §10-6.6), the grantor of the transferor trust generally will be treated as the grantor of the transferee trust.

   a. **Exception – transfer from one trust to another trust pursuant to GPOA**. Under Treas. Reg. §1.671-2(e)(5), if a person with a general power of appointment over a transferor trust exercises that power in favor of another trust, then such person will be treated as the grantor of the transferee trust, even if the grantor of the transferor trust is treated as the owner of the transferor trust under Subpart E.

   b. **Example**. Eden, as grantor, creates Trust 1, with Tom, as Trustee. In accordance with applicable state law, Tom distributes the assets of Trust 1 to Trust 2, under Declaration of Trust established by Terry, as Trustee. Under Treas. Reg. §1.671-2(e)(5), Eden, as grantor of the transferor trust, is grantor of the transferee trust.

B. **"Income"**

1. **Generally, means taxable income**. The term "income" is used throughout Subpart E. In certain instances, it is not clear whether "income" refers to taxable income or fiduciary accounting income. The lack of clarity is due to different meaning given to "income" in Treas. Reg. §1.671-2(b) and Code §643(b):

   a. **Treas. Reg. §1.671-2(b)**. Treas. Reg. §1.671-2(b) provides, "[W]hen it is stated in the regulations under subpart E that "income" is attributed to the grantor or another person, the reference, unless specifically limited, is to income determined for tax purposes and not to income for trust accounting purposes. When it is intended to emphasize that income for trust accounting purposes (determined in accordance with the provisions set forth in §1.643(b)-1) is meant, the phrase "ordinary income" is used."

[17] *See* Treas. Reg. §1.671-2(e)(4).

b. **Code §643(b)**. Where "income" is defined in subchapter J of chapter 1 of the Code, it is defined as fiduciary accounting income. Specifically, Code §643(b) provides that for purposes of subparts A through D of subchapter J, "the term "income", when not preceded by the words "taxable", "distributable net", "undistributed net", or "gross", means the amount of income of the estate or trust for the taxable year determined under the terms of the governing instrument and applicable local law." Accordingly, while Code §643(i) makes it clear that "income" refers to fiduciary accounting income, Code §643(i) does not appear to apply to Subpart E.

C. **"Portion"**

1. **Background**. If any of Code §§673 to 679 identify a grantor (or another person) as owner of any "portion" of a trust, the items of income, deductions and credits attributable to that portion are taken into account in computing the grantor's taxable income.[18] Any portion of a trust not treated as owned by the grantor (or another person) will be taxable under the subparts A through D of part I, subchapter J, chapter 1 of the Code.[19]

2. **Overview of "portions" that a grantor (or other person) may be treated as owning**. The term "portion" is not defined in the Code or the Treasury regulations. However, Treas. Reg. §1.671-3(a) identifies several ways in which a grantor (or other person) may be treated as owning a portion of a trust, listed immediately below and discussed in further detail in sections II.C.3 through II.C.8, below.

   a. The grantor can be treated as owner of the entire trust.[20]

   b. The grantor can be treated as owner of all items attributable to specific trust assets.[21]

   c. The grantor can be treated as owner of a pecuniary share of all items of trust income and principal.[22]

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[18] *See* Code §671; Treas. Reg. §1.671-3.

[19] *See* Treas. Reg. §1.671-3(a)(2).

[20] *See* Treas. Reg. §1.671-3(a)(1).

[21] *See* Treas. Reg. §1.671-3(a)(2).

d. The grantor can be treated as owner of the principal portion of the trust.[23]

e. The grantor or other per can be treated as owner of a fractional share of all items of trust income and principal.[24]

f. The grantor or other per can be treated as owner of a pecuniary amount of all items of trust income and principal.[25]

3. **Grantor is treated as owner of entire trust**. Certain powers and interests that trigger grantor trust status generally trigger grantor trust status as to an entire trust, meaning that the grantor will be treated as owner of the entire trust. For example:

a. **Example – Code §676**. As discussed below in section III.D, a grantor who retains a power to revoke a trust will be treated as owner of the entire trust under Code §676.

b. **Planning point**. The desirability of many of the estate planning transactions involving grantor trusts turn on full grantor trust status. For example:

i. **Example.** If a grantor were to sell an appreciated asset to a trust for a promissory note and the trust were a grantor trust only as to principal and not as to income or only as to income and not as to principal, the transaction would be partially taxable to the grantor. If the trust were a grantor trust as to corpus but not as to income, the grantor would be taxed on interest payments made from the trust on the note. If the trust were a grantor trust as to income but not as to corpus, the grantor would have taxable gain on the appreciation in the asset sold to the trust.

4. **Grantor is treated as owner of all items attributable to specific trust property**. A grantor (or other person) who holds a §§673-679 power over a specific trust asset and its income will be treated

[22] *See* Treas. Reg. §1.671-3(a)(3)

[23] *See* Treas. Reg. §1.671-3(b)(2).

[24] *See* Treas. Reg. §1.671-3(a)(3).

[25] *See id.*

as owner of the specific trust asset and taxable on all items of income, deduction and credit attributable to the asset.[26]

a. **Allocation of items of income, deduction and credit between property over which grantor trust power held and other trust property**. Items of trust income, deduction and credit that are "directly related" to the specific property with respect to which the grantor trust power is held are attributable to the portion of the trust taxable to the grantor (or other person treated as owner). Items that are directly related to trust assets other than the specific property with respect to which the grantor trust power is held are taxed as if Subpart E did not apply. Items which do not relate directly to either the trust property subject to a grantor power or to the other trust property must be allocated between the share attributable to the grantor (or other person) and the share attributed to the trust/beneficiaries in a manner that is "reasonable in light of all the circumstances of each case, including the terms of the governing instrument, local law and the practice of the trustee if it is reasonable and consistent."[27]

b. **Example – QSST**. In the case of a Qualified Subchapter S Trust with respect to which the current income beneficiary elects for the QSST rules to apply, the current income beneficiary is generally treated as the owner, for purposes of Code §678(a), of the part of the trust consisting of the S corporation stock.

i. Treas. Reg. §1.1361-1(j)(8) specifies the extent to which the current income beneficiary of a QSST is treated as owner of the trust as follows:

"(8) *Coordination with grantor trust rules.* If a valid QSST election is made, the income beneficiary is treated as the owner, for purposes of section 678(a), of that portion of the trust that consists of the stock of the S corporation for which the QSST election was made. However, solely for purposes of applying the preceding sentence to a QSST, an income beneficiary who is a deemed section 678 owner only by reason of section

[26] Treas. Reg. §1.671-3(a)(2).

[27] Treas. Reg. §1.671-3(a)(2).

1361(d)(1) will not be treated as the owner of the S corporation stock in determining and attributing the federal income tax consequences of a disposition of the stock by the QSST. For example, if the disposition is a sale, the QSST election terminates as to the stock sold and any gain or loss recognized on the sale will be that of the trust, not the income beneficiary. Similarly, if a QSST distributes its S corporation stock to the income beneficiary, the QSST election terminates as to the distributed stock and the consequences of the distribution are determined by reference to the status of the trust apart from the income beneficiary's terminating ownership status under sections 678 and 1361(d)(1). The portions of the trust other than the portion consisting of S corporation stock are subject to subparts A through D of subchapter J of chapter 1, except as otherwise required by subpart E of the Internal Revenue Code."

5. **Grantor treated as owner of ordinary income portion of trust**. Under Treas. Reg. §1.671-3(b)(1), if a grantor or other person is treated as owner with respect to only the ordinary income (or fiduciary accounting income) of a trust, such grantor or other person must take into account in computing his or her tax liability the trust's items of fiduciary accounting income. *However, under Treas. Reg. §1.671-3(c), the grantor's income inclusions in respect of the trust are capped at the trust's distributable net income, as defined in Code §643(a).*[28]

   a. **Examples of circumstances in which a grantor or another person might be treated as owner of the "ordinary income" portion of a trust.**

      i. **Grantor retains right to income**. Grantor creates an irrevocable trust which provides that the ordinary income is to be payable to him for life and that on his death the corpus shall be distributed to B, an unrelated person. Except for the right to receive income, grantor retains no right or power which would cause him to be

[28] Treas. Reg. §1.671-3(c) provides that a grantor or other person treated as owner of a trust's corpus "will take into account in computing his tax liability those items which would be included in computing the tax liability of a current income beneficiary, including expenses allocable to corpus which enter into the computation of distributable net income."

treated as owner under §§671 through 677.[29] Assuming "income" for this purpose means "ordinary income" or "fiduciary accounting income," grantor will be treated as owner of the ordinary income portion of the trust.

ii. **Grantor retains right to allocate income**. Grantor retains a right to allocate income between or among noncharitable beneficiaries, with the principal to pass absolutely to a certain beneficiary upon grantor's death. The grantor's power to allocate income results in the grantor being treated as owner of the income of the trust under Code § 674(a), described below in section III.B.1. (The grantor's power to allocate does not fall within any of the exceptions of Code § 674(b), (c) or (d)). Assuming "income" for this purpose means "ordinary income" or "fiduciary accounting income," grantor will be treated as owner of the ordinary income portion of the trust.

iii. **Grantor retains power to borrow trust income**. Grantor retains a right to borrow the income, but not the corpus, of trust. Under Code §675(2) (described below in section III.C.3), grantor is treated as owner of the income of the trust. Assuming "income" for this purpose means "ordinary income" or "fiduciary accounting income," grantor will be treated as owner of the ordinary income portion of the trust.

b. **Numerical examples illustrating income inclusions to a grantor or another person treated as owner of the "ordinary income" portion of a trust.**

i. **Example 1**. Grantor creates an irrevocable trust under which FAI is payable to grantor for life. On grantor's death, the trust corpus is to go to B, an unrelated person. Other than the income interest, grantor retains no interest or power described in Subpart E. The trust has two receipts: $25,000 of dividends and $500 of capital gains. Local law treats dividends as FAI but allocates the capital gains to principal. The trust has one expense, a $3,000 trustee's fee. Local law charges one-third (1/3) of the trustee's fee against income and

29 Treas. Reg. §1.677(a)-1(g) (example 1).

two-thirds (2/3) against principal. What will be the grantor's income inclusions in respect of the trust?

a. The grantor is treated as owner of the "ordinary income" portion of the trust under Code §677(a).

b. Accordingly, under Treas. Reg. §1.671-3(b)(1), the grantor must take into account in computing his tax liability the trust's items of FAI. Under local law, the trust's FAI would include the $25,000 of dividends (but not the capital gains), reduced by one-third of the trustee commission. The trust's FAI is therefore $24,000 ($25,000 dividend income less $1,000 of trustee commissions).

c. However, under Treas. Reg. §1.671-3(c), the grantor's income inclusions in respect of the trust will be capped at the trust's DNI. Dividends enter into the computation of the trust's DNI but capital gains likely do not.[30] Additionally, even though local law charges 1/3 of the trustee's fee against income and 2/3 against principal, the entire trustee's fee reduces DNI. DNI will therefore include $25,000 of dividend income, less $3,000 of trustee commissions. Accordingly, DNI is $22,000 ($25,000 dividend income less entire $3,000 trustee commission).

d. Therefore, the grantor's income inclusion in respect of the trust is $22,000 of dividend income.

ii. **Example 2**. Grantor creates an irrevocable trust and retains the right to borrow ordinary income without adequate interest or security. The grantor retains no other power or interest that would render the trust a grantor trust. The trust has three receipts: $15,000 of interest, $25,000 of dividends and $60,000 of capital gains. Local law treats interest and dividends as FAI but allocates capital gains to principal. The trust has one expense, a $15,000 trustee's fee. Local law charges one-third (1/3) of the trustee's fee against income and two-thirds (2/3) against principal. What will be the grantor's income inclusions in respect of the trust?

[30] *See* Code §643(a)(3).

a. The grantor is treated as owner of the "ordinary income" portion of the trust under Code §675(2).

b. Accordingly, under Treas. Reg. §1.671-3(b)(1), the grantor must take into account in computing his tax liability the trust's items of FAI. Under local law, the trust's FAI would include the $15,000 of interest and $25,000 of dividends (but not the capital gains), reduced by one-third of the trustee commission. The trust's FAI is therefore $35,000 ($15,000 interest income, plus 25,000 dividend income, less $5,000 of trustee commissions).

c. However, under Treas. Reg. §1.671-3(c), the grantor's income inclusions in respect of the trust will be capped at the trust's DNI. Interest and dividends enter into the computation of the trust's DNI but capital gains likely do not.[31] Additionally, even though local law charges one-third of the trustee's fee against income and two-thirds against principal, the entire trustee's fee reduces DNI. DNI will therefore include the $15,000 of interest and the $25,000 of dividend income, less $15,000 of trustee commissions. Accordingly, DNI is $25,000 ($15,000 interest income, plus $25,000 dividend income, less entire $15,000 trustee commission).

d. Therefore, the grantor's income inclusion in respect of the trust is $25,000, a portion of which is interest income and a portion of which is dividend income.

iii. **Example 3**. Grantor creates an irrevocable trust which provides that the ordinary income is to be payable to him for life and that on his death the corpus shall be distributed to B, an unrelated person. Except for the right to receive income, grantor retains no right or power which would cause him to be treated as owner under §§671 through 677. Under the applicable local law capital gains are allocated to corpus. During the taxable year, the trust has $5,000 of dividends and $1,000 of capital gain. The trust has $200 of expenses allocable to income and $100 of expenses allocable to corpus. Since grantor has a right to receive income he

[31] *See id*.

is treated as an owner of a portion of the trust under §677(a).[32]

a. The grantor is treated as owner of the "ordinary income" portion of the trust under Code §677(a).

b. Accordingly, under Treas. Reg. §1.671-3(b)(1), the grantor must take into account in computing his tax liability the trust's items of FAI. Under local law, the trust's FAI would include the $5,000 of dividends (but not the capital gains), reduced by the $200 of expenses allocable to corpus. The trust's FAI is therefore $4,800.

c. However, under Treas. Reg. §1.671-3(c), the grantor's income inclusions in respect of the trust will be capped at the trust's DNI. Interest and dividends enter into the computation of the trust's DNI but capital gains likely do not.[33] Additionally, even though local law charges certain expenses again income and certain expenses against principal, all of the expenses reduce DNI. DNI will therefore include the $5,000 of dividends, less $200 of expenses allocable to corpus and the $100 of expenses allocable to corpus. Accordingly, DNI is $4,700 ($5,000 dividend income, less $200 expense allocable to corpus, less entire $100 expense allocable to income).

d. Therefore, the grantor's income inclusion in respect of the trust is $25,000, a portion of which is interest income and a portion of which is dividend income.

c. **Planning point - state income tax rationale for creating grantor trust as to income**. If a grantor is treated as owner of a trust's income but not its corpus, it may be possible to avoid state income tax on trust receipts allocable to corpus (*e.g.*, capital gains).[34] However, before

32 *See* Treas. Reg. §1.677(a)-1(g) (example 1).

33 *See* Code §643(a)(3).

34 See *e.g.*, New York Tax Law §605(b)(3)(D), which provides that a New York resident trust with no New York tangible personal or real property, no New York source income and no New York trustees will not be subject to New York State income tax.

such an approach is implemented, transfer tax considerations (including the possible application of Code §2702) should be considered.

6. **Grantor treated as owner of corpus**. Under Treas. Reg. §1.671-3(b)(2), if a grantor or other person is treated as owner with respect to only the corpus of a trust, such grantor or other person must take into account in computing his or her tax liability the items of the trust's taxable income that are allocated to corpus. *However, under Treas. Reg. §1.671-3(c), the grantor's income inclusions in respect of the trust will be limited to the income that would be taxable to a trust under the "normal" rules of subchapter J, if all DNI had actually been distributed to current income beneficiaries*.[35]

   a. **Examples of circumstances in which a grantor (or other person) might be treated as owner of corpus.**

      i. **Reversionary interest in corpus not causing grantor to be treated as owner under Code §673**. If a grantor retains a reversionary interest in a trust which is not such as to require that the grantor be treated as owner under Code §673 (*e.g.*, because at the inception of the trust the reversionary interest is worth 5% or less of the trust's value, based on the then-prevailing interest rate under Code §7520), the grantor may nevertheless be treated as owner under Code §677(a)(2) since any income allocable to corpus (*e.g.*, capital gain) is accumulated for future distribution to him.

   b. **Numerical examples illustrating income inclusions to a grantor treated as owner of the corpus of a trust.**

      i. **Example 1**. Lauren creates a trust to pay income to Ben for a term of 35 years. There is no authority to pay principal. Thereafter, the trust is to revert to Lauren (or her estate). The present value of Lauren's remainder interest is less than 5% of the trust. The trust has three receipts: $15,000 of interest, $25,000 of dividends and

[35] More specifically, Treas. Reg. §1.671-3(c) provides that a grantor or other person treated as owner of a trust's ordinary income will take into account "only those items of income, deduction, and credit which would not be included under subparts A through D in the computation of the tax liability of the current income beneficiaries if all distributable net income had actually been distributed to those beneficiaries."

$60,000 of capital gains. Local law treats interest and dividends as FAI but allocates capital gains to principal. The trust has one expense, a $15,000 trustee's fee. Local law charges one-third (1/3) of the trustee's fee against income and two-thirds (2/3) against principal. What will be the grantor's income inclusions in respect of the trust?

a. Lauren is treated as owner of the corpus of the trust under Treas. Reg. §1.671-3(a)(3) and Code §677(a)(2). This is because (taxable) income allocable to corpus (*e.g.*, capital gain) may be accumulated for future distribution to Lauren.

b. Accordingly, under Treas. Reg. §1.671-3(b)(2), Lauren must take into account in computing her tax liability the trust's income that is allocable to corpus. The only item that Lauren must therefore take into account is the $60,000 capital gain. (In calculating FAI, income is reduced by the share of trustee commissions allocable to income under local law. However, in determining income that is allocable to corpus under state law, there is no subtraction for trustee commissions.)

c. The interest, dividends and entire trustee commission enter into the computation of DNI, and therefore would affect the computation of the tax liability of a current income beneficiary. As a result, the interest and dividends would not be attributed to the grantor, and the trustee commissions would not reduce the income includible to the grantor.

d. Therefore, the grantor's income inclusion in respect of the trust is $60,000 of capital gain income.

ii. **Example 2**. Grantor creates a trust which provides that the ordinary income is payable to his adult son. Ten years and one day from the date of the transfer or on the death of grantor's son, whichever is earlier, corpus is to revert to grantor. Assume that as of the inception of the trust, the value of grantor's reversionary interest is less than 5% of the value of the trust fund. Grantor retained no other right or power which would cause him to be treated as an owner under Subpart E. Under the terms of the trust instrument and applicable local law, capital gains must be applied to corpus. During the taxable year, the trust had the following items of income: $10,000 of dividends and $2,000 of capital gains. In addition, the trust had the following expenses: $400 of expenses allocable to income and $200 of expenses allocable to corpus.[36] What will be grantor's income inclusions with respect to the trust?

a. Grantor is treated as owner of the corpus of the trust under Treas. Reg. §1.671-3(a)(3) and Code §677(a)(2). This is because (taxable) income allocable to corpus (*e.g.*, capital gain) may be accumulated for future distribution to grantor.

b. Accordingly, under Treas. Reg. §1.671-3(b)(2), grantor must take into account in computing his tax liability the trust's income that is allocable to corpus. The only item that grantor must therefore take into account is the $2,000 capital gain. (In calculating FAI, income is reduced by the share of trustee expenses allocable to income under local law and the trust instrument. However, in determining income that is allocable to corpus, there is no subtraction for expenses allocable to corpus.)

c. The interest and expenses enter into the computation of DNI, and therefore would affect the computation of the tax liability of a current income beneficiary. As a result, the interest and expenses would not be attributed to the grantor.

d. Therefore, the grantor's income inclusion in respect of the trust is $2,000 of capital gain income.

iii. **Example 3**. 5 and 5 withdrawal rights. See section III.F.4.b, below.

7. **Grantor is treated as owner of a fractional share of items of trust income and/or principal**. If the portion of a trust treated as owned by a grantor (or other person) consists of an undivided fractional interest in the trust, the grantor (or other person) is required to take into account that fractional share of the trust's

[36] *See* Treas. Reg. §1.677(a)-1(g) (example 2).

items of income, deduction and credit.[37] A grantor (or other person) may also be treated as owner of a fractional share of items of trust income or trust principal (rather than of the entire trust fund), in which case the principles of Treas. Reg. §1.671-3(b) (discussed in section II.C.5 and II.C.6, above) will also apply. The portion of the trust not taxed to the grantor (or another person) is taxed to the trust and the beneficiary, under the "normal" rules of subchapter J.

a. **Example – grantor treated as owner of fraction of entire trust**. Grantor creates a trust that requires the trustee to pay all income currently to the beneficiaries. Grantor retains a right to withdraw and reacquire one-half of the trust assets at any time. In the current taxable year, the trust has $10,000 of ordinary dividend income, $4,000 of interest income, $2,000 of deductions and $100,000 long-term capital gain. Grantor is deemed to own an undivided one-half share of the trust under the grantor trust rules and, accordingly, needs to include on his personal income tax return one-half of all items of trust income, deduction and credit. Thus, grantor includes $5,000 of trust dividend income, $2,000 of trust interest income, $1,000 of the trust's interest deductions and $50,000 of the trust's capital gain. The other one-half is taxed to the trust and the beneficiary, under the ordinary rules relating to simple trusts.

8. **Grantor is treated as owner of a pecuniary amount of items of trust income and/or principal**. If the portion of a trust treated as owned by a grantor (or another person) consists of an interest represented by a dollar amount, the grantor (or other person) will be required to take into account that fractional share of the trust's items of income, deduction and credit.[38] The numerator of the fraction is the amount subject to the control of the grantor (or other person), and the denominator is the fair market value of the trust corpus on the first day of the taxable year in question.[39] A grantor (or another person) may also be treated as owner of a pecuniary amount of items of trust income or trust principal (rather than the entire trust fund), in which case the principles of Treas. Reg.

[37] *See* Treas. Reg. §1.671-3(a)(3).

[38] *See id*.

[39] *See id*.

§1.671-3(b) (discussed in sections II.C.5 and II.C.6) will also apply. The portion of the trust not taxed to the grantor (or another person) is taxed to the trust and the beneficiary, under the "normal" rules of subchapter J.

a. **Example – grantor treated as owner of pecuniary amount of entire trust**. Grantor retains the right to revest in himself or herself $10,000 of a trust worth $100,000. Under Code §676 and Treas. Reg. §1.671-3(a)(3), the grantor is treated as owner of 10% of the entire trust fund.

b. **Example – grantor treated as owner of pecuniary amount of corpus**. Grantor retains a reversionary interest of $10,000 in a trust worth $100,000. As of the inception of the trust, the grantor's reversionary interest does not exceed 5% of the value of the trust fund. Under Code §677(a)(2), Treas. Reg. §1.671-3(b)(2), and Treas. Reg. §1.671-3(a)(3), the grantor is treated as owner of 10% of the trust corpus.

c. **Example – beneficiary treated as owner of pecuniary amount (Crummey powers)**.[40] If a beneficiary of a trust has the right to temporarily withdraw amounts in respect of additions made to the trust (*e.g.*, $12,000 or $24,000) and the trust's grantor has no powers that would result in the grantor being treated as owner of the trust,[41] a good argument can be made for tracing the actual income realized by the trust during the duration of the Crummey power. That is, a beneficiary of a 60-day demand power would own only the actual income, deduction, gain, and loss attributable to the withdrawable portion of the trust and realized during the actual 60 days during which the power was exercisable.[42] Thus, if the additions to the trust to which the demand power relates were held in a non-interest-bearing account for the duration of the demand

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[40] This example comes from Howard M. Zaritsky & Norman H. Lane, *Federal Income Taxation of Estates and Trusts* (3rd ed.), ¶ 12.02

[41] *See* Code §678(b).

[42] Neither the Code nor the Regulations explicitly provide that a trust can be a grantor trust for a portion of a taxable year (*e.g.*, 60 days in the example above). However, practitioners generally believe that a trust can in fact be a grantor trust for a portion of a taxable year, and this seems to be the implication of Treas. Reg. §1.671-3(a)(1).

power, the beneficiary would be taxed on none of the trust income. Alternatively, the beneficiary could be deemed to own a fraction of the total trust income, deduction, gain, and loss. The fraction would be based on the fraction of the trust fund subject to the beneficiary's withdrawal and the fraction of the year during which the power is exercisable. Thus, for example, if the power relates to a $10,000 addition to a $90,000 trust and is exercisable for two months, the beneficiary would own 1/ 60 of the total trust income, deductions, gains, and losses, computed as follows: ($10,000/$100,000 _ 2/ 12). This latter approach seems appropriate, because most Crummey demand powers empower the trustee to satisfy the beneficiary's withdrawal demand with any trust assets, not merely those most recently added.

D. **"Adverse party"**

1. **Definition**. Code §672(a) provides that for purposes of Subpart E, an "adverse party" is any person who has a substantial beneficial interest in the trust which would be adversely affected by the exercise or nonexercise of the power which such person possesses respecting the trust.

   a. **"Beneficial interest"**. In order for a party to be an adverse party, he or she must have a beneficial interest in a trust. A person having a ***general power of appointment*** over trust property is deemed to have a beneficial interest in the trust.[43] A trustee is not an adverse party merely because of his or her role as trustee. (A trustee does not have a beneficial interest in a trust.)

   b. **"Substantial"**. In order for a party to be an adverse party, his or her beneficial interest in a trust must be "substantial." Treas. Reg. §1.672(a)-1(a) states that a person's interest is "substantial" if its "value in relation to the total value of the property subject to the power is not insignificant." It is possible for more than one beneficiary of a trust to have a beneficial interest that is "substantial."

   c. **"Adversely affected"**. In order for a party to be an adverse party, his or her substantial beneficial interest in a trust

[43] Code §672(a), Treas. Reg. §1.672(a)-(1)(a).

must be adversely affected by the exercise or nonexercise of a power that he or she possess with respect to the trust.

2. **Adverse party with respect to a portion of a trust**. A party may be an adverse party with respect to the exercise or nonexercise of a power over a portion of a trust. For example, if a beneficiary's right to share in the income or corpus of a trust is limited as to only a part, he or she may be an adverse party only as to that part.[44] Similarly, the interest of a remainderman is adverse to the exercise of any power over the corpus of a trust, but not to the exercise of a power over any income interest preceding his remainder.[45]

   a. **Example – adverse party as to fraction of trust**. A, B, C and D are equal income beneficiaries of a trust and the grantor can revoke with A's consent. The grantor is treated as owner of a portion which represents 3/4 of the trust. The grantor is not treated as owner of the portion which represents one-fourth of the trust. A is an income beneficiary as to one-quarter of the trust, and his beneficial interest in the trust would be adversely affected by consenting to the grantor's revocation of the trust.[46]

   b. **Example – remainderman an adverse party only with respect to corpus**. Grantor creates a trust which provides for income to be distributed to A for 10 years and then for the corpus to go to X if he is then living. A power exercisable by X to revest corpus in the grantor is a power exercisable by an adverse party. However, a power exercisable by X to distribute part or all of the ordinary income to the grantor may be a power exercisable by a nonadverse party (which would cause the ordinary income to be taxed to the grantor).[47]

E. **"Nonadverse party"**. Code §672(b) provides that for purposes of Subpart E, a "nonadverse party" means any person who is not an adverse party.

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[44] *See* Treas. Reg. §1.672(a)-1(b).

[45] *See* Treas. Reg. §1.672(a)-1(d).

[46] *See* Treas. Reg. §1.672(a)-1(b). Note that an implicit assumption in this example is that "income" means taxable income.

[47] Treas. Reg. §1.672(a)-1(d).

F. **"Related or subordinate party"**

1. **Basic definition**. Code §672(c) provides that for purposes of Subpart E, the term "related or subordinate party" means any ***nonadverse*** party who is in any of the following relationships with the grantor:

   a. the grantor's spouse, but only if such spouse is "living with the grantor",

   b. the grantor's father or mother,

   c. the grantor's issue,

   d. the grantor's brother or sister

   e. an employee of the grantor,

   f. a corporation or any employee of a corporation in which the stock holdings of the grantor and the trust are significant from the viewpoint of voting control, or

   g. a subordinate employee of a corporation of which the grantor is an executive

2. **Relationships excluded from basic definition**. Persons holding any of the following relationships with the grantor are not considered to be related or subordinate to the grantor: nieces, nephews, grandparents, spouses of children, spouses of grandchildren, partners, attorneys,[48] accountants and financial advisors.

3. **"Subservient to the grantor"**. Under Code §§672(f), 674 and 675, grantor trust status can turn on whether a "related or subordinate" party is "subservient to the grantor." Code §672(e) provides that a related or subordinate party is *presumed to be subservient* to the grantor in respect of the exercise or nonexercise of the powers conferred on him or her, unless such party is shown not to be subservient by the *preponderance of the evidence*.

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[48] *See, e.g., Estate of Hilton W. Goodwyn*, 35 T.C.M. 1026 (1976), where lawyers serving as trustees allowed the grantor to make almost all decisions affecting a trust, including decisions about how much income was to be distributed to each beneficiary. Nevertheless, the court held that the lawyer-trustees were not "related or subordinate" parties.

a. **Can a person who is "subservient" but not "related or subordinate" cause a trust to be a grantor trust?** As described above, under Code §§672(f), 674 and 675, grantor trust status can turn on whether a related or subordinate party is "subservient to the grantor." It does not appear that grantor trust status can result under these Code sections merely because party is subservient to a grantor if the party is not otherwise related or subordinate to the grantor. *See, e.g., Estate of Hilton W. Goodwyn*, discussed in footnote 48.

G. **"Spouse"**. Code § 672(e) provides that for purposes of Subpart E, a grantor is treated as holding any power or interest held by his spouse.

III. Powers and Interests That Cause a Trust to be a Grantor Trust

A. Code §673: Reversionary interests.

1. **General rule – Code §673(a)**. Code §673(a) provides that a grantor will be treated as owner of any portion of a trust in which the grantor (or the grantor's spouse[49]) has a reversionary interest in either the corpus or the income therefrom, if, as of the inception of that portion of the trust, the value of such interest exceeds the value of 5% of that portion.

a. **Rules for determining value of a reversionary interest.**

i. **Valuation tables of Reg. §20.2031-7 applied at inception of trust**. To determine whether a grantor (or the grantor's spouse) has a greater than 5% reversionary interest, the value of the grantor's (or the grantor's spouse's) interest is valued at the creation of the trust using the tables in Reg. §20.2031-7.

a. **Rule of thumb**. Generally, if the reversionary interest of a grantor (or grantor's spouse) will not be triggered for 32 or 33 years, the value of the reversionary interest will be less than 5% of the value of the trust fund, and the trust will not be a grantor trust under Code §673(a).

b. **Postponement of date specified for reversion**. Treas. Reg. §1.673(d)-1 provides that a postponement of the date specified for the

[49] *See* Code §672(e).

reacquisition of possession or enjoyment of any reversionary interest is considered a new transfer in trust commencing with the date on which the postponement is effected and terminating with the date prescribed by the postponement. *However, a grantor will not be treated as the owner of any portion of a trust for any taxable year if he would not be so treated in the absence of any postponement.*[50]

i. **Example**. Grantor places property in trust for the benefit of his son B. Upon the expiration of 12 years or the earlier death of B the property is to be paid over to grantor or his estate. After the expiration of 9 years, grantor extends the term of the trust for an additional 2 years. Grantor is considered to have made a new transfer in trust for a term of 5 years (the remaining 3 years of the original transfer plus the 2-year extension). However, he is not treated as the owner of the trust under Code §673 for the first three years of the new term because he would not be so treated if the term of the trust had not been extended. Grantor is treated as the owner of the trust, however, for the remaining 2 years.[51]

ii. **Assume maximum exercise of discretion in favor of grantor – Code §673(c)**. Code §673(c) provides that for purposes of Code §673(a), the value of a grantor's reversionary interest shall be determined by assuming the maximum exercise of discretion in favor of the grantor. In other words, if a trustee or other person holds any discretionary power to revest the trust fund in the grantor, the value of the grantor's reversionary interest must be determined by assuming that such person will exercise his or her power to the greatest extent possible in favor of the grantor. In order for Code §673(c) to be triggered, it seems that there needs to be a reversionary interest in the grantor prior to the application of Code §673(c) (*See* example 2, below).

[50] *See* Treas. Reg. §1.673(d)-1.

[51] *See* Treas. Reg. §1.673(b)-1 (example).

a. **Example 1 – discretionary trust for children with reversion to grantor**. Grantor funds a discretionary trust for the benefit of his children to last for 20 years. At the expiration of the 20 year period, the trust fund is to revert to grantor. In determining whether the trust is a grantor trust under Code §673, the value of the grantor's reversionary interest at the inception of the trust needs to be determined by assuming the maximum exercise of discretion in favor of the grantor. This means that in determining the value of the grantor's reversionary interest, it needs to be assumed that no distributions are made to the grantor's children during the trust's 20 year term. Thus, the trust will be a grantor trust under Code §673.

b. **Example 2 – Code §673(c) not applicable to create a reversionary interest**. Grantor creates a discretionary trust for the benefit of his issue, his spouse and himself. The trust is not a grantor trust under Code §673 (though it may be a grantor trust under other Code sections, including §677 and §674). Code §673(c) provides that in determining whether the trust is a grantor trust under Code §673, the value of the grantor's reversionary interest at the inception of the trust needs to be determined by assuming the maximum exercise of discretion in favor of the grantor. However, in order for Code §673(c) to apply, there must be a pre-existing reversionary interest in the grantor, and the trust in this example includes no reversionary interest in the grantor.

b. **Clifford regulations**. As described above in section I.B.2.a.i, in response to *Helvering v. Clifford*, Treasury adopted the so-called "Clifford Regulations" in 1946. While the Clifford Regulations ultimately formed the basis for Congressional codification of the grantor trust rules in current Subpart E, there several ways in which the Clifford Regulations differ from current Subpart E. One of these relates to the circumstances under which a grantor's retention of a reversionary interest will cause the grantor to be taxed as the trust's owner. Under the Clifford Regulations, a grantor was treated a trust's owner if he or she retained a reversionary interest in the trust's income or corpus that would vest within 10 years of the inception of the trust. Certain regulations under Subpart E still refer to reversionary interests in excess of 10 years, concluding that such reversionary interests are insufficient to grantor trust status.[52] Rather than ignoring these regulations entirely, any reference to a 10-year reversionary interest should be read as a reference to a reversionary interest that will take effect far enough in the future that the value of such interest, at the inception of the trust, is worth less than 5% of the value of the trust.

2. **Exception for reversionary interest taking effect at death of minor lineal descendant – Code §673(b)**. A grantor (or the grantor's spouse) will not be treated as owner of a trust under the general reversionary interest rule of Code §673(a) if the reversionary interest takes effect only upon the death of a beneficiary before the beneficiary reaches age 21 so long as the beneficiary (a) is a lineal descendant of the grantor, and (b) holds all present interests in the trust.

   a. **"Present interest"**. For purposes of the Code §673(b) exception for reversionary interests taking effect at the death of a minor lineal descendant, "present interest" is defined the same way it is for purposes of Code §2503(c), which allows a gift tax exclusion for certain gifts to minors.[53]

B. **Code §674: Power to control beneficial enjoyment**.

1. **General rule – Code §674(a)**. Code §674(a) provides that a grantor shall be taxable as owner of any portion of a trust in respect of which beneficial enjoyment of the corpus or the income therefrom is subject to a power of disposition, exercisable by the *grantor (or the grantor's spouse[54]) or a nonadverse party*, or both, *without the approval or consent of any adverse party*.

   a. **"Power to dispose of beneficial enjoyment"**. Code §674(a) does not describe what is meant by a "power to dispose of the beneficial enjoyment" of trust corpus or income. Treas. Reg. §1.674(a)-1(a) provides that any power that can "affect the beneficial enjoyment of a portion

[52] *See, e.g.,* Treas. Reg. §1.673(a)-1(b); Treas. Reg. §1.673(b)-1(c) (example).

[53] S Rept No. 99-313 (PL 99-514) p. 871.

[54] *See* Code § 672(e).

of a trust" is a power to dispose of beneficial enjoyment, *regardless of the capacity in which the power is held*. A power held in a fiduciary capacity or a power held through a power of appointment is a power to dispose of beneficial enjoyment.[55]

i. **Example**. A power that enables the holder to allocate income or principal among multiple trust beneficiaries is clearly a power to affect beneficial enjoyment.[56]

b. **General rule of Code §674(a) is broad and sweeping**. The general rule of Code §674(a) and Treas. Reg. §1.674(a)-1(a) is sweeping, and based on this general rule alone, many discretionary trusts would be treated as grantor trusts. The exceptions to the general rule found in Code §§674(b), (c) and (d) and the regulations thereunder play an important role in limiting the reach of Code §674.

2. **Exceptions to general rule – Code §§674(b), (c) and (d).** Code §§674(b), (c), (d) specify a number of powers that can affect beneficial enjoyment which will not trigger grantor trust status. Certain of these powers may be exercised by anyone, and grantor trust status will be avoided. (These powers are described below in section III.B.2.a.) Other of these powers may be exercised only by an "independent trustee" in order for grantor trust status to be avoided. (These powers are described below in section III.B.2.b). Finally, one of these powers may be exercised by any person other than the grantor or the grantor's spouse in order for grantor trust status to be avoided. (This power is described below in section III.B.2.c.)

a. **Powers to affect beneficial enjoyment that can be exercised by any person without triggering grantor trust status:**

i. **Power to apply income in support of a dependent**. Code §674(b)(1) provides that a grantor is not taxable as a trust's owner merely because a trustee, the grantor

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[55] Treas. Reg. §1.674(a)-1(a).

[56] *See* Rev. Rul. 54-41, 1954-1, CB 22 (grantor with power to decide whether or not to distribute trust income treated as owner); *Laganas v. Comm'r,* 281 F.2d 731 (1st Cir. 1960) (power to determine which beneficiary would be the recipient income is a power to affect beneficial enjoyment)

acting as trustee or co-trustee, or another person may apply or distribute income of the trust to discharge a support obligation of the grantor. A grantor will, however, be taxable as a trust's owner to the extent that trust income is actually paid or applied (in the discretion a trustee, the grantor acting as trustee or co-trustee, or another person) to discharge a support obligation of the grantor.

ii. **Postponed power to affect beneficial enjoyment**. Code §674(b)(2) provides that a postponed power to affect the beneficial enjoyment of a trust's income will result in grantor trust treatment under the general rule of Code §674(a), *unless* the power is postponed for a period which, if it were a reversionary interest, would be protected from grantor trust status under Code §673. Code §673 treats the grantor as owner of any portion of a trust in respect of which he or she has retained a reversionary interest worth, at the time of the transfer, more than 5% of the property transferred. Accordingly, a grantor will not be taxed as owner if there is 5% or less possibility that a power will become effective in the grantor after the transfer of the property to the trust.[57]

a. **Power worth less than 5% of value of trust causes trust to be a grantor trust only upon expiration of postponement period**. If a power to affect the beneficial enjoyment of a trust is postponed for a period that is sufficiently long that such power does not cause the trust to be a grantor trust, the trust will become a grantor trust only upon the expiration of the period of postponement, when the power to affect beneficial enjoyment becomes operative.

i. **Example – power to substitute beneficiaries**. Grantor creates a trust on January 1, 2006. Trust income is to be paid to grantor's daughter. Grantor retains a power to substitute other beneficiaries, beginning on January 1, 2040. Grantor's power to affect beneficial enjoyment is exercisable so far in the future that it will not

[57] *See* Rept No. 99-313 (PL 99-514) p. 871 .

cause the trust to be a grantor trust. However, beginning on January 1, 2040, when the grantor's power to affect beneficial enjoyment to becomes operative, the trust will be treated as a grantor trust as to grantor.

b. **Example – charitable lead trust**. A charitable lead trust ("CLT") may be a grantor trust or a nongrantor trust, depending on its terms. If a CLT is a nongrantor trust, the settlor gets no income tax charitable deduction upon the funding of the trust. Rather, the trust generally will be entitled to a deduction during each year of the lead term as trust property is distributed to charity. If the CLT is a grantor trust, the settlor is entitled to an income tax charitable deduction upon the funding of the trust. For this reason, it may be favorable for a CLT to be structured as a grantor trust. One technique that is used to achieve grantor trust status for a CLT is to give the grantor's spouse a power to make discretionary distributions to family members after the lead period. If the right of the grantor's spouse to affect beneficial enjoyment of the trust assets after the lead period is, at the time of the transfer to the CLT, worth more than 5% of the value of the trust, the grantor of the trust will be treated as the trust's owner.

iii. **Power exercisable only by Will – Code §674(b)(3)**. Code §674(b)(3) generally provides that a power exercisable solely by one's Will does not create a grantor trust as to the grantor.

a. **Exception**. There are certain circumstances in which a power exercisable Will will trigger grantor trust status. Specifically, a trust will be a grantor trust under the general rule of Code §674(a) if there is a testamentary power in the grantor (or the grantor's spouse[58]) to appoint the "income" of a trust in which income is accumulated for testamentary disposition by the grantor (or the grantor's spouse) or to appoint income which may

[58] *See* Code §672(e).

be accumulated for such distribution without the consent of an adverse party.

i. **Example**. A trust instrument provides that trust income is to be accumulated during the life of the grantor's spouse, who may appoint the trust income by Will, without the consent of an adverse party. The trust falls within the exception to the exception of Code §674(b)(3), meaning that it is treated as a grantor trust taxable to the grantor under the general rule of Code §674(a).

ii. **Meaning of "income"**. For purposes of Code §674(a)(3), "income" seems to mean "taxable income."[59] This means that if capital gains are allocable to corpus, a power to accumulate capital gains for testamentary disposition by the grantor will cause the grantor to be taxed as owner with respect to any capital gains or losses of the trust.

b. **Testamentary GPOA versus LPOA**. Code §674(a)(3) appears to make no distinction between a testamentary general power of appointment and a testamentary limited power of appointment. (There are important distinctions between these types of appointment powers for transfer tax purposes.) In other words, so long as a testamentary general power of appointment does not fall within the exception to the exception to Code §674(b)(3) described above in section III.B.2.a.iii.a, such a power would not seem to render a trust a grantor trust under Code §674(b)(3). However, it is possible that a grantor's power to appoint trust property to his or her estate, his or her creditors or the creditors of his or her estate could be viewed as a Code §673 reversionary interest that would make the trust a grantor trust.

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[59] *See* Treas. Reg. §1.674(b)-1(b)(3), which states that if a trust instrument provides that the income of a trust is payable to another person for life, but the grantor has a testamentary power of appointment over the remainder, and under local law capital gains are added to corpus, the grantor is treated as the owner of a portion of the trust, and capital gains and losses are included in that portion.

iv. **Power to allocate among charitable beneficiaries – Code §674(b)(4)**. Code §674(b)(4) provides that a power to allocate beneficial enjoyment of principal or income among charitable beneficiaries does not cause a trust to be treated as a grantor trust under §674(a). In order for a trust to fall within Code §674(b)(4), the trust's corpus or income must be irrevocably payable for purposes specified in Code §170 (relating to definition of charitable contributions) or for certain other charitable purposes.

v. **Power to distribute principal – Code § 674(b)(5)**.

a. **General rule**. Code § 674(b)(5) provides that a grantor (or the grantor's spouse[60]) or a non-adverse party can make discretionary distributions of trust principal (without the consent of an adverse party) without triggering grantor trust status if (i) there is a power to distribute corpus to trust beneficiaries that is limited by a reasonably definite standard or (ii) there is a power to distribute corpus to current income beneficiaries, and such distributions are charged against the current income beneficiaries' respective proportionate shares. Each of (i) and (ii) is discussed further below.

i. **Power to distribute corpus is limited by a "reasonably definite standard."** Under Code §672(b)(5)(A), a power to distribute corpus to or for a beneficiary, beneficiaries or a class of beneficiaries that is limited by a "reasonably definite standard" set forth in the trust instrument will not cause a trust to be a grantor trust.

a. **"Reasonably definite standard"**. Treas. Reg. §1.674(b)-1(b)(5) provides that "a clearly measurable standard under which the holder of a power is legally accountable is deemed a reasonably definite standard…. For instance, a power to distribute corpus for the education, support, maintenance, or health of the beneficiary; for his reasonable

[60] *See* Code §672(e).

support and comfort; or to enable him to maintain his accustomed standard of living; or to meet an emergency, would be limited by a reasonably definite standard. However, a power to distribute corpus for the pleasure, desire, or happiness of a beneficiary is not limited by a reasonably definite standard…"

i. **Example – payment of medical and educational expenses**. Grantor creates a trust, the income of which is to be paid to grantor's children for life, remainder to grantor's grandchildren. Grantor's spouse has the power to distribute corpus to pay educational and medical expenses for any beneficiary (including remaindermen). Spouse's power to distribute corpus does not cause the trust to be a grantor trust (even though spouse is a non-adverse party and, moreover, that spouse's powers are imputed to grantor). This is because payments for medical and educational expenses are considered to be payments made pursuant to a reasonably definite standard.

ii. **Power to distribute corpus to current income beneficiaries if distributions charged against their respective proportionate shares**. Under Code § 674(b)(5)(B), the ability to make distributions of corpus to a current income beneficiary will not cause a trust to be a grantor trust, so long as such distributions of corpus are required to be charged against a beneficiary's proportionate share of corpus held in trust for the payment of income to such beneficiary as if the corpus constituted a separate trust.

a. **Single beneficiary**. If a trust has only one beneficiary, the grantor (or the grantor's spouse) or a non-adverse party can have complete discretion to distribute corpus without rendering the trust a grantor trust. This is because if a trust has only a single beneficiary, distributions of corpus will necessarily be charged against such beneficiary's "share" of trust corpus.

b. **Exception – power to add beneficiaries will result in grantor trust**. The flush language of Code §674(b)(5) provides that a power will not fall within the Code §674(b)(5) exception to grantor trust status if any person (including an adverse party) has a power to add beneficiaries, except where beneficiaries are added to provide for after-born or after-adopted children. In other words, if any person has a power to add beneficiaries (other than after-born or after-adopted children), the trust will be a grantor trust, taxable to its grantor.

i. **Example – power to add charitable beneficiaries.** In *Madorin v. Comm'r,* 84 TC 667 (1985), (mentioned below in section IV.C), the trust in question was a grantor trust because the trustee had the ability to add charitable beneficiaries.

vi. **Power to withhold income temporarily – Code §674(b)(5).**

a. **Rule**. Code §674(b)(6) provides that a power to accumulate "income"[61] for the benefit of a current income beneficiary will not result in grantor trust status if the accumulated income must ultimately be paid in one of three ways:

i. **Accumulated income is paid to the beneficiary from whom it is withheld, the beneficiary's estate, or the beneficiary's appointees under a broad limited power of appointment**. A power to distribute or accumulate fiduciary accounting income[62] for the benefit of a current income beneficiary will not result in grantor trust status if the accumulated income is payable to the

[61] As described in below section III.B.2.a.vi.a.iii.b, per Treas. Reg. §1.674(b)-1(b)(6), "income" for this purpose actually means fiduciary accounting income.

[62] *Id*.

beneficiary from whom it was withheld, his estate, or his appointees (or personas designated by name, as a class, or otherwise as alternate takers in default of appointment) under a power of appointment held by the beneficiary which does not exclude from the class of possible appointees any person *other than* the beneficiary, his estate, his creditors or the creditors of his estate;[63] or

ii. **Accumulated income is paid to current income beneficiaries in shares irrevocably specified in the trust agreement**. A power to accumulate fiduciary accounting income[64] for a current income beneficiary will not result in grantor trust status if the accumulated income must ultimately be payable on termination of the trust, or in conjunction with a distribution of the corpus which is augmented by the accumulated income, to the current income beneficiaries in shares which have been irrevocably specified in the trust instrument, or if any beneficiary does not survive a date of distribution which would reasonably be expected to occur within his lifetime, to his appointees (or alternate takers in default of appointment) under any power of appointment, general or special, or if he or she has no power of appointment, to one or more designated alternate takers (other than the grantor or the grantor's estate) whose shares have been irrevocably specified in the trust instrument.[65]

a. **Example 1**. A trust instrument provides that the income shall be paid in equal shares to the grantor's two adult daughters but the grantor reserves the power to withhold from either beneficiary any part of that

[63] *See* Code §674(b)(6)(A); Treas. Reg. §1.674(b)-1(b)(6)(a).

[64] As described in below section III.B.2.a.vi.a.iii.b, per Treas. Reg. §1.674(b)-1(b)(6), "income" for this purpose actually means fiduciary accounting income.

[65] *See* Code 674(b)(6)(B), Treas. Reg. §1.674(b)-1(b)(6)(c).

beneficiary's share of income and to add it to the corpus of the trust until the younger daughter reaches the age of 30 years. When the younger daughter reaches the age of 30, the trust is to terminate and the corpus is to be divided equally between the two daughters or their estates. *Although exercise of this power may permit the shifting of accumulated income from one beneficiary to the other* (since the corpus with the accumulations is to be divided equally) the power is excepted under section 674(b)(6)(B) and Treas. Reg. §1.674-1(b)(6)(c).[66]

b. **Example 2**. The facts are the same as in example 1, except that the grantor of the trust reserves the power to distribute accumulated income to the beneficiaries in such shares as he chooses. The combined powers are not excepted by section 674(b)(6)(B) since income accumulated pursuant to the first power is neither required to be payable only in conjunction with a corpus distribution nor required to be payable in shares specified in the trust instrument. *See*, *however*, section 674(c) and §1.674(c)-1 for the effect of such a power if it is exercisable only by independent trustees.[67]

iii. **Accumulated income is paid to beneficiary from whom it was withheld, or if beneficiary does not survive a date of distribution which could reasonably be expected to occur within his lifetime, to appointees designated in the trust instrument**. A power to accumulate fiduciary accounting income[68] for a current

[66] *See* Treas. Reg. §1.674(b)-1(b)(6) (example 1).

[67] *See* Treas. Reg. §1.674(b)-1(b)(6) (example 2).

[68] As described in below section III.B.2.a.vi.a.iii.b, per Treas. Reg. §1.674(b)-1(b)(6), "income" for this purpose actually means fiduciary accounting income.

income beneficiary will not result in grantor trust status if the accumulated income is payable to the beneficiary from whom it was withheld, or if he or she does not survive a date of distribution which could reasonably be expected to occur within his or her lifetime, to his appointees under any power of appointment, general or special, or if he has no power of appointment to one or more designated alternate takers (other than the grantor or the grantor's estate) whose shares have been irrevocably designated in the trust instrument.[69]

a. **Example**. A trust provides for payment of income to the grantor's adult son with the grantor retaining the power to accumulate the income until the grantor's death, when all accumulations are to be paid to the son. If the son predeceases the grantor, all accumulations are, at the death of the grantor, to be paid to his daughter, or if she is not living, to alternate takers (which do not include the grantor's estate) in specified shares. The power is excepted under section 674(b)(6) (flush language) and Treas. Reg. §1.674(b)-1(b)(6)(b) since the date of distribution (the date of the grantor's death) may, in the usual case, reasonably be expected to occur during the beneficiary's (the son's) lifetime. It is not necessary that the accumulations be payable to the son's estate or his appointees if he should predecease the grantor for this exception to apply.[70]

b. **"Income"**. Code §674(b)(6) refers to a power to accumulate "income." As described above in section II.B, Treas. Reg. §1.671-2(b) states that for purposes of Subpart E, "income," when not modified by the word "ordinary" means taxable income.

[69] Code 674(b)(6), flush language; Treas. Reg. §1.674(b)-1(b)(6)(b).

[70] Treas. Reg. §1.674(b)-1(b)(6) (example 1)

However, Treas. Reg. §1.674(b)-1(b)(6) indicates that for purposes of Code §674(b)(6), "income" means fiduciary accounting income.

c. **Exception – power to add beneficiaries**. The flush language of Code §674(b)(6) provides that a power will not fall within the Code §674(b)(6) exception to grantor trust status if any person (including an adverse party) has a power to add beneficiaries, except where beneficiaries are added to provide for after-born or after-adopted children. In other words, if any person has a power to add beneficiaries (other than after-born or after-adopted children), the trust will be a grantor trust, taxable to its grantor under the general rule of Code §674(a).

   i. **Planning point – power to add beneficiaries**. From an estate planning perspective, grantor trust status may be considered desirable for a number of reasons. Accordingly, when creating trusts, settlors may seek to include powers aimed at ensuring that a trust is treated as a grantor trust. Including a power that allows any person to add beneficiaries will result in grantor trust status. However, grantors typically will not themselves wish to retain a power to add beneficiaries, as such a power will result in the trust fund being included in the grantor's estate. Grantors may also be reluctant to give third parties the power to add beneficiaries.

vii. **Power to withhold income during disability of a beneficiary – Code §674(b)(7).**

a. **General rule**. Section 674(b)(7) provides that grantor trust status will not result from a power to accumulate income (which means ordinary income in this case, see below) during (i) the existence of a legal disability of any current income beneficiary or (ii) the period during which any income beneficiary.

This means that the power to accumulate FAI is available with respect to beneficiaries who are minors or under a legal disability, even though accumulated income is not ultimately distributed in the ways specified in Code §674(b)(6) (described above).

i. **"Income"**. Like Code §674(b)(6), Code §674(b)(7) refers to a power to accumulate "income." As described above in section II.B, Treas. Reg. §1.671-2(b) states that for purposes of Subpart E, "income," when not modified by the word "ordinary" means taxable income. *However*, as with the regulations under Code §674(b)(6), Treas. Reg. §1.674(b)-1(b)(7) indicates that for purposes of Code §674(b)(7), "income" means fiduciary accounting income.

b. **Exception – power to add beneficiaries**. A power will not fall within the Code §674(b)(7) exception to grantor trust status if any person (including an adverse party) has a power to add beneficiaries, except where beneficiaries are added to provide for after-born or after-adopted children. In other words, if any person has a power to add beneficiaries (other than after-born or after-adopted children), the trust will be a grantor trust, taxable to its grantor under the general rule of Code §674(a).

c. **Example**. Grantor creates trust for his daughter, who is a minor. The trust agreement gives the trustee (a non-adverse party) discretion to accumulate or distribute income. The trustee also has the power to distribute corpus. The trust is to terminate when daughter reaches age 35, at which time it is to be paid outright to her, or, if she is not then living, to grantor's son. Based on the foregoing, the trust is not a grantor trust as to fiduciary accounting income because it falls within the exception of §647(b)(7) (power to withhold income during disability). The trust is also not a grantor trust as to corpus because it falls within the exception of §647(b)(5)(B) (power to distribute corpus if distribution is chargeable against beneficiary's share of trust; here, the trust has a single beneficiary).

viii. **Power to allocate between income and corpus**. Code § 674(b)(8) provides that a power to allocate receipts and disbursements between income and corpus, even though expressed in "broad language," will not cause a trust to be a grantor trust.

b. **Powers to accumulate or distribute income and/or pay out corpus that can be exercised by an "independent trustee" without triggering grantor trust status – Code §674(c):**

i. **General rule – Code §674(c)**. Code §674(c) provides that grantor trust status will not be triggered as a result of a power of disposition over trust assets that is *solely exercisable* (without the approval of any other person, including a trust protector) by a trustee or trustees, *none of whom are the grantor* (or the grantor's spouse), and *no more than half of whom are "related or subordinate parties"* (as defined above in II.F) who are "*subservient of the wishes* of *the grantor"* (as described above in II.F.3) to accumulate income or pay out corpus.

a. **Accumulate income**. "Independent trustees" (as described above) can distribute, apportion or accumulate income to or for a beneficiary or beneficiaries, or to, for or within a class of beneficiaries without triggering grantor trust status.

b. **Pay out corpus**. "Independent trustees" can pay out corpus to or for a beneficiary or beneficiaries or to or for a class of beneficiaries (whether or not income beneficiaries).

ii. **Exceptions.**

a. **Power to add beneficiaries**. The flush language of Code §674(c) provides that a power will not fall within the Code §674(c) exception to grantor trust status if any person has a power to add beneficiaries, except where beneficiaries are added to provide for after-born or after-adopted children. In other words, if any person has a power to add beneficiaries (other than after-born or after-adopted children), the trust will be a grantor trust, taxable to its grantor under the general rule of Code §674(a).

b. **Power to remove and replace trustees**. Treas. Reg. §1.674(d)-2 provides that a power in the grantor to remove, substitute, or add trustees (other than a power exercisable only upon limited conditions which do not exist during the taxable year, such as the death, or resignation, or breach of fiduciary duty of an existing trustee) may prevent a trust for qualifying for the Code §674(c) exception to grantor trust status. For example, if a grantor has an unrestricted power to remove an independent trustee and substitute any person, including himself, as trustee, the trust will not qualify for the exception to grantor trust status in Code §674(c). If, on the other hand, the grantor's power to remove, substitute or add trustees is limited so that its exercise could not alter the trust in a manner that would disqualify it under Code §674(c), the power will not disqualify the trust. Thus, for example, a power in the grantor to remove or discharge an independent trustee on the condition that he will substitute another independent trustee will not prevent a trust from qualifying for the Code §674(c) exception to grantor trust status.[71]

iii. **Examples – Code §674(c).**

a. **Example – spouse as trustee**. Wife creates a discretionary trust for the benefit of her children. The trustees are Husband, A and B. A and B are not related or subordinate as to Wife. The trust is a grantor trust. Even though more than half of the trustees are not related or subordinate to Wife, Husband is a trustee. And if the grantor's spouse is a trustee, a trust cannot fall within the Code §674(c) exception to grantor trust status.

b. **Example – attorney as trustee**. Wife creates a discretionary trust for the benefit of her children. The trustee is Wife's attorney. Attorney signs of on all distributions and decisions requested by Wife. The trust does not seem to be a grantor trust. Even though Attorney may effectively be subservient to the wishes of Wife, *Estate of Hilton W. Goodwyn*

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[71] *See* Treas. Reg. §1.674(d)-2.

(discussed in footnote 48) indicates that Attorney is not a "related or subordinate" person as to Wife within the meaning of Code §672(e).

c. **Powers to accumulate or distribute income based on a standard that can be exercised by any trustee other than grantor or grantor's spouse – Code §674(d).**

i. **General rule – Code §674(d)**. Code §674(d) provides that a grantor is not taxable as a trust's owner merely because a nonadverse trustee or trustees has the power (exercisable without the consent of another person) to distribute, apportion or accumulate income to or for a beneficiary or the beneficiaries of a trust, so long as such power is limited by a reasonably definite external standard et forth in the trust agreement. The exception of Code §674(d), however, is not available if the grantor or the grantor's spouse (*if living with the grantor*) is a trustee.

a. **"If living with the grantor"**. It is not clear whether the requirement of Code §674(d) that the grantor's spouse be living with the grantor is overridden by Code §672(c), which, for purposes of Subpart E, imputes all powers of a grantor's spouse to the grantor.

ii. **Exceptions to general rule of Code §674(d).**

a. **Power to add beneficiaries**. The flush language of Code §674(d) provides that a power will not fall within the Code §674(d) exception to grantor trust status if any person has a power to add beneficiaries, except where beneficiaries are added to provide for after-born or after-adopted children. In other words, if any person has a power to add beneficiaries (other than after-born or after-adopted children), the trust will be a grantor trust, taxable to its grantor.

b. **Power to remove and replace trustees**. Treas. Reg. §1.674(d)-2 provides that a power in the grantor to remove, substitute, or add trustees (other than a power exercisable only upon limited conditions which do not exist during the taxable year, such as the death, or resignation, or breach of fiduciary duty of an existing trustee) may prevent a trust for qualifying for the Code §674(d) exception to grantor trust status. For example, if a grantor has an unrestricted power to remove an independent trustee and substitute any person, including himself, as trustee, the trust will not qualify for the exception to grantor trust status in Code §674(d). If, on the other hand, the grantor's power to remove, substitute or add trustees is limited so that its exercise could not alter the trust in a manner that would disqualify it under Code §674(d), the power will not disqualify the trust. Thus, for example, a power in the grantor to remove or discharge an independent trustee on the condition that he will substitute another independent trustee will not prevent a trust from qualifying for the Code §674(d) exception to grantor trust status.[72]

iii. **Overlap between Code §674(d) and other exceptions to grantor trust status under Code §674(a)**. According to *Ferguson, et al.*,[73] Code §674(d) "covers roughly the same turf as §§674(b)(6), (b)(7) and (c). But unlike §674(b)(6), §674(d) does not require that the income withheld from a beneficiary be ultimately distributed in any particular way. Unlike §674(b)(7), §674(d) is not limited solely to powers relating to minors and legally disabled persons. Finally, unlike §674(c), §674(d) does not require that the power be held by an 'independent trustee.'"

C. **Code §675**: **Administrative powers**.

1. **Overview/purpose**. Code §675 treats a grantor as owner of any portion of a trust if administrative control of the trust is exercisable primarily for the benefit of the grantor, rather than for the beneficiaries of the trust.[74] Code §675 identifies four categories of administrative powers (discussed below) that can trigger grantor trust status.

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[72] Treas. Reg. §1.674(d)-2.

[73] *See* Ferguson, Freeland and Ascher, supra note 7, at § 10.12[D].

[74] *See* Treas. Reg. §1.675-1(a).

2. **Power to deal for less than adequate and full consideration – Code §675(1)**. Under Code §675(1), a grantor will be taxable as owner of a trust, or portion of a trust, if the grantor or any nonadverse person (or both), has a power exercisable without the approval or consent of any adverse party, to purchase, exchange or otherwise deal with or dispose of trust principal or income for less than adequate consideration in money or money's worth.

   a. **Planning point**. Irrevocable trust agreements rarely include a provision that allows a grantor or a nonadverse person to deal with trust assets for less than adequate and full consideration. If such a provision were included, the assets of the trust would likely be included in the grantor's estate. Furthermore, a grantor might be hesitant to give to a third party a power to deal with trust assets for less than adequate and full consideration.

3. **Power to borrow without adequate interest and security – Code §675(2)**. Under Code §675(2), a grantor will generally be taxable as owner of a trust, or portion of a trust, over which the grantor or any nonadverse party has the power to borrow the trust principal or income, directly or indirectly, without both adequate interest and adequate security.

   a. **Exception**. Grantor trust status will not result under Code §675(2) if a trustee (other than the grantor or, under Code §672(e), the grantor's spouse) is authorized under a general lending power to make loans to any person without regard to interest or security.

   b. **Planning point**. The ability of a grantor to borrow trust principal or income without adequate interest could be viewed as a retained power in the grantor that could cause estate inclusion.

4. **Actual borrowing of trust fund – Code §675(3)**. Code §675(3) provides that a grantor will be taxable as owner of any portion of a trust in respect of which the grantor has, directly or indirectly, borrowed the corpus or income and has not completely repaid the loan, including any interest, before the beginning of the next tax year.

   a. **Exception**. A grantor's actual borrowing of a trust, or portion of a trust, that has not been completely repaid before the beginning of the next tax year will not cause the grantor to be taxable as the trust's owner if the loan (i) provides for adequate interest and adequate security and (ii) is made by a trustee other than the grantor and other than a "related or subordinate" trustee who is subservient to the grantor.[75]

b. **Uncertainty in applying "portion" rules**. As described above in section II.C.4 , Treas. Reg. §1.671-3 provides rules for determining the "portion" of a trust with respect to which a grantor will be taxable as owner. The application of the "portion" rules, however, creates some uncertainty in the context of Code §675(3). The IRS has taken the position that a grantor who borrows any amount from a trust should be taxable as owner of the entire trust. In *Benson v. Comm'r*,[76] the Tax Court agreed with this position, holding that a grantor who had borrowed all of the income of a trust should be treated as owner of the entire trust. However, in *Bennett v. Comm'r*,[77] the Tax Court held that a grantor who had borrowed principal should be taxed on the "portion of the current year's trust income which the total unpaid loans at the beginning of the taxable year bear to the total trust income of prior years plus the trust income for the taxable year at issue."[78] Finally, in *Holden v. Comm'r*,[79] the Tax Court took a third approach, holding that a grantor who had borrowed trust principal should be taxed only on income derived from the trust on the sum borrowed.

c. **Indirect borrowing – Rev. Rul. 85-13**. As stated above, a grantor can be taxable as owner of a trust under Code §675(3) based on an "indirect borrowing." In Rev. Rul. 85-13, a key ruling for planning transactions involving grantor trusts (discussed in section IV.B below), the trust that was the subject of the ruling trust was treated as a grantor trust because of an indirect borrowing by the grantor. Specifically, the IRS ruled that the grantor's

[75] *See* Code §675(3); Treas. Reg. §1.675-1(b)(3).

[76] 76 T.C. 1040 (1981).

[77] 79 T.C. 470 (1982).

[78] *Id*.

[79] 34 T.C.M. 129 (1975).

receipt of the entire corpus in exchange for an unsecured promissory note given to the grantor's spouse, as trustee, constituted an indirect borrowing of the trust corpus which caused the grantor to be the owner of the entire trust under Code §675(3).[80]

5. **General powers of administration – Code §675(4)**. Code §675(4) treats the grantor as owner of any portion of a trust over which *any person* (including, it seems, an adverse party) has certain specified powers of administration that are *exercisable in a nonfiduciary capacity*, without the approval of any person in a fiduciary capacity. The powers of administration that can trigger grantor trust status under §675(4) are:

   a. **Power to vote stocks and securities – Code §675(4)(A)**. Code §675(4)(A) provides that a grantor will be treated as owner of any portion of a trust over which any person has a power, exercisable in a nonfiduciary capacity, 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 view point of voting control, without the approval of any person in a fiduciary capacity.

      i. **Planning point – Code §2036(b)**. Code §2036(b) provides that the retention of the right to vote (directly or indirectly) shares of a corporation in which a decedent owned (directly or constructively) or had the right (either alone or in conjunction with any person) to vote stock possessing 20% of the total combined voting power of all classes of stock will result in inclusion of the value of the shares in the decedent's gross estate. Accordingly, it is unusual to find a trust agreement under which a grantor retains a right to vote shares of a corporation in which shareholdings are significant.

   b. **Power to control trust fund investments – Code §675(4)(B)**. Code §675(4)(B) provides that a grantor will be treated as owner of any portion of a trust over which any person has a power, exercisable in a nonfiduciary capacity, without the approval of any person in a fiduciary capacity, to control the investment of the trust fund either by directing the investments or reinvestments, or by vetoing proposed investments or reinvestments, to the extent that

[80] *See also Rothstein v. U.S.*, 735 F.2d 704 (2d Cir. 1984), cited below in section IV.B.

the trust fund consists of stock or securities of corporations in which the holdings of the grantor and the trust are "significant" from the viewpoint of voting control.

i. **Planning point – investment advisor of Delaware trust**. As a general matter, Delaware has favorable trust laws. In order for a trust to avail itself of favorable Delaware trust laws, the trust needs to have sufficient nexus to Delaware. Having a Delaware trustee provides such nexus. Delaware law allows trustees to protect themselves from liability with respect to trust investments by naming third-party investment advisors. Delaware law further provides that a trust's *investment advisor is a fiduciary*. Accordingly, if Delaware trust has a third-party investment advisor, the authority of the investment advisor to control trust investments will *not* cause the trust to be a grantor trust, given that, under Delaware law, the investment advisor makes decisions in a fiduciary capacity.

c. **Power to reacquire trust assets – Code §675(4)(C)**. Code §675(4)(C) provides that a power to reacquire the trust corpus by substituting other property of equivalent value will result in grantor trust treatment, when such power is exercisable in a nonfiduciary capacity, without the approval or consent of any person in a fiduciary capacity.

i. **Can power to "reacquire" be exercisable by a person other than grantor?** The introductory language of Code §675(4) states that the administrative powers enumerated in Code §675(4) will result in grantor trust status if such powers are exercisable by *any person* in a nonfiduciary capacity, without the approval or consent of any person in fiduciary capacity (emphasis added). However, it is uncertain whether a power to reacquire trust assets, exercisable in this manner by a person other than the grantor will result in grantor trust status. This is because it is not clear how a person other than a grantor can "reacquire" asset assets.

ii. **Is a power to reacquire exercisable in a "fiduciary capacity"?** Whether a power to reacquire trust assets is exercisable in a fiduciary capacity is a question of fact on which the IRS generally will not rule.[81]

iii. **Planning point**. If a grantor is given a power, exercisable in a nonfiduciary capacity, to reacquire trust assets by substituting assets of equivalent value, the power should not cause inclusion in the grantor's estate under Code §§2038,[82] 2036,[83] 2042,[84] 2033 and 2039.[85]

D. **Code §676: Power to revoke**.

1. **General rule – Code §676(a)**. Code §676(a) provides that a grantor will be treated as owner of any portion of a trust, where at any time the power to revest in the grantor the title to such portion is exercisable by *a grantor or a nonadverse party*, or both.

2. **Exception for certain postponed powers – Code §676(b)**. Grantor trust status will not result if a power to revest title to trust property in the grantor cannot be exercised until after the occurrence of an event or for a long enough period of time long to avoid application of Code §673 if the power were a reversionary interest. However, once the triggering event occurs or period of time expires, the grantor may be treated as the owner unless the power is relinquished.[86]

3. **Planning point**. A power to revoke should never be included in a trust agreement if an objective is for the trust fund not to be includible in the grantor's estate. However, where is so-called "revocable trust" is used as a Will substitute, the grantor's power to revoke the trust will result in grantor trust status.

E. **Code §677: Income for benefit of grantor**.

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[81] *See, e.g.,* Priv. Ltr. Rul. 9413045 (Jan. 4, 1994).

[82] *See, e.g., Estate of Jordahl v. Comm'r*, 65 TC 92 (1975), acq., 1977-1 CB-1.

[83] *See, e.g.,* Priv. Ltr. Rul. 924702 (Aug. 24, 1992); Priv. Ltr. Rul. 9227013 (Mar. 30, 1992).

[84] *See, e.g.,* Priv. Ltr. Rul. 9843024 (July 24, 1998).

[85] *See, e.g.,* Priv. Ltr. Rul. 200603040 (Jan. 30, 2006).

[86] Code §676(b).

1. **General rule – Code §677(a)**. Code §677(a) provides that a grantor is taxable as the owner of any portion of a trust as to which the grantor, or any nonadverse party (or both) has the ability to use the trust *income*[87] for the benefit of the grantor or the grantor's spouse[88] in one or more specified ways (discussed immediately below), without the consent or approval of an adverse party (a) income is or may be distributed to or accumulated for the grantor or the grantor's spouse or (b) income may be applied to pay premiums on a life insurance policy on the life of grantor or grantor's spouse. Each of (a) and (b) is discussed further below.

a. **Income is or may be distributed to or accumulated for the grantor or grantor's spouse – Code §§671(a)(1) and (2)**. Code §677(a)(1) and (2) tax a grantor as owner of any portion of a trust whose income without the approval or consent of an adverse party is, or in the discretion of the grantor or a nonadverse party (or both) may be, distributed to or accumulated for the grantor or the grantor's spouse.

i. **"Income"**. The regulations under Code §677 indicate that the reference to "income" in Code §677(a) means "taxable income."[89] Accordingly, a trust instrument that calls for mandatory or discretionary distributions of "ordinary income" to a grantor or a grantor's spouse should result in the grantor being taxable on items allocable to income under local law, such as interest

[87] The meaning of "income" for purposes of Code §677(a) is discussed below in section III.E.1.a.i.

[88] The references to the grantor's "spouse" in Code §677 seem unnecessary, given that Code §672(e) attributes to the grantor any power or interest held by his or her spouse. However, the references to "spouse" in §677 predate the enactment of the spousal attribution rule of Code §672(e).

[89] See Treas. Reg. §1.677(a)-1(g) (examples 1 and 2). Example 1 of Treas. Reg. §1.677(a)-1(g) indicates that a grantor's retention of the right to receive trust "ordinary income" results in the grantor being taxable as owner of items allocated to income under local law (e.g., interest and dividends) but not items allocated to corpus (e.g., capital gain). Example 2 of Treas. Reg. §1.677(a)-1(g) indicates that a grantor's retention of a reversionary interest in the corpus of a trust (which is not sufficient in size to cause the entire trust to be taxable to the grantor under Code §673) results in the grantor being taxable on capital gains and other items of taxable income allocable to corpus under local law. Under the trust instrument, capital gains and other items of taxable income are being accumulated for future distribution to the grantor.

and dividends. (See example 1, below.) Similarly, a trust instrument that calls for mandatory distributions of "ordinary income" to a third-party beneficiary, with a reversionary interest in the grantor (which reversionary interest is not sufficient to trigger grantor trust status Code § 673) should result in the grantor being taxable on items allocable to corpus under local law, such as capital gains. (See example 2, below.)

ii. **Cf. Code § 673 reversionary interest**. As described above in section III.A, a grantor is treated as owner of any portion of a trust in which the grantor (or the grantor's spouse[90]) has a reversionary interest that, as of the inception of that portion of the trust, exceeds the value of 5% of the portion. In a case where a grantor's reversionary interest does not meet this 5% threshold, the grantor may be treated as owner of a portion of the trust under Code § 677. For example, if ordinary income of a trust is to be paid to a third-party beneficiary for a period of 40 years, with the trust fund to revert to the 40-year period, the value of the reversionary interest is unlikely to be sufficient to trigger grantor trust status under Code § 673. However, because income allocable to corpus (e.g., capital gain) can be accumulated for the grantor, the grantor will be taxable as owner on items of income allocable to corpus. (See example 2, below).

iii. **Examples.**

a. **Example 1 – Grantor taxable as owner of ordinary income**. Grantor creates an irrevocable trust which provides that the ordinary income is to be payable to him for life and that on his death the corpus shall be distributed to B, an unrelated person. Except for the right to receive income, grantor retains no right or power which would cause him to be treated as owner under §§671 through 677. Under the applicable local law capital gains are allocated to corpus. During the taxable year, the trust has $5,000 of dividends and $1,000 of capital gain. The trust has $200 of expenses allocable to income and $100 of expenses allocable to corpus.

[90] *See* Code §672(e).

Since grantor has a right to receive income he is treated as an owner of a portion of the trust under §677(a).[91]

i. The grantor is treated as owner of the "ordinary income" portion of the trust under Code §677(a).

ii. Accordingly, under Treas. Reg. §1.671-3(b)(1) (discussed in section II.C, above), the grantor must take into account in computing his tax liability the trust's items of FAI. Under local law, the trust's FAI would include the $5,000 of dividends (but not the capital gains), reduced by the $200 of expenses allocable to corpus. The trust's FAI is therefore $4,800.

iii. However, under Treas. Reg. §1.671-3(c) (discussed in section II.C, above), the grantor's income inclusions in respect of the trust will be capped at the trust's DNI. Interest and dividends enter into the computation of the trust's DNI but capital gains likely do not.[92] Additionally, even though local law charges certain expenses again income and certain expenses against principal, all of the expenses reduce DNI. DNI will therefore include the $5,000 of dividends, less $200 of expenses allocable to corpus and the $100 of expenses allocable to corpus. Accordingly, DNI is $4,700 ($5,000 dividend income, less $200 expense allocable to corpus, less entire $100 expense allocable to income).

iv. Therefore, the grantor's income inclusion in respect of the trust is $25,000, a portion of which is interest income and a portion of which is dividend income.

b. **Example 2 – Grantor taxable as owner of corpus**. Grantor creates a trust which provides that the

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[91] *See* Treas. Reg. §1.677(a)-1(g) (example 1).

[92] *See* Code §643(a)(3).

ordinary income is payable to his adult son. Ten years and one day from the date of the transfer or on the death of grantor's son, whichever is earlier, corpus is to revert to grantor. Assume that as of the inception of the trust, the value of grantor's reversionary interest is less than 5% of the value of the trust fund. Grantor retained no other right or power which would cause him to be treated as an owner under Subpart E. Under the terms of the trust instrument and applicable local law, capital gains must be applied to corpus. During the taxable year, the trust had the following items of income: \$10,000 of dividends and \$2,000 of capital gains. In addition, the trust had the following expenses: \$400 of expenses allocable to income and \$200 of expenses allocable to corpus.[93] What will be grantor's income inclusions with respect to the trust?

i. Grantor is treated as owner of the corpus of the trust under Treas. Reg. §1.671-3(a)(3) and Code §677(a)(2). This is because (taxable) income allocable to corpus (*e.g.*, capital gain) may be accumulated for future distribution to grantor.

ii. Accordingly, under Treas. Reg. §1.671-3(b)(2) (discussed in section II.C, above), grantor must take into account in computing his tax liability the trust's income that is allocable to corpus. The only item that grantor must therefore take into account is the \$2,000 capital gain. (In calculating FAI, income is reduced by the share of trustee expenses allocable to income under local law and the trust instrument. However, in determining income that is allocable to corpus, there is no subtraction for expenses allocable to corpus.)

iii. The interest and expenses enter into the computation of DNI, and therefore would affect the computation of the tax liability of a current income beneficiary. As a result, the interest and expenses would not be attributed to the grantor.

[93] *See* Treas. Reg. §1.677(a)-1(g) (example 2).

iv. Therefore, the grantor's income inclusion in respect of the trust is $2,000 of capital gain income.

c. **Example 3 – GRAT**. The IRS has issued several private letter rulings concluding that GRATs are grantor trusts on the basis of Code §677.[94] These rulings aside, the Tax Court has in several cases held that a grantor of a trust who retains an annuity is taxable on the entire income of the trust (including income allocable to corpus, such as capital gains) if the entire corpus of the trust can return to the grantor.[95] If the assets of a GRAT do not increase in value at a rate higher than the relevant §7520 rate, all of the GRAT's assets will return to the grantor.

b. **Income may be applied to pay premiums on a life insurance policy on the life of grantor or grantor's spouse – Code §677(a)(3)**. Code §677(a)(3) taxes the grantor as owner of any portion of a trust whose "income" without the approval or consent of an adverse party is, or in the discretion of the grantor or a nonadverse party (or both) may be applied to the payment of premiums on policies of insurance on the life of the grantor or the grantor's spouse.

i. **"Income"**. As described above in section III.E.1.a.i and footnote 102 examples 1 and 2 of Treasury Reg. § 1.677(a)-1(g) indicate that "income" in Code § 677(a) refers to taxable income, rather than fiduciary accounting. Examples 1 and 2 concern the ability to distribute or accumulate income to or for a grantor or grantor's spouse, (addressed in Code §677(a)(1) and (2)), rather than the ability to apply income to life insurance premiums (addressed in Code § 673(a)). However, assuming that for purposes of Code §677(a)(3), "income" similarly refers to taxable income, an ability to premiums on an insurance policy

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[94] *See* Priv. Ltr. Rul. 9444033 (Aug. 5, 1994); Priv. Ltr. Rul. 9448018 (Aug. 12, 1994); Priv. Ltr. Rul. 9451056 (Sept. 26, 1994); Priv. Ltr. Rul. 9449012 (Sept. 9, 1994) ; Priv. Ltr. Rul. 9449013 (Sept. 9, 1994); Priv. Ltr. Rul. 9504021 (Oct. 28, 1994) .

[95] *See Weigl v. Comm'r*, 84 T.C. 1192, 1228 (1985); *Stern v. Comm'r*, 77 TC 614, 648 (1981), *rev'd on other grounds*, 747 F.2d 555 (9th Cir. 1984).

on the life of grantor or grantor's spouse, whether from items allocable to FAI (e.g., dividends or interest) or items allocable to corpus (e.g., capital gain) would seem to cause a grantor to be taxable as owner the relevant portion of trust income.

a. **Is actual payment of premiums on a policy owned by the trust required?** Even though the plain language of Code §677(a)(3) indicates that a mere *ability* to pay life insurance premiums from income should be sufficient to trigger grantor trust status as to a portion of the trust, case law predating Code § 677(a)(3) suggests otherwise.[96] However, recent IRS guidance seems to confirm that a mere ability to pay policy premiums should be sufficient to trigger grantor trust status. In FAA 20062701F the IRS stated that the a trustee power to purchase life insurance on the life of the grantor or the grantor's spouse from trust income was sufficient to trigger grantor trust status under Code §677(a)(3), irrespective of whether a policy was actually acquired by the trust.

c. **Exception to general rule of Code §677(a) – postponed powers**. The flush language of Code §677 provides that a grantor is not taxable as owner of the income of a trust if a power to apply income for the benefit of the grantor or his spouse can occur only after an event that would not cause the grantor to be treated as the owner if the power were a reversionary interest.

i. **Example**. Grantor creates a trust for the benefit of his daughter. Grantor does not retain a reversionary interest in the trust, but the trust instrument provides that if daughter dies before grantor, income accruing after daughter's death may, at the trustee's discretion, be paid to the grantor or the grantor's surviving issue for the remainder of grantor's life. If, at the inception of the trust, the chance of grantor's daughter predeceasing grantor is less than 5%, then the power to

[96] *See, e.g., Corning v. Comm'r*, 104 F.2d 329 (6th Cir. 1939); *Iverson v. Comm'r*, 3 T.C. 756 (1944); *Weil v. Comm'r*, 3 T.C. 579 (1944), acq., 1944 C.B. 29; *Rand v. Comm'r*, 40 B.T.A 233 (1939), acq. 1939-2 C.B. 30, aff'd, 116 F.2d 929 (8th Cir. 1941), cert. denied, 313 U.S. 594 (1941); *Moore v. Comm'r*, 39 B.T.A. 808 (1939), acq. 1939-2 C.B. 25.

apply income for grantor's benefit can occur only after an event that would not cause grantor to be treated as owner if the power were a reversionary interest. Accordingly, grantor is not treated as owner of any portion of the trust under Code § 677.[97]

ii. After the occurrence of the event, the grantor may be treated as owner of the income of the trust, unless the power is relinquished.[98]

2. **Obligations of support – Code §677(b)**. Code §677(b) provides that "income" of a trust will not be considered taxable to a grantor under Code §677(a) (or any other provision of chapter 1 of the Code) merely because such income in the discretion of the trustee, the grantor acting as trustee or co-trustee, or another person *may* be applied or distributed for the support of any beneficiary (other than the grantor's spouse) in discharge of a support obligation of the grantor (or the grantor's spouse[99]).[100]

a. **Actual distributions in discharge of support obligations**. While grantor trust treatment will not result from the mere possibility that income might be distributed to a beneficiary in discharge of a grantor's (or grantor's spouse's[101]) support obligation, if income is actually distributed to a beneficiary in discharge of a beneficiary, following are the income tax consequences:

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[97] If, in the example above, the grantor retained a reversionary interest in the trust in the event that his daughter predeceased him, and the value of this reversionary interest was less than 5% of the value of the trust at its inception, the grantor might be treated as owner of the trust under Code § 677 (assuming the value of the reversionary interest was not large enough to subject the trust to grantor trust treatment under Code § 673).

[98] *See* Code §677(a) (flush language).

[99] While there is no mention in Code § 677(b) of the support obligations of a grantor's spouse, reference to support obligations of a spouse is made in Treas. Reg. § 1.677(b)-1.

[100] Whether a grantor (or a grantor's spouse) has an obligation to support a particular beneficiary is determined under state law.

[101] *See* footnote 99.

i. If income[102] from the current year is applied or distributed to a beneficiary in discharge of a support obligation of the grantor (or the grantor's spouse[103]), the grantor may be treated as owner of such income under Code § 677.[104]

ii. If principal or accumulated income is used to discharge a support obligation of the grantor, amounts used to discharge the support obligation are treated as constructive distributions to the grantor, who will be taxed as if he or she is a beneficiary of the trust and as if the amounts so used were paid to him or her within the meaning of Code §§ 661(a)(2) and 662.[105] Accordingly, if a distribution that discharges a grantor's support obligation is made from a trust that has accumulated income from prior years and has no current income, the grantor will be subject to throwback treatment and taxed on the accumulation distribution.

F. **Code §678: Person other than grantor treated as substantial owner**,

1. **Background – *Mallinckrodt***. As described above in section I.B.2.b, Code § 678 is a codification of the 8th Circuit's decision in *Mallinckrodt v. Nunan,* 146 F.2d 1 (8th Cir.), *cert. denied*, 324 U.S. 871 (1945). *Mallincrkrodt* concerned a beneficiary of a trust who was entitled to receive as much of the otherwise undistributed income of a trust created by his father as the beneficiary requested. The 8th Circuit held that the beneficiary was to be treated as owner of the trust, whether or not he actually demanded income in a give year, in view of his "position of power over the disposition of trust income."

2. **General rule – Code § 678(a)**. A person other than the grantor of a trust is treated as the owner of any portion of the trust with respect to which:

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102 In view of examples 1 and 2 of Treas. Reg. § 1.677(a)-1(g) (discussed in section III.E.1.a.i and footnote 89, above), it seems logical to assume that for purposes of Code § 677(b) and Treas. Reg. § 1.677(b)-1, "income" refers to taxable income rather than fiduciary accounting.

103 Treas. Reg. § 1.677(b)-1(a)

104 Code § 677(b); Treas. Reg. § 1.677(b)-1(a).

105 Treas. Reg. § 1.677(b)-1(b).

a. Such person has a power exercisable solely by himself to vest the corpus or income therefrom in himself, or

b. Such person has previously partially released or otherwise modified such a power and after the release or modification retains such control as would, within the principles of Code §§ 671 through 677, subject a grantor of a trust to treatment as the owner thereof.

i. **"Partially released or otherwise modified"**. The Code and the Treasury Regulations do not provide a definition of "partially released or otherwise modified." However, in at least one private letter ruling, the IRS indicated that a "lapse" for purposes of Code § 2514(e) constitutes a "release" for purposes of Code § 678 and ruled that a beneficiary holding a 5% annual withdrawal right over a trust that she fails to exercise should be treated as if she partially released a power to withdraw under Code § 678(a)(2).[106]

3. **Exception where grantor is taxable – Code § 678(b)**. Code §678(b) provides that Code § 678(a) does not apply "with respect to a power over income" if the grantor is treated as owner under another provision of Subpart E.

a. **Rationale**. As described above in section I.B.1, the grantor trust rules were enacted at a time when there was a concern that high bracket taxpayers were setting up trusts in order to shift income to lower tax brackets. Code § 678(b) was likely intended to prevent grantors otherwise treated as owners under Subpart E from shifting the tax consequences of their trusts merely by granting another individual a power described in Code § 678.[107]

b. **"Powers over income"**. Even though the general rule of Code § 678(a) applies to powers over income or corpus, the exception in Code §678(b) applies only to powers over income. However "[i]t has been suggested that the 'over income' language [in Code § 678(b)] was an error in

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[106] *See* Priv. Ltr. Rul. 9034004 (May 17, 1990); *But see* Rev. Rul. 67-241, 1976-2 C.B. 225, both of which are discussed in section III.F.4.a.

[107] *See* Ferguson, et. al., supra note 7, at § 10.16[C].

drafting and should be disregarded."[108] Many practitioners agree with the approach of disregarding the words "over income. Moreover, in a number of private letter rulings, the IRS has in fact read the words "over income" out of Code §678(b).[109]

4. **Examples**.

a. **Beneficiary has withdrawal right over fiduciary accounting income**. If a beneficiary has a withdrawal right over all of the fiduciary accounting income, the beneficiary is taxable on items allocable to FAI (e.g., dividends and interest) but not on items allocable to corpus (e.g., capital gains). However, under Treas. Reg. §1.671-3(c), the beneficiary's income inclusions in respect of the trust's FAI will be capped at the trust's distributable net income. See section II.C.6.

b. **"5 and 5" power**. Rev. Rul. 67-241, the only published IRS guidance concerning a beneficiary's right to annually withdraw from a trust the greater of $5,000 or 5% of the trust fund, concludes that, under Code § 678(a)(1), the beneficiary is taxable as owner of that portion of the trust with respect to which she has a current year withdrawal right. However, in Priv. Ltr. Rul. 9034004, the IRS concluded that a beneficiary with a right to annually withdraw from trust corpus an amount equal to the larger of $5,000 or 5% of the trust fund, would, in each year she let her withdrawal right lapse, be treated as if she had "partially released" a power to withdraw within the meaning of Code § 678(a)(2). Accordingly, the IRS ruled that the beneficiary would be treated as the owner of an increasing portion of the trust in each year she failed to exercise her withdrawal right.

c. **Crummey power**. If a beneficiary of a trust has the right to temporarily withdraw amounts in respect of additions made to the trust (e.g., $12,000 or $24,000), and the trust's grantor has no powers that would result in the grantor being

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[108] *See* Early, Income Taxation of Lapsed Powers of Withdrawal: Analyzing Their Current Status, 62 J. Taxn, 198, 200 (1985).

[109] *See e.g.*, Priv. Ltr. Rul. 8326074 (Mar. 29, 1983); Priv. Ltr. Rul. 8308033 (Nov. 23, 1982); Priv. Ltr. Rul. 8142061 (July 21, 1981); Priv. Ltr. Rul. 81303074 (Oct. 23, 1980).

treated as owner under Subpart E, a good argument can be made for tracing the actual income realized by the trust during the duration of the Crummey power. (See section II.C.8.c, above.) If, however, the grantor has a power under Subpart E that would otherwise cause the grantor to be taxable on the entire trust, there is some uncertainty as to whether the beneficiary will nevertheless be treated as owner with respect to the pecuniary amount has a right to withdraw. This uncertainty is due to the fact that Code § 678(b) provides that a grantor's Subpart E power will trump a beneficiary's Code § 678(a) power over "income." Based on the language of the statute alone, it seems that the beneficiary with a withdrawal right would be taxable as owner of a trust in spite of the grantor's Subpart E power (particularly if the additions to a trust over which a beneficiary has a withdrawal right are characterized under the trust agreement as additions to principal). However, as described above in section III.F.3.b, many practitioners and the IRS seem to take the position that the words "of income" should be read out of Code § 678(b), meaning that a beneficiary with a withdrawal right would not be taxable as owner of any portion of a trust where the grantor held another Subpart E power over the entire trust.

IV. Consequences of Grantor Trust Status

A. **Trust's items of income, deduction and credit taken into account by grantor**. Under Code §671, a person who is identified as the grantor of a portion of a trust must take into account in computing his, her or its own taxable income the items of income, deduction and credit attributable to the portion of the trust. The trust itself does not take these items of income, deduction and credit into account.

B. **Transactions between grantor and grantor trust disregarded**. In Rev. Rul. 85-13[110], the IRS ruled that a sale transaction between a grantor and a grantor trust of which the grantor is treated as owner is disregarded for federal income tax purposes. Accordingly, no gain or loss is realized on the sale, and the buyer takes a carryover basis in the property (rather than a cost basis). If the consideration in the sale transaction includes a note,

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[110] 1985-1 CB 184.

the payment and receipt of interest on the note is disregarded for income tax purposes.[111]

C. **Recognition event upon conversion from grantor trust to non-grantor trust**. If a trust that is a grantor trust becomes a non-grantor trust (e.g., because the grantor or another person who holds a power described in §§673 through 679 renounces the power or because of the death of the grantor or other person treated as owner), there is a deemed transfer of the assets held by the grantor trust to a non-grantor trust. If, at the time of the deemed transfer, the trust or its assets are encumbered by liabilities in excess of the trust's basis in its assets, the deemed transfer will result in taxable gain.[112]

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[111] *Cf. Rothstein v. U.S.,* 735 F.2d 704 (2d Cir 1984), where the court held that a sale transaction between a grantor and a grantor trust should not be disregarded for federal income tax purposes. The court reasoned that if a grantor is treated as owner of a trust under Subpart E, this means that the grantor must include items of income, deduction and credit attributable to the trust in computing the grantor's taxable income and credits, but that the trust should continue to be viewed as a separate taxapayer.

[112] *See* Treas. Reg. §1.1001-1(e) (example 5); *Madorin v. Comm'r,* 84 T.C. 667 (1985); Tech. Adv. Mem. 200010010 (March 13, 2000).