# THE REST OF THE STORY: INCOME TAX ISSUES RELATED TO TRANSFER TAX PLANNING WITH GRANTOR AND NON-GRANTOR TRUSTS

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**FIDUCIARY INCOME TAX: TRICKS & TRAPS**[*]

## I. INTRODUCTION

This presentation arises out of the "Checklist of Income Tax Issues Related to Various Lifetime Transfer Tax Techniques" prepared by Florida attorney Tim Flanagan for the ACTEC Fiduciary Income Tax Committee. The Checklist is a comprehensive and structured listing of the income tax issues that practitioners must consider when engaging in estate planning for clients. The objective of this presentation is to focus on selected income tax issues that frequently arise in estate planning with trusts, where awareness of the issue may permit the practitioner to take advantage of an opportunity, or avoid a potential pitfall.

## II. SECTION 678 - A TANGLED WEB OF FIDUCIARY INCOME TAX ISSUES BUT WITH FEW CLEAR ANSWERS

"Crummey Powers" are probably the most common tool in the estate planner's arsenal to qualify lifetime gifts to irrevocable trusts for the gift tax annual exclusion. Such powers are normally designed to lapse on an annual basis to the extent the lapse does not exceed the greater of $5,000 or 5% of the aggregate value of the assets out of which the lapsed powers could be satisfied. In addition, many trusts are drafted to give the beneficiary a non-cumulative right to annually withdraw 5% of the trust principal which right, if not exercised, lapses at the end of the calendar year. In both situations, the lapse of the withdrawal right does not constitute the release of a general power of appointment for federal gift or estate tax purposes due to the exceptions found in Section 2041(b)(2) and Section 2514(e). But what are the fiduciary income tax consequences under Section 678 for the persons holding such powers? Now, for the rest of the story.

The absolute right to withdraw property from a trust is a general power of appointment. The exercise or release of a general power of appointment is treated as a taxable transfer for federal gift and estate tax purposes by the person possessing the power. See Sections 2514(b) and 2041(a)(2). Under Sections 2041(b)(2) and 2514(e) the "lapse" of a power is treated as a release. However, these sections go on to provide that the "release" rule will apply only to the extent that during any calendar year the property that could have been appointed by the exercise of the lapsed power exceeds the greater of $5,000 or 5% of the aggregate value of the assets out of which, or the proceeds of which, the exercise of the lapsed powers could be satisfied. It is important to note that under both Section 2041 and Section 2514 the lapse of a power of appointment is clearly defined as a release of the power. The release rule is just made inapplicable to the extent the lapse does not exceed the 5 & 5 limitations.

Subpart E of Part 1 of Subchapter J contains the "grantor trust" rules of Sections 671 - 679. These rules deal primarily with the circumstances under which the grantor of a trust will be treated as the owner of the trust for income tax purposes. Section 678 contains the rules pursuant to which a person other that the grantor will be treated as the owner of a trust for income tax purposes. Section 678(a) provides as follows:

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[*] This outline is based on an outline prepared originally for the American College of Trust and Estate Counsel by T. Randolph Harris, Mary Ann Mancini and Howard S. Tuthill, III.

"(a) General Rule. A person other than the grantor shall be treated as the owner of any portion of a trust with respect to which:

(1) such person has a power exercisable solely by himself to vest the corpus or the income therefrom in himself, or

(2) such person has previously partially released or otherwise modified such power and after the release or modification retains such control as would, within the principles of sections 671 to 677, inclusive, subject a grantor of a trust to treatment as the owner thereof."

Section 678 was enacted as part of the Internal Revenue Code of 1954 and was substantially a codification of rules laid down by the Eighth Circuit in *Mallinckrodt v. Nunan*.[1] The Eighth Circuit ruled, in essence, that if the grantor of a trust would be taxed as the owner of the trust because of broad retained powers, then a trust beneficiary should also be taxed as the owner of the trust where the beneficiary holds similar broad powers. Clearly a power held solely by a trust beneficiary to vest trust income or principal in himself or herself during his or her lifetime falls within the provisions of Section 678(a)(1).[2] The question that has produced disagreement is whether the lapse of a power of withdrawal falls within Section 678(a)(2) with the effect of causing the trust beneficiary to be income taxable on an ever increasing portion of the trust.

In a series of private letter rulings beginning in the early 1980's the IRS has taken the position that a beneficiary's power to vest the corpus or income of a trust in the beneficiary constitutes a general power of appointment and the lapse of that power constitutes a partial release or other modification of the power as provided in Section 678(a)(2).[3] Unlike the gift and estate tax rules, Subpart E does not contain a 5 & 5 exception to what constitutes a release. The result of falling with Section 678(a)(2) is that the beneficiary becomes a grantor to the trust and to the extent the beneficiary has an interest in the trust that would cause the grantor to be treated as the owner under Sections 671 - 677, then the beneficiary will continue to be treated as the owner of the portion of the trust over which the power of withdrawal has lapsed. Arguments against the IRS position are that (i) unlike Sections 2514 and 2041, there is nothing is Section 678 that treats a lapse as a release of a power and (ii) Section 678(a)(2) only deals with a "partial" release whereas the lapse of a withdrawal power would constitute a total release of the power. In addition, the actual words of the statute - "partially released or otherwise modified" - seem to suggest some actual action by the beneficiary.

On balance it seems that the position of the IRS is correct. To come out otherwise would establish different rules for a lapse and a release and an easy way to manipulate the statutory intent. Further, since Section 678 was enacted several years after the estate and gift tax provisions, Congress may well have assumed that the legislative intent to treat a lapse as a release was settled and didn't need to be included in the statute. With respect to the "partial" release argument, the annual lapse

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1 146 F.2d 1 (8th Cir. 1945), cert. denied, 324 U.S. 871 (1945)

2 See Rev. Rul. 67-241, 1967-2 C.B. 225.

3 PLRs 8342088,8521060,8809043,9034004,9448018,9450014,9504024, 200022035,200104005

of an ongoing annual withdrawal right would most likely be viewed as a partial release of that ongoing power. A total release would probably require a disclaimer or renunciation of the entire withdrawal right. With respect to the passive nature of the lapse, it is likely that a court would find a beneficiary's decision to allow a power to lapse as much an act by the beneficiary as a formal release. While the position of the IRS seems clear, we are not aware of any formal pronouncement from the IRS by Revenue Ruling or Regulation.

Assuming the IRS position with respect to Section 678(a)(2) is correct it is obvious that the income tax reporting for a trust with multiple Crummey power holders can quickly become complex and time consuming. To avoid this problem, taxpayers have focused on Section 678(b) to try and avoid the problem. Section 678(b) provides:

> "(b) Exception Where Grantor Is Taxable. Subsection (a) shall not apply with respect to a power over income, as originally granted or thereafter modified, if the grantor of the trust or a transferor (to whom section 679 applies) is otherwise treated as the owner under the provisions of this subpart other than this section."

The intent of this section is to permit the normal grantor trust rules as they apply to the original grantor of the trust to override the provisions of 678(a)(2). Thus, if the entire trust is treated as a grantor trust to the original grantor, no portion of the trust income will not be treated as owned by the beneficiaries with lapsing withdrawal rights. The question here is what is meant by the words "shall not apply with respect to a power over income"? Section 678(a)(1) refers to a power "to vest the corpus or the income therefrom in himself." What is meant by the word "income" in 678(a)(1) and in 678(b). Since the words corpus and income are used separately does the word income mean accounting income or can it be read as "taxable income" which would include all forms of income (including capital gains) generated by the trust. The term "income" as used in Subpart E is defined in the Regulations at Section 1.671-2(b) to be income for tax purposes rather than trust accounting purposes, as would be the case under Section 643(b) for Subparts A through D of Subchapter J. Treas. Reg. Section 1.671-2(b) provides in part:

> "(b) Since the principle underlying subpart E…is in general that income of a trust over which the grantor or another person has retained substantial dominion or control should be taxed to the grantor or other person rather than to the trust…, when it is stated in the regulations under subpart E that "income" is attributed to the grantor or another person, the reference, unless specifically limited, is to income determined for tax purposes and not to income for trust accounting purposes. When it is intended to emphasize that income for trust accounting purposes (determined in accordance with the provisions set forth in Section 1.643(b)-1), is meant, the phrase "ordinary income" is used."

While the quoted Regulation deals with the use of the term "income" in the Regulations, if the word "income" in Section 678(b) can be read to mean taxable income and the original grantor of the trust is treated under the provisions of 671 - 677 as the owner of the entire trust, then Section 678(b) should override Section 678(a) and the beneficiaries holding lapsing withdrawal rights will not be treated as the owners of a portion of the trust. If the word "income" is limited to accounting income then potentially both the original grantor and the beneficiaries holding lapsing withdrawal rights will be treated as owning different portions of the trust for federal income tax purposes. This analysis is further complicated by the meaning of the word "portion" as used in Subpart E. For example, if the original grantor was only treated as the owner of income allocable to corpus and the word "income" in Section 678(b) means accounting income then the section would have no application whatsoever. It should be noted that Treas. Reg. Section 1.678(b)-1 refers to a "power over income" and not to a power over "ordinary income." On the other hand the wording of Section 678(b) may simply be a mistake in the original legislative drafting.

Happily, however, for whatever reason, to date the IRS appears to have taken the position that Section 678(b) overrides the provisions of Section 678(a) where the original grantor is otherwise treated under the grantor trust rules as the grantor of the "entire" trust.[4]

The last issue we will deal with in this section is the income tax status of the trust upon termination of grantor trust status as to the original grantor of the trust. Assume grantor establishes an initial pot trust with discretion in the Trustee to spray income and principal among the grantor's wife and descendants with Crummey hanging withdrawal rights in 3 children and 7 grandchildren. For 10 years Grantor has been making contributions of the maximum annual exclusions for himself and his wife and splitting the gifts with his wife. Grantor now dies. Do we now have a straight forward complex trust or does Section 678 come in to play with the trust treated as owned for income tax purposes by 10 separate individuals? To make matters worse, assume that on grantor's death the pot trust divides in to 3 equal trusts for the grantor's children. Assuming Section 678 does apply, who are the owners for income tax purposes of the 3 trusts for the children.

The argument against grantor trust status for the 10 Crummey power beneficiaries would be that Section 678(b) directs that Section 678(a) "shall not apply" as long as the trust is treated as a grantor trust to the original grantor. Alternatively, the IRS could argue that Section 678(b) only holds Section 678(a) in abeyance until grantor trust status to the original grantor ends. At that time the 10 Crummey power holders whose powers were subject to Section 678(a) automatically become owners of the trust in proportion to their lapsed Crummey powers. The IRS does not appear to have taken a formal position on this issue by Revenue Ruling or Regulation, however, in PLR 9321050 (specifically revoking PLR 9026036 on the Section 678 issue) the IRS appears to have taken the position that the death of the original grantor does not cause the beneficiary who held a lapsed power to become the owner of a portion or all of the trust. The specific facts in that PLR were that wife created a trust for husband. Husband had the power to appoint to himself all or any portion of the trust assets for a period of 30 days following execution of the trust. Husband was the income beneficiary and held a testamentary power of appointment to appoint the trust asset among husband's and wife's descendants. Husband also had the right to acquire any asset in the trust by substituting other property of equivalent value. The IRS ruled that during wife's lifetime she would be treated as the owner of the ordinary income and corpus of husband's trust. The IRS also ruled that following wife's death, if husband survived he would not be treated as the owner of the ordinary income or corpus of husband's trust. It was this last ruling that prompted the IRS to issue this PLR revoking PLR 9026036 where the IRS ruled that the husband would be treated as the owner of the ordinary income and corpus of husband's trust following wife's death. The PLR does not contain any detailed explanation for the IRS position or the reason for the change in it position.

While a literal reading of Section 678(a) would suggest that the Crummey power holders would automatically become the "owners" of the trust for income tax purposes, that result will produce incredibly complex tax accounting burdens for the trustee. In the example above, who

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[4] PLRs 8326074, 8701007, 9141027, 9309023, 200730011.

would be treated as the owner or owners of the trusts for the three children? Is the trust for child 1 a normal complex trust or is it owned for federal income tax purposes by all 10 Crummey power holders? It may very well be that in PLR 9321050 the IRS was simply taking a practical position knowing that it will be impossible for both taxpayers and the IRS to administer trusts where years of lapsed powers held by numerous beneficiaries spring to life as ownership of the trust for income tax purposes following the death of the grantor. One can only hope!

Note: For more detailed reading on Section 678 see: Jonathan G. Blattmachr and Frederick M. Sembler, *Crummey Powers and Income Taxation*, The Chase Review (July, 1995); F. Ladson Boyle and Jonathan G. Blattmachr, *Blattmachr on Income Taxation of Estates and Trusts* (Practising Law Institute, New York City, Fifteenth Edition); Howard M. Zaritsky, *Grantor Trusts: Sections 671 - 679* (Tax Management, Inc., Portfolio No. 858-2nd); Christopher P. Cline, *Powers of Appointment - Estate, Gift, and Income Tax Considerations* (Tax Management, Inc., Portfolio No. 825-3rd; M. Carr Ferguson, James J. Freeland and Mark L. Asher, *Federal Income Taxation of Estates, Trusts and Beneficiaries* (Aspen Law & Business, Third Edition).

## III. AMT CONSEQUENCES OF TRUST EXPENSES THAT ARE SUBJECT TO THE 2% FLOOR UNDER SECTION 67

A great deal of attention has been paid to whether or not particular trust expenses are subject to the 2% deductibility floor. However, little attention has been paid to the AMT consequences of such characterization. Now, for the rest of the story.

Section 67(e) of the Code provides in part that "the deduction for costs which are paid or incurred in connection with the administration of the estate or trust and which would not have been incurred if the property were not held in such trust or estate . . . shall be treated as allowable in arriving at adjusted gross income." Although there is much controversy over exactly what expenses are described by section 67(e), the focus here is on the consequences of not being described by section 67(e). Let us assume that a non-grantor trust has a pure investment advisory expense of $100,000, and that under the *Knight* case that expense is not described in section 67(e). What is the effect of "flunking" section 67(e)?

Before turning to section 67(a) or 67(b), we must first look to section 63(d), which defines "itemized deductions" as "the deductions allowable under this chapter other than – (1) the deductions allowable in arriving at adjusted gross income, and (2) the deduction for personal exemptions provided by section 151." Thus, because our investment advisory expense "flunks" section 67(e), it is deemed an "itemized deduction."

Turning to section 67(b), we learn that the term "miscellaneous itemized deductions" refers to all "itemized deductions" other than the twelve specific deductions listed in section 67(b), which does not include investment advisory expenses (which are primarily deductible under section 212). Now that our investment advisory expense is categorized as a "miscellaneous itemized deduction", it is subject to the 2% floor contained in section 67(a). The negative consequences of being subject to the 2% floor depend entirely on the other elements of the trust's tax return for the year. For example, if the trust has $2,000,000 of adjusted gross income for the year and no other miscellaneous itemized deductions, our $100,000 investment advisory expense will only be allowed to the extent it exceeds $40,000. Thus, section 67(a) costs the trust $40,000 of deductions, or roughly $15,000 of federal tax. On the hand, if the trust has adjusted gross income of only $100,000 (if, for example, a $10,000,000 trust had flat investment results but still had to pay a 1% investment management fee), section 67(a) has no significant negative tax effect for the year.

The story does not end at section 67(a). Although many trust and estate lawyers do not understand the complexities of the alternative minimum tax, most of us are at least aware that section 55 requires the computation of "alternative minimum taxable income." If the alternative minimum taxable income exceeds $22,500 (for an estate or trust), a tax rate of 26% - 28% is applied to the excess to compute the tentative minimum tax, and if that exceeds the regular tax, the excess is the AMT.

In computing alternative minimum taxable income, section 56(b) provides (among many other adjustments) that "No deduction shall be allowed – (i) for any miscellaneous deduction (as defined in section 67(b))." Thus, when an expense "flunks" section 67(e), it also becomes non-deductible for purposes of computing AMT.

In the case of the trust with AGI of $2,000,000 and no miscellaneous itemized deductions other than the $100,000 investment advisory fee, there will ordinarily be no AMT consequences. However in the other scenario, where the trust has only $100,000 of AGI, the loss for AMTI purposes of the $100,000 investment advisory fee deduction will cause the trust to have alternative minimum taxable income of $100,000 and after reduction for the $22,500 exemption, the 26% tentative minimum tax is roughly $20,000. Because the regular tax would have been zero, the trust owes AMT of about $20,000.[5]

In short, in evaluating the tax consequences of a particular expense "flunking" section 67(e), it is necessary to look beyond the effect of the 2% floor pursuant to section 67(a), and analyze whether there will also be nasty AMT consequences.

## IV. AVOIDING THE APPLICATION OF SECTION 1014(e)

We all know that Section 1014(e) denies a basis step-up when appreciated property acquired by a decedent by gift passes to the donor of the gift on account of the decedent's death within one year of the gift. However, this does not mean that substantial basis step-ups cannot be obtained through the making of gifts to a dying spouse. Now, for the rest of the story.

Where appreciated property was gifted to a decedent within one year of his or her death, and upon the decedent's death such property passes to the person who originally transferred it to the decedent (or his or her spouse), then, under Section 1014(e), the basis of such property will not be stepped-up under Section 1014(a). This rule is applied arithmetically, and cannot be avoided by demonstrating that the decedent's death was unexpected. As a result, care should be taken when

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5 Practitioners should be aware that making distributions to beneficiaries does not avoid these potential negative consequences. Although the beneficiary will not receive any taxable income if the trust has $100,000 of gross income and $100,000 of deductions, the beneficiary will be required to reduce his or her deductions for AMT purposes by the $100,000 passed through miscellaneous itemized deduction.

transferring property between spouses as gifts, if, upon the death of one spouse, the surviving spouse receives such property under the decedent's Will.

Section 1014(e) was enacted in 1981, obviously to prevent married couples from utilizing the newly enacted unlimited marital deduction to obtain a stepped-up basis on all marital property in the case of a terminally ill spouse. There are no regulations under 1014(e), although there had been a regulations project which was closed in 1986.

Note that the limitation does not apply if the transferred property is bequeathed to someone other than the original transferor (or his or her spouse). Query, would Section 1014(e) apply if the property was distributed to a GPOA marital trust under the decedent's Will? What about a QTIP Trust? What about a credit shelter trust where the spouse is the sole trustee and sole beneficiary? Would the same rules for not aggregating assets held in a marital trust with the spouse's own assets for valuation purposes, apply here as well? Under those rules, so long as the marital trust is drafted to assure that the spouse does not have too much control over the trust fund (such as, for example, holding a general power of appointment over the trust fund), then the entity interests held in the marital trust will be valued without aggregating such interests with any of the entity interests held by the spouse directly. [6]

If the spouse of a terminally ill individual has substantial appreciated assets, and the individual has at least some chance of living for at least a year, the spouse should give appreciated assets to the individual, so that he or she may pass them back to the spouse at death. This is basically a no-lose situation. If the donee spouse lives at least one year, they are home free with a basis step-up; if he or she fails to live at least one year, the property comes back to the donor spouse with the original basis, and no harm has been done. The only downside is that there is always a possibility that the "healthy" spouse could die first.

It is important that the transfer of appreciated property from one spouse to the other is a gift with no strings attached, and with no agreement that the property will be returned at death. However, if an outright gift is inadvisable because, e.g., the terminally ill spouse does not have the capacity to execute an appropriate will to return the property to the donor spouse, the original gift can be made in the form of a QTIP trust for the ill spouse, with the remainder coming back to the donor spouse at the ill spouse's death.

Even if the donee spouse is not expected to, or in fact does not, survive at least one year after receiving the gift, it may be possible to obtain at least a partial basis step-up for the property.

In the context of a very complex fact pattern, the IRS ruled in PLR 9026036 that where property was to be returned at the donee spouse's death to the donor spouse in the form of a life income trust, only the portion of the trust allocable to the life income interest would be affected by Section 1014(e), and the remainder interest in the trust would not be deemed to pass back to the

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6 See *Estate of Bonner v. US.*, 84 F.3rd 196 (5th Cir. 1996), *Estate of Mellinger v. Comm'r*, 112 T.C. 26 (1999), acq. 1999-2 C.B., *Estate of Nowell v. Comm'r*, T.C. Memo. 1999-15, *Estate of Fontana v. Comm'r*, 118 T.C. 318 (2002), LTR. Rul. 200648028 (August 4, 2006). But see Rev. Rul. 79-7, 1979-1 C.B. 294, where the IRS found that the decedent had so much control over the trust fund that aggregation was appropriate.

donor spouse and would thus qualify for a basis step-up. This ruling was partially reversed as to other issues and reissued as PLR 9321050, but there was no change to the provisions of the ruling relating to Section 1014.

Although these rulings cannot be relied on as precedent, they certainly provide enough support to take the position that the property bequeathed back to the donor spouse in a QTIP trust (without the possibility of principal distributions to the spouse) will receive a partial step-up proportionate to the fraction of the trust actuarially attributable to the remainder interest.

For Example:

Mr. Client is terminally ill and may well die in less than one year. Mrs. Client owns various assets with a current value of $5,000,000 and an adjusted basis of $1,000,000, which are expected to be sold within a few years. Mr. and Mrs. Client are both 80 years of age. Mrs. Client makes an outright gift of all the appreciated assets to Mr. Client, who shortly thereafter executes a new will bequeathing the assets to a QTIP trust for Mrs. Client. She will be entitled to the net income from the trust for her life, but the trustee is not permitted to make principal distributions to her.

If Mr. Client survives for more than one year, it is clear that the assets will receive a full basis step-up. Assuming no further appreciation, when Mrs. Client (or the QTIP trust) sells the assets there will be no capital gain, as contrasted with the $4,000,000 capital gain which would have been realized if the inter-spousal gift had not been made.

If Mr. Client instead dies within one year after receiving the gift, the QTIP trustee will have a good argument that, although the portion of the trust allocable to Mrs. Client's income interest will not receive a basis step-up, the portion allocable to the remainder interest will. Because the value of Mrs. Client's life income interest is approximately 35% of the trust at a 6% §7520 rate, the trust should receive a basis step-up of 65% of $4,000,000, or $2,600,000 – still a substantial benefit.[7]

If Mr. Client instead bequeaths the property to a trust in which Mrs. Client has only a discretionary interest, such as a credit shelter sprinkle trust, arguably, §1014(e) does not apply at all because Mrs. Client has not received any portion of the property back. Of course, the IRS might well take the position that, because it is impossible to determine how much, if any, of the trust will not go to the spouse, §1014(e) should apply to the entire amount that could be distributed to her, *i.e.*, the entire amount of the trust.

If the family's financial situation is such that a bequest back from the dying spouse can go to the next generation without including any interest to the surviving spouse, the appreciated property in an amount equal to the dying spouse's available applicable exclusion amount can be transferred to the dying spouse and indisputably receive a full basis step-up when transferred to the next generation at the death of the dying spouse.

[7] This percentage may seem high for an 80 year old surviving spouse. Interestingly, the percentage increases to about 50% if the surviving spouse is 70 years old.

## V. MAKING A TRUST BENEFICIARY THE "GRANTOR" FOR GRANTOR TRUST PURPOSES

We all recognize the potential benefits of intentional grantor trust status. Are there other situations where a trust beneficiary (who is interested in transfer tax planning) can be treated as the owner of a trust for federal income tax purposes under Section 678 or otherwise? Now, for the rest of the story.

For example:

When an elderly client is the income beneficiary of a trust that will terminate at her death but will not be includible in her estate, there will not be a basis step-up at her death, and the remaindermen will owe capital gains tax upon their post-death sale of appreciated assets from the trust. Selling the assets at the trust level is no better, because the capital gains tax will be paid out of the trust and thus effectively by the remaindermen. However, the use of an S corporation can shift the capital gains tax to the beneficiary herself, generating an estate planning benefit.

Consider having the trustee form an S corporation within the trust, into which all of the appreciated assets are transferred in exchange for the S corporation stock. Pursuant to section 351(a) there will be no gain recognition on the exchange, and the new S corporation will have the same basis in the assets as the trust previously had. In order to qualify the trust as an eligible S corporation shareholder, the beneficiary will make a timely qualified subchapter S trust ("QSST") election pursuant to section 1361(d). Pursuant to section 1361(d)(1)(B), the effect of the QSST election is that "for purposes of section 678(a), the beneficiary of such trust shall be treated as the owner of that portion of the trust which consists of stock in an S corporation with respect to which the election under paragraph (2) is made."

The trustee, who is also president of the S corporation, sells the appreciated assets owned by the corporation. The beneficiary is treated as the owner of the S corporation for income tax purposes, and accordingly is required to report on her own personal income tax return all of the corporation's taxable income, regardless of whether the corporation has made any distributions to the trust. This effectively reduces her gross estate by the amount of the capital gains tax, and assuming the trust remaindermen also receive the beneficiary's probate estate, they realize a benefit equal to the estate tax that would have been payable on the capital gains tax.

Because of the requirements for QSST qualification, the use of this technique requires that the beneficiary of the trust be the sole beneficiary and entitled to all of the net income of the trust. Because this is not as common a trust structure as it use to be, many trusts will not qualify, but it may be possible to use a technique such as "decanting" to effectively modify the trust so that it can qualify as a QSST.

Note that there may be an additional income tax related benefit from the incorporation of trust assets into a QSST. If the trust assets generate substantial income (that the beneficiary does not need but must receive under the terms of the trust), and the assets are incorporated into a QSST, the beneficiary will still be taxed on all the income earned within the S corporation, but will only receive the income actually distributed by the corporation as a dividend – which may be very low (but beware that the IRS may take exception if the corporation becomes entirely non-income producing).

As another example, is it possible  to use the rules in Section 678 to make a surviving spouse the "owner" of a credit shelter trust, requiring the spouse to pay the tax on trust income that she will not likely receive.

Assume the following facts:  Husband dies and his Will creates a Credit Shelter Trust for his wife.  The trust designates wife as the sole trustee with the power to pay income and principal to wife pursuant to an ascertainable standard.  Can Section 678(a) be applied to wife's power over income and principal as sole trustee to treat the wife as the owner of the entire trust for federal income tax purposes.  This issue has been raised at several meetings of the ACTEC Fiduciary Income Tax Committee and several Fellows on the Committee have indicated that they do use this technique to cause the surviving spouse to be taxable on trust income (ordinary income and capital gains).  The question seems quite simple:  Is the power held by a sole beneficiary/trustee to pay income and principal to the beneficiary/trustee pursuant to an ascertainable standard "a power exercisable solely by the beneficiary/trustee to vest the corpus or the income of the trust in the beneficiary/trustee?"  We are unaware of any pronouncement from the IRS by ruling or Regulation on this issue.  There is, however, a 1960 decision by the Ninth Circuit Court of Appeals in *United States v. de Bonchamps,*[8] that is on point.

In *De Bonchamps* the taxpayers were the two daughters of the testator.  The Will gave each daughter a life estate in one-half of the decedent's estate.  Upon the death of a daughter, the remainder was to go to her children then living and the issue of any deceased child per stirpes. Specifically the Will provided:

> "Each of my said daughters may consume, use, invest and reinvest her share and the income therefrom for her needs, maintenance and comfort during her life without any restriction and her children and the issue of a predeceased child shall take only what remains of her share on her death."

The government argued that the powers given the life tenants were so broad that they should be treated as the beneficial owners of the entire property and taxed on the ordinary income and capital gains.  The Court indicated that the situation presented was most similar to a trust and that the most pertinent cases were the cases in the Clifford area and more specifically the *Mallinckrodt* case.[9]   The Court went on to say that these cases gave rise to the grantor trust rules in Subpart E of Part I of Subchapter J, and specifically Section 678 which the Court said dealt with the situation confronted by the Court.  The Court stated that the question to be answered is "whether the powers of these taxpayers may be said to constitute a power to vest the corpus in themselves." In ruling in favor of the taxpayers the Court said"

> We have concluded that, upon the record before us, the powers of these life tenants are not the equivalent of a power to vest in themselves the corpus of the estate of the capital gains in question.  A life tenant under these testamentary provisions may not in any manner control the disposition of the corpus save by consuming it for the enumerated purposes.  She may not give it away nor make

8 278 F.2nd 127 (9th Cir. 1960); see also *Townsend v. Commissioner*, 5 T.C. 1380 (1945).

9 *Helvering v. Clifford*, 309 U.S. 331, 60 S. Ct. 554 (1940); *Mallinckrodt v. Nunan,* 146 F.2nd 1 (8th Cir. 1945).

> testamentary disposition of it. She has no power of appointment. She may not change the beneficiaries nor reapportion their shares.
>
> Nor has any one of these life tenants the unlimited power to take the corpus of the estate to herself. Her power to consume is expressly limited to her needs, maintenance and comfort. Nor may it be said that the boundaries of such power as so expressed are so vague as to constitute no real limitation upon the power to consume.

In essence the Court ruled that the powers held by the daughters were limited and subject to review and thus were not exercisable "solely" by the daughter. Applying the rationale in *De Bonchamps* to the facts outlined above, it is quite likely that Section 678(a) would not apply to make the beneficiary/trustee the owner of the trust. How this decision might be impacted by the provisions in trust agreements is uncertain. For example, how might the IRS or the Courts view a power in a sole beneficiary/trustee to:

> "pay or apply all or any part of the income and principal to or for the benefit of the beneficiary/trustee that my trustee in its discretion (or sole discretion or sole, absolute and uncontrolled discretion) considers advisable for the beneficiary/trustee's education, maintenance in health and reasonable comfort or support in the beneficiary/trustee's accustomed standard of living, with no duty to consider other income or other resources available to the beneficiary/trustee. "

This exact provision appears in many trust documents. Without a duty to consider other resources it would seem that the beneficiary/trustee has the absolute power to withdraw amounts required to meet the reasonable comfort or accustomed standard of living standard whether or not the funds were actually needed to provide that support. Would this be viewed as a power that is caught under 678(a)(1) and (2) or will the fact that the determination of the ceiling on the invasion right is always subject to review prevent the application of Section 678(a)?

Lastly, can we use lapsed hanging powers to get the result we want?

With credit to Richard A. Oshins, Esq., Oshins & Associates, LLC, Las Vegas, Nevada for this idea:

A trust has hanging powers, so to the extent the gifts to the trust exceed the greater of the 5 or 5 amount, the Crummey beneficiary has a general power of appointment and therefore that portion of the trust would be a grantor trust with respect to such beneficiary.

To the extent the amount over which the power to withdraw has lapsed, Section 678 provides that a person other than the grantor shall be treated as the owner of any portion of a trust with respect to which : ". . . such person has a power exercisable solely by himself to vest corpus or income therefrom in himself or has previously partially released such power and after the release retains such control as would under Sections 671 through 677 cause the person to be considered a grantor."

The Section 678(b) exception to this rule, with respect to a power over income, applies if the original grantor would otherwise be treated as an owner. The exception doesn't apply, however, so long as the trust is not a grantor trust with respect to the original grantor.

The Crummey beneficiary would have a grantor trust power if he held a lifetime limited power of appointment over such property, which is the power to control beneficial enjoyment under Section 674. (The exception under Section 674 is for testamentary powers of appointment, not lifetime powers of appointment.)

The trust would therefore be a wholly grantor trust with respect to the Crummey beneficiary, due to his general power of appointment over the property that has not lapsed and his lifetime limited power of appointment over property that has lapsed.

In addition, the trust fund property over which the Crummey power has lapsed is not includable in the Crummey beneficiary's estate because the limited power of appointment only applies with respect to powers that lapsed under the 5 or 5 power, and over those amounts for which the Crummey beneficiary is not considered a transferor. So Sections 2036 and 2038 do not cause estate tax inclusion in the Crummey beneficiary's estate (although the amounts that have not lapsed are includable in the Crummey beneficiary's estate until the lapse occurs).

## VI. STEPPING UP THE BASIS OF GRANTOR TRUST ASSETS

One of the drawbacks of lifetime giving to a trust is that any appreciated assets in the trust at the time of the grantor's death will not get a basis step-up pursuant to Section 1014. This is equally true whether the trust is a grantor trust or not, but in the case of the grantor trust it may be possible to get a step-up by getting the appreciated assets into the grantor's estate. Now, for the rest of the story.

The principal benefit (or detriment depending on your point of view) of grantor trust status is that the trust is treated as owned by the grantor for federal (and for many but not all states) income tax purposes. All items of income, credit and deduction are reported on the grantor's income tax return (not the trust return), and any transaction between the grantor and his or her grantor trust is disregarded for income tax purposes. Accordingly, the grantor has the power to exchange cash or other high basis assets for low basis assets in the trust without recognition of gain, in effect giving the trust a step up in basis it would not have received had the grantor died without having made the exchange. If cash is not readily available, the grantor may want to negotiate a line of credit with a bank that can be accessed by the grantor or his or her advisors shortly before death to make the exchange. Following the grantor's death the low basis assets now in his estate get a step up in basis and can be sold income tax free and the proceeds used to pay back the loan. If an exchange is not possible the trustee of the grantor trust may want to consider a sale of the appreciated assets shortly before the grantor's death. This would cause the gain to be reported on the grantor's final income tax return and any tax due would be a debt deduction on the grantor's federal estate tax return. The trust would receive, in effect, a step up in basis, and the capital gains tax cost would be substantially reduced by the deduction on the estate tax return. When making last minute decisions to swap or sell assets from a grantor trust it is important to keep in mind that grantor trust status ends on of the day preceding the date of the grantor's death.

## VII. INCOME TAX REIMBURSEMENT PROVISIONS IN GRANTOR TRUSTS: TO INCLUDE OR NOT TO INCLUDE?

A grantor's payment of an income tax liability generated by income from assets in the trust, which is actually his or her liability under the grantor trust rules, effectively allows the trust to invest on an after-tax basis and has the economic effect of allowing a grantor to "add" more assets to the trust for the benefit of the trust's beneficiaries without transfer tax consequences. But is this really the best approach for the grantor? Now, for the rest of the story.

While it seems sensible that the grantor's payment of his or her own income tax liability should not be a gift, the Service, in Ltr. Rul. 9444033, stated that, by paying a trust's tax liability, a grantor would be treated as having made an additional transfer to the trust, unless the trust instrument provides for the reimbursement of the grantor from trust funds. This position had been subject to considerable criticism, and in Ltr. Rul. 9543049 the Service deleted the language in Ltr. Rul. 9444033 relating to the gift tax implications of the grantor's payment of the income tax liability generated by the grantor trust income.

Rev. Rul. 2004-64[10] put this issue to rest, by holding that no gift resulted from the grantor's payment of the income taxes on income includible in his or her gross income which was generated by his or her grantor trust.

In Rev. Rul. 2004-64, the IRS ruled that when the grantor or a grantor trust pays the income tax attributable to the inclusion of the trust's income in the grantor's taxable income, the grantor is not treated as making a gift of the amount of the tax to the trust beneficiaries, because the grantor, not the trust, is liable for the income taxes. The IRS also ruled that if the trust instrument directs the independent trustee to reimburse the grantor for the amount of income tax, the reimbursement is not a gift from the beneficiaries of the trust to the grantor, because the reimbursement is mandated by the terms of the trust. However, the grantor's right to be reimbursed from trust assets for the tax is a right to have trust property expended in discharge of the grantor's legal obligation, so the full value of the trust would be includible in the grantor's gross estate under Section 2036. This is also true if governing state law requires the trust to reimburse the grantor for the taxes paid, unless the trust instrument provides to the contrary.

The ruling further held that a mere authorization in the trust instrument to reimburse the grantor for taxes the grantor pays on income tax attributable to the trust will not cause the trust to be includible in the grantor's estate. However, this assumes "there is no understanding, express or implied," between the grantor and the trustee regarding the trustee's exercise of its discretion. Other facts the ruling notes that might cause estate tax inclusion are a power retained by the grantor to remove the trustee and appoint the grantor, or applicable state law subjecting the trust assets to the claims of the grantor's creditors.

The safest approach to avoid these issues appears to be to draft the trust instrument to prohibit reimbursement of the grantor for the tax on trust-generated income. However, compelling reasons to authorize reimbursement may be present in some cases. If so, careful consideration should be given to whether the factors that might cause inclusion in the grantor's gross estate are present. Among other things, the trust instrument must not give the grantor the power to appoint

[10] 2004-2 C.B. 6.

himself or herself as trustee, directly or indirectly (such as the grantor having the power to remove a trustee and replace the removed trustee with a non-independent trustee) and the trust should not be created pursuant to the laws of a state that might subject the trust assets to the claims of the grantor's creditors because of the reimbursement provision.

If a potential grantor of a grantor trust wanted to avoid this issue (or if he or she simply did not want to be "out-of-pocket" for the income taxes generated by trust income) the trust could include a reimbursement clause. If a reimbursement clause is included in the trust, however, then not only is there possible inclusion of the trust in the grantor's estate for estate tax purposes, but if the grantor paid the income tax and was not reimbursed by the trust, a gift would result, not from payment of the income tax liability, but from failure by the grantor to enforce his or her right of reimbursement.

The other, perhaps more certain way, to prevent the grantor of what would otherwise be a grantor trust from being taxed on the trust's income, when that becomes an economic issue, is to give the grantor the power to release the power(s) that made the trust a grantor trust (or to give the trustee the power to revoke those powers). Note, however, that if the trust is a grantor trust as to ordinary income because of the Section 677(a)(3) power to pay premiums out of trust income, that power can't be released by the grantor and would not normally be allowed to be revoked by the trustee (unless the trust can be modified under state law). However, an independent Trustee (as defined in Section 672(c)) could be given the power to amend the trust agreement, and, exercising this power, delete the provision that permits the payment of premiums from the income of the trust.

Also note the IRS pronouncement that a grantor trust which contained a "toggling" power, allowing the trustee to turn off grantor trust status and turn it back on, which was used to achieve a tax savings for the grantor, was declared to be a "transaction of interest" in Notice 2007-73[11]; accordingly, it was a reportable transaction and subject to the taxpayer reporting requirements under Treas. Reg. Section 1.6011-4(b)(6) and Sections 6111 and 6112. Presumably, a power held by a trustee solely to “turn off” grantor trust status but not then “turn it back on”, or the ability of the grantor to relinquish the power, would not be subject to this rule.

## VIII. MISCELLANEOUS ISSUES

### A. <u>Should certain assets be subject to a Section 675(4) substitution power.</u>

Section 675(4)(C) provides that one grantor trust power is the administrative power to reacquire trust assets by substituting assets having an equivalent fair market value, held in a non-fiduciary power (by the grantor or any other person), without the approval or consent of anyone acting in a fiduciary capacity. In *Jordahl v. Comm'r*,[12] the Tax Court held that such a power held by the grantor-insured was not an incident of ownership in the policy owned by the trust for purposes of Section 2042(2). In *Jordahl*, however, that power was held in a fiduciary capacity; <u>query</u> if the estate tax result would have been the same for a power held in a non-fiduciary capacity (as is

[11] 2007-36 I.R.B. 545.

[12] 65 T.C. 92 (1975).

required for grantor trust status).[13] Would the result be the same if the asset was not a life insurance policy but voting stock in a "controlled corporation" as defined in Section 2036(b)?

Note the technique of giving the power of substitution to someone other than the grantor (presumably a non-adverse party), to avoid any Section 2042(2) risk for the grantor (but raising the possibility the power would be used by the powerholder to remove the asset from the trust). Conceptually, it's difficult to understand how a third party could reacquire the asset (since he or she never owned it), but see Ltr. Ruls. 9026036, 9037011, and 9247024, approving such a power as conferring grantor trust status on the trust and the IRS model CLAT that used a third party substitution power. In addition, the same issue would be raised where the grantor contributed cash to the trust which acquired the asset; there, the grantor isn't reacquiring the policy, since he or she never owned it.

B. State income tax issues

For all trusts it is crucial for the trustee to focus on the filing requirements of the states where trustees reside (or do business if a corporate trustee) and where beneficiaries reside. The reason for this is that there are a significant number of states that base trust taxation solely on the presence of a trustee or a beneficiary in the state regardless of the actual situs of the trust.

C. QPRT Planning for post QPRT period

Upon the termination of the QPRT term, in most situations it will make sense for the residence to be held in a continuing grantor trust for the grantor's children or spouse and children. This will avoid awkward problems present with an outright distribution where the children don't want to rent the house back to the grantor/parent or where one or more of the children are in financial difficulties (claims by a spouse in a divorce or by a judgment creditor) and claims are made against the share of the house in the problem child's name. Further, if the house is in a grantor trust, the grantor can enter into a lease agreement with the trustee and the rent payment won't constitute taxable income to the trust, the deductible expenses (real estate taxes) will remain a deduction on the grantor's personal income tax return and the residence will not be subject to depreciation. If the house is sold while the trust remains a grantor trust the grantor will be entitled to the applicable capital gains exemption for the sale of a principal residence.

D. Comments on drafting documents to permit change and manipulation of income tax results

Given the complexity and constant change in our tax laws and the ever changing dynamics within families, it is extremely difficult to draft trust agreements that anticipate all future circumstances. The key today is flexibility and the ability to change documents to deal with unanticipated issues. Several states have enacted what are referred to as "decanting statutes" that within certain limitations give the trustee the flexibility to make necessary changes without having to resort to court modifications. Since only a few states have these statutes, estate planners should consider including decanting provisions in all trust documents. If the grantor or testator is unwilling

[13] See Ltr. Ruls. 9413045 and 9227013. See also, Rev. Rul. 2008-22, holding a power of substitution not to be a retained power under Sections 2036 or 2038 (if certain conditions are met), but not referring to Section 2042.

to give the independent trustee such a broad power of appointment, at the very least the document should give the independent trustee the power to change the governing law (without judicial proceedings, if possible) and thereby give the trustee the ability to take advantage of more favorable laws in another jurisdiction.

E. Income tax treatment of termination of grantor trust status: the arguments

Assuming the trust is drafted as a grantor trust, it will cease to be a grantor trust upon the death of the grantor (if there are two grantors - because each contributed to the trust, or joint or community property was contributed - at the death of the first grantor, half of the trust's grantor status would presumably end, however, if state law uses a contribution rule and considers a trust with two grantors the same as a joint account, if the deceased grantor contributed all of the property to the grantor trust, the entire trust may lose its grantor trust status), or upon termination of the power(s) which caused it to be treated as a grantor trust during the grantor's life. Because the grantor relinquished that power (or all such powers) or they were revoked under a power granted in the trust instrument. As a result, the trust will no longer be disregarded for income tax purposes, and instead will be treated as a separate taxable entity.

As discussed below, on termination of the trust's grantor status during the grantor's lifetime, if the trust then has any outstanding liabilities (to the grantor or to a third party), the termination of that status will be treated as a sale of the policy by the grantor for the liability. That deemed sale would generate gain, to the extent the outstanding liability exceeded the grantor's basis in the policy.

There is less certainty about the income tax consequences of termination of grantor trust status as a result of the death of the grantor, where the trust has outstanding liabilities (to the grantor or to a third party). As discussed below, some commentators believe that the grantor's death has no tax consequences; under that analysis, death is not an event that triggers gain recognition. Another possible result, and the one which the IRS would likely endorse, is that the income tax consequences on the death of the grantor follow those that are deemed to occur when grantor trust status is terminated during the grantor's life, as set forth in the regulations under Section 1001 and other authorities, discussed below. Under that analysis, the income tax consequences would be the same whether termination of grantor trust status is a result of the grantor's death or a termination of the applicable grantor trust power(s) during the grantor's life.

On termination of the trust's grantor trust status during the grantor's life, the grantor will be deemed to have transferred to the trust for income tax (but not for gift or GST tax) purposes: (i) the assets in the trust, and (ii) the liabilities of the trust.[14]

Under the Section 1001 Regulations, there may be immediate income tax consequences to the grantor when grantor trust status is terminated, if the trust has any outstanding liabilities (whether to the grantor or to a third party) and those liabilities exceed the grantor's basis in the assets deemed transferred to the trust; however, as in any other capital asset sale context, the grantor will recognize gain only to the extent the liabilities of the trust exceed the grantor's basis in the assets deemed transferred to the trust. Under the general rule of Treas. Reg. Section 1.1001-

14 See Treas. Reg. Section 1.1001-2(c) Example 5; *Madorin v. Commissioner*, 84 T.C. 667 (1985); Rev. Rul. 77-402, 1977-2 C.B. 222; TAM 200011005 (Mar. 17, 2000).

2(a)(1), the amount realized from a sale or other disposition of property includes the amount of liabilities from which the transferor is discharged as a result of such sale or disposition; in this case, the trust's deemed assumption of the grantor's liabilities will be treated as a discharge of the grantor's liabilities in consideration for the assets (the policy) that the grantor is deemed to have transferred to the trust.

However, Treas. Reg. Section 1.1001-2(a)(3) provides an exception to this rule when a liability is incurred for purposes of acquiring property and is not taken into account in determining the transferor's basis in such property (for example, where the loan is between the grantor and the trust and thus is ignored for income tax purposes under Rev. Rul. 85-13, above). Under these circumstances, the assumed liability will not be included in the amount realized by the transferor and therefore will not cause recognition of gain. Note that the exception does not, by its terms, apply to liabilities disregarded for income tax purposes because of the relationship of the lender and the borrower and the implications of Rev. Rul. 85-13. It may be that it was intended to apply to liabilities that were too contingent to be an adjustment to basis.

Example 5 of Treas. Reg. Section 1.1001-2(c) illustrates what is deemed to occur on termination of grantor trust status during the grantor's life. In the Example, a grantor was considered to be the partner of a partnership in which the grantor trust held an interest. Upon termination of grantor trust status on the renunciation of a grantor trust power, a constructive transfer of the partnership interest to the trust was deemed to occur. The Example concludes that the grantor is required to recognize gain to the extent the allocable share of partnership liabilities assumed by the trust exceeds the grantor's basis in the partnership interest. Similarly, in *Madorin v. Commissioner*, above, a grantor transferred to a grantor trust an interest in a partnership that held encumbered assets. The grantor deducted the net losses from the partnership until the trustee renounced a power that had caused the trust to be a grantor trust. The court held that the grantor was released from his share of the underlying liabilities and recognized a gain to the extent that these liabilities exceeded the basis of the partnership interest.

It should be noted that at least one article has suggested that this exception does not apply to exclude liabilities that were originally incurred by the trust, rather than the grantor, to acquire assets.[15] Citing TAM 200011005, the article concludes that in order to fall within the exception of Treas. Reg. Section 1.1001-2(a)(3), the liability must have been incurred as a result of the grantor's acquisition of an asset, rather than the trust's. It seems, however, that the factual background described in TAM 200011005 may require a narrower application of the ultimate conclusion reached by the IRS than the article suggests.

In TAM 200011005, the grantor transferred appreciated stock to a grantor trust that was administered as two separate GRATs for a short period, with the grantor trust making annuity payments to the grantor. In order to make the required annuity payments to the grantor, the trustee borrowed money from another trust. On termination of the grantor trust status, the trust disposed of the appreciated stock to remainder trusts for the benefit of the grantor's nephews. The IRS believed that under Treas. Reg. Section 1.1001-2(a), the debts incurred by the grantor trust for purposes of making the annuity payments and secured by the trust assets should be treated as

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15 See Deborah V. Dunn & David A. Handler, *Tax Consequences of Outstanding Trust Liabilities When Grantor Status Terminates*, Journal of Taxation, July 2001.

amounts realized by the grantor when the trust ceased to be a grantor trust. The taxpayer argued, in relevant part, that the exception provided by Treas. Reg. Section 1.1001-2(a)(3) should apply, because the debt was incurred by reason of the trust's acquisition of the stock. The IRS disagreed, stating that language of the exception can only be reasonably read to refer to indebtedness incurred in connection with the grantor's acquisition of the stock. In essence, the debt under these facts was not acquisition indebtedness because neither the grantor nor the trust incurred the debt in order to *acquire* the stock. Rather, the trust incurred the indebtedness because it <u>held</u> the stock.

The article correctly summarizes the conclusion of TAM 200011005 that the liabilities must have been incurred as a result of the *grantor's* acquisition of the stock in order to fall within the intended application of the exception; however, the article fails to discuss the specific facts which lead the IRS to this conclusion in the TAM. Arguably, if the *trust* had incurred the liabilities in connection with *acquiring* the stock, the exception would have applied. Applying this reasoning, the liability incurred by the insurance trust for purposes of acquiring the life insurance policy could be the type of acquisition indebtedness contemplated by Treas. Reg. Section 1.1001-2(a)(3), and, therefore, under that reasoning, any discharge of that indebtedness resulting from termination of the trust's grantor trust status would fall within the exception and would therefore not be included in the amount realized by the grantor for income tax purposes.

However, even if the exception contained in Treas. Reg. Section 1.1001-2(a)(3) does not apply, the termination of the trust's grantor trust status still should not result in a recognition of gain by the grantor, as long as the liability incurred by the trust to acquire the assets does not exceed the grantor's basis in the asset.

As discussed above, there is substantial uncertainty and debate among commentators regarding the income tax consequences on termination of grantor trust status as a result of the grantor's death, where the trust has outstanding liabilities at that time. As discussed above, the authorities dealing with the income tax consequences on termination of grantor trust status where the trust has outstanding liabilities only pertain to termination during the grantor's life.[16]

Some commentators view the transfer of assets that is deemed to occur on the grantor's death as tantamount to a testamentary transfer of the assets to the trust. Under this theory, a gain-on-death rule is contrary to the rule of Section 1001 and, accordingly, no gain should be triggered on the deemed transfer of the assets to the trust upon the death of the grantor.

On the other hand, the IRS will likely argue, and other commentators believe, that when grantor trust status is terminated by the grantor's death, the deemed transfer of the assets to the trust triggers gain to the extent any assumed liability exceeds the grantor's basis in the assets transferred, just as in the case of termination of grantor trust status during the grantor's life.[17]

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[16] See Treas. Reg. Section 1.1001-2(c) Example 5; *Madorin v. Commissioner,* above; Rev. Rul. 77-402; TAM 200011005.

[17] See Treas. Reg. Section 1.1001-2(c) Example 5; *Madorin v. Commissioner,* above; Deborah V. Dunn & David A. Handler, *Tax Consequences of Outstanding Trust Liabilities When Grantor Status Terminates*, above; Fred Nicholson, Sale to a Grantor Controlled Trust: Better Than a GRAT, 37 Tax Management Memorandum 99 (1996), in which the author acknowledges

Thus, under this analysis, as discussed above, on the grantor's death and the corresponding termination of grantor trust status of the trust, the grantor will be deemed to have transferred the asset(s) to the trust in exchange for the assumption by the trust of the loan incurred in connection with the acquisition of the asset(s). Under the general rule of Treas. Reg. Section 1.1001-2(a)(1), the grantor will recognize gain to the extent the liability assumed by the trust exceeds the grantor's basis in the policy. However, if it is determined that the exception of Treas. Reg. Section 1.1001-2(a)(3) applies, because the liability was incurred in connection with the acquisition of the asset(s) and was not taken into account in determining the transferor's basis, then no gain will be recognized by the grantor (or his or her estate) on termination of the trust's grantor trust status, even if the liability deemed assumed exceeds the grantor's basis in the asset(s).

If the exception contained in Treas. Reg. Section 1.1001-2(a)(3) does not apply, because of the conclusion reached in TAM 20011005, termination of the trust's grantor trust status should still not result in a recognition of gain by the grantor because the liability (the loan proceeds) should equal the grantor's basis in the asset(s). Consequently, the liability associated with the asset(s) and deemed assumed by the trust will be offset by the grantor's basis in the policy, and no gain should be recognized on the termination of the trust's grantor trust status as a result of the grantor's death.

F. Transfer for value of a policy on termination of grantor trust status

There is another issue that may arise upon the termination of the trust's grantor trust status that holds a life insurance policy for which the trust borrowed funds to pay the premiums and the resultant deemed transfer of the policy in exchange for the release of the grantor's liability – whether a transfer for value of the policy under Section 101(a)(2) has occurred upon that deemed transfer.

Under the transfer for value rules of Section 101(a)(2), life insurance proceeds in excess of the owner's investment in the contract will be taxed as ordinary income if there has been a transfer of the policy or any interest in the policy during the insured's lifetime for valuable consideration. If a policy is transferred for value, the amount includable in taxable income is the death benefit minus (i) actual value of any consideration received (in this case, relief from the liability), and (ii) premiums and other amounts subsequently paid by transferee (which, in this case would not occur).

Transfers for value include a sale of a policy or an interest in a policy, a transfer of rights in and to policy proceeds for consideration, and transfers of a policy subject to a loan (which exceed the owner's basis in the policy). Treas. Reg Section 1.101-1(b)(4). Transfers are broadly defined under this Section, but it isn't clear that they are broadly enough defined to include a deemed transfer for income tax purposes that does not involve an actual transfer of an interest in a policy or its proceeds – this deemed "transfer" does not change who will benefit from the policy proceeds (i.e., the beneficiaries of the trust don't change), which is the concern which underlies the transfer for value concept. See e.g., PLR 9410034, which held that where a partnership was

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that the reasoning in Treas. Reg. Section 1.1001-2(c) and the *Madorin* case may cause the recognition of gain on the grantor's death to the extent the deemed transfer of assets subject to a liability exceeds the grantor's basis in those assets.

terminated for tax purposes because 50% of the partners (who would have benefited from the proceeds) changed, there was a transfer for value of its policies; here, however, there is no change in the trust beneficiaries as a result of the grantor's death. See also PLR 200826009, where a transfer of the policy and therefore a transfer for value was not found to have taken place, when the policy was held in a limited liability company, even though interests in the company were transferred, because the company's partnership status was not deemed to have been terminated since less than fifty percent of the capital and profits interests in the partnership were transferred in a 12-month period.

In addition, it is arguable that since the loan from the grantor to his or her grantor trust is ignored for income tax purposes, as discussed above, there is no liability to which the policy is subject, and that at the grantor's death, an interest in the policy is not being transferred, only death proceeds are being paid (unless perhaps the policy were a survivorship policy and the other insured were still alive).

If there is a transfer for value issue in this situation, there is an unresolved issue as to when the "transfer" takes place – at the moment of, the moment before, or the moment after the event ending grantor trust status - in this case, the insured's death. There isn't any direct authority on this issue, but there is an arguably analogous area – the termination of grantor trust status of a foreign trust taxed under Section 679. There, on the one hand, Reg. Sec. 1.679-2(c)(2), provides that the deemed transfer takes place on the first day of the year <u>after</u> the year in which grantor trust status ends, but on the other hand, Reg. Sec. 1.684-2(e), example (2), provides upon the death of the grantor, he or she is treated as having transferred the property to the trust <u>immediately before</u>, but on the same day as, grantor trust status of the trust ends. In the transfer for value situation, if Reg. Sec. 1.684-2(e), example (2) applies, it would seem that if the rule is that the policy would be deemed to be transferred immediately before, but on the same day as, the grantor died, there would be a deemed transfer of the policy during the insured's life.

If there is a transfer for value in this situation, the transfer would have to be analyzed to ensure that the deemed transfer or the trust, which is now a non-grantor trust, falls into one of the exceptions to the transfer for value rule.[18]

Briefly, there are five exceptions to the transfer for value rule under Section 101(a)(2). If a policy is transferred for valuable consideration, but the transfer fits within one of these exceptions, the death benefit will not be subject to income tax. One of the five exceptions, the carry-over basis exception could be applicable in the context of a deemed transfer that would occur when a grantor trust becomes a non-grantor trust and the non-grantor trust has an outstanding liability. If the basis in the policy in the hands of the recipient (the non-grantor trust) is determined, in whole or in part, by reference to the original owner's basis in the policy (the grantor trust), the transfer for value rules will not apply. This exception can protect part-sale, part-gift situations where the transferor's basis (the grantor's basis in the assets held in the grantor trust) is greater than the consideration paid by the transferee (the amount of the liability).

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18 See Brody and Leimberg, Avoiding the Tax Trap of the Transfer for Value Rule, Vol. 32 <u>Estate Planning</u>, No. 10, at 3 (2005), and Using a Transactional Analysis to Avoid the Transfer for Value Rule, Vol. 32 <u>Estate. Planning</u>, No. 11, at 3 (2005) for a full discussion of the transfer for value rule and those exceptions.

If the liability is greater than the grantor trust's basis in the policy, another exception could be utilized to avoid the transfer for value rule. Under that exception, if the trust is a partner of insured, at the moment of the deemed policy transfer (when the trust becomes a non-grantor trust), then for the transfer for value rules will not apply; there is no de minimus rule on how much of a partnership interest the trust would have to own to be considered a partner for this purpose. Accordingly, one way to avoid this issue (if it is an issue) would be to have the trust and the insured be partners in a state law valid partnership prior to the deemed transfer of the policy when grantor trust status of the trust stops.

However, in Section 3.01(8) of Rev. Proc. 2008-3[19], the Service reiterated that it would not issue advance rulings on either the status of partnerships substantially all of the assets of which consist of life insurance on the lives of the partners, or whether the transfer of the life insurance policies to such partnerships would constitute a transfer for value.[20]

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[19] 2008-1 I.R.B. 110.

[20] But see, PLR 200747002, implying (by not raising the issue), that a limited liability company formed to own policies funding a cross-purchase arrangement would be treated as a partnership for income tax purposes.