Turning Off Grantor Status

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May 15, 2013

As practitioners, we often recommend that intervivos trusts, established by the client, be "**grantor trusts**" for income tax purposes. That is, while the gift in trust will be a completed gift for estate, gift, and generation skipping tax purposes, the income tax treatment of the trust will be as if no gift had been made.

In many situations, this seems to be the best of all worlds. The grantor can (and must) pay the income tax on the trust's income without that payment being treated as a further gift to the trust. Additionally, sales between the grantor and the trust are not taxable events. These benefits have made grantor trust status one of the most widely used "enhancers" to gifts in trust.

In fact, it is also one reason why gifts in trust are considered by many, including the authors, to be superior to outright gifts to descendants, where grantor trust status for income tax purposes is not possible.

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The law surrounding this area of taxation has been evolving, but is based upon Internal Revenue Code ("IRC") sections 671-677 and 679 (this article does not address the so called "beneficiary defective trust" made possible through the application of section 678). In short review, section 671 provides that if a grantor is treated as the "owner" of any portion of a trust, then in computing the grantor's taxable income and credits, those items of income, deductions, and credits against tax attributable to that portion of the trust shall be taken into account in computing the grantor's income, losses, and credits.

Thus, to the extent the grantor is treated as the owner under sections 671-677 and 679, then the income, deductions, and credits against income of the trust appear on the grantor's income tax return, not the trust's income tax return. Therefore, it is the grantor's income, and the grantor must pay the income tax thereon, even though the trust actually keeps the income. This allows tax-free accumulation of income from the trust's perspective.

Three revenue rulings have been issued in recent years, giving considerable comfort in an area once fraught with concern.

Rev. Rul. 2004-64, 2004-27 I.R.B. 7 (7/6/2004)

Rev. Rul. 2004-64, 2004-27 I.R.B. 7 (7/6/2004) clarified that the grantor's payment of income tax attributable to trust income was **not** a further gift to the trust and its beneficiaries. That ruling also contained an exposition on the various clauses practitioners had been including in their trusts to provide for reimbursement of tax payments by the grantor, generally summarized as follows: (i) provisions for mandatory reimbursement of tax to the grantor, would, in the future, cause inclusion of the trust assets in the grantor's estate for estate tax purposes as a retained interest in the trust, (ii) clauses prohibiting reimbursement of tax to the grantor were approved and no inclusion in the grantor's estate would occur by reason of these provisions, and (iii) clauses that give the trustee discretion of whether or not to reimburse would be closely scrutinized to see if there was an prior understanding or arrangement as to reimbursement, and any prior arrangement would be treated as a clause mandating reimbursement. While practitioners have different views on such a "permissive reimbursement clause," it is not the focus of this article. However, it is important to note that having to prove a negative, that there had been no prior arrangement or plan, may be difficult, at least if the same trustee is serving at the time of reimbursement that was serving at the time of creation.

Rev. Rul. 2008-22, 2008-16 I.R.B. 796 (4/21/2008)

While there are a number of ways to create "grantor trust" status, it seems that the most common is a power of substitution of assets, held by the grantor in a non-fiduciary capacity. More precisely, the power allows the trust property to be reacquired by the grantor through substitution of property having equivalent value. Inclusion of such a power should invoke application of Section 675(4)(C), thus invoking grantor trust status.

The second revenue ruling specifically related to a power of substitution. Rev. Rul. 2008-22, 2008-16 I.R.B. 796 (4/21/2008) clarified that a properly drafted power of substitution would not cause inclusion in the grantor's estate under sections 2036 and 2038. Also clarified was the concern, under *Estate of Jordahl v. Commissioner*, 65 T.C. 92 (1975), *acq. in result*, 1977-2 C.B. 1 that the grantor had been determined to hold the power of substitution in a fiduciary capacity, which had been good in *Jordahl*,

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but a confusing issue for those focusing upon the power of substitution issues, since section 675(4)(C) requires that the power of substitution be held in a non-fiduciary capacity. Rev. Rul. 2008-22 specifically assumes that the power of substitution is not held in a fiduciary capacity by the grantor, with approval both from an income and estate tax viewpoint.

With the issuance of 2008-22, use of powers of substitution gained even more momentum, but one gap remained. What if the assets of the trust, over which the grantor has a power of substitution, included a life insurance policy on the grantor's life? Rev. Rul. 2008-22 spoke to inclusion under sections 2036 and 2038, but had been silent about whether the retained power of substitution, held in a non-fiduciary capacity, might be the basis for inclusion of an insurance policy under section 2042, which focuses upon incidents of ownership.

Rev. Rul. 2011-28, 2011-49, I.R.B. 830 (12/5/2011)

A final sigh of relief was heard with the issuance of Rev. Rul. 2011-28, 2011-49, I.R.B. 830 (12/5/2011). Therein, the section 2042 incident of ownership issue was addressed and determined not to cause inclusion. Thus, it now seems that almost everyone is using one form or other of grantor trust status with respect to intervivos trusts, primarily via a power of substitution. (Nonetheless, the IRS has not definitely stated that section 2036(b) would not be triggered if the grantor retained a power of substitution over stock described in that section.)

But Can One Turn Off the Power?

Most thoughtful clients will ask thoughtful questions: What if I don't want to pay the income tax for the trust in the future – can I turn grantor trust status off? What if the gains in the trust are so large that it would be a burden for me to pay tax if the gains are recognized? Accordingly, well-crafted powers of substitution include an express power in the grantor to release the power of substitution, thus ending the 675(4)(C) trigger.

However, the inquiry of whether grantor trust status has truly been turned off by the release of the power cannot end there. For while inclusion of a power of substitution may be a convenient way to assure grantor trust status, there are, in sections 673-677 and 679, many other ways to trigger grantor trust status. An examination of all of sections 673-677 and 679, and all of the provisions of the trust, is required before one can be confident that grantor trust status has truly been turned off. Care must be exercised, because while you only have to "flunk" one provision of sections 673-677 and 679 to create a grantor trust, you must pass every provision thereof to keep it from remaining a grantor trust.

Section 674 and Powers Affecting Beneficial Enjoyment

Section 674 begins with the general rule that most trusts we draft are grantor trusts. Section 674(a) provides the default rule, that the grantor is treated as the owner of any portion of a trust where beneficial enjoyment of corpus or income is subject to a power of disposition, exercisable by the grantor (which would be very rare, except that section 672(e) provides that the grantor will be treated as holding any power or interest held by the grantor's spouse) **or by a non-adverse party or both, without the approval or consent of any adverse party**.

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In most modern trusts, such a power will be held by a non-adverse party or deemed to be held by the grantor through attribution, whether the trustee is the spouse, a child, a brother, or a bank. Most trusts would be grantor trusts if section 674 ended with paragraph (a). However, sections 674(b), 674(c), and 674(d) contain exceptions, and if all powers fit within an exception, grantor trust status is spared.

Careful examination of all of these paragraphs is mandatory, but sections 674(b)(5), 674(c), and 674(d) will most often provide comfort and from time to time with a change of trustee, will provide the exception for most distribution powers.

Section 674(b)(5) and 674(c) provide exceptions for the power of a non-adverse trustee to distribute principal (see section 674(b)(5)) and income (see section 674(d)) upon an ascertainable standard. But note that in section 674(d), the exception to the general rule in section 674(a) is only applicable if (i) the power to allocate income is limited by a reasonably definite standard contained in the instrument (health, education support and maintenance which we often include for purposes of section 2041 would be typical) and (ii) the power is not held by the grantor or the grantor's spouse living with the grantor.

Thus, service of a spouse as trustee, even if the only distribution power is subject to an ascertainable standard for descendants, may trigger grantor trust status, at least as to the income of the trust. To turn off grantor trust status in that instance, it may be necessary to release the power of substitution AND to change trustees so that the trustee is someone other than the grantor's spouse. (It is also important to note that, pursuant to section 672(e), any power held by the grantor's spouse is attributed to the grantor.)

Likewise, section 674(c) will be most important in avoiding (or turning off) grantor trust status if the power to distribute goes beyond distribution powers limited to health, education, support and maintenance. A typical example would be a provision allowing a trustee to distribute for any purpose, so long as the trustee is an independent trustee.

Section 674(c) provides an exception to the general grantor trust rule set forth in 674(a), excepting broad powers to:

1. distribute, apportion, or accumulate income to or for a beneficiary or beneficiaries, or to for or within a class of beneficiaries; or
2. pay out corpus to or for a beneficiary or beneficiaries or to or for a class of beneficiaries (whether or not income beneficiaries).

However, the lead in language in section 674(c) provides that to take advantage of this exception to the general rule, this power must be held by a trustee or trustees, none of whom is the grantor, and no more than half of whom are related or subordinate parties who are subservient to the wishes of the grantor. This two-part test, the first part being the related or subordinate party test set forth in section 672(c) and the second part being whether such related or subordinate parties are in fact subservient to the wishes of the grantor, is a further opportunity for uncertainty. Whether or not a related or subordinate party is in fact also subservient to the wishes of the grantor leaves room perhaps for a saving situation (either for or against grantor trust status) but would not be a provision one would wish to rely upon.

Thus, compliance with this rule requires first looking back to section 672 for the definition of a related or subordinate party, which encompasses:

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1. the grantor's spouse if living with the grantor; and
2. any one or more of the following: he grantor's father, mother, issue, brother or sister; an employee of the grantor; a corporation or any employee of a corporation in which the stock holdings of the grantor and the trust are significant from the viewpoint of voting control; a subordinate employee of a corporation in which the grantor is an executive.

Obviously, once again, if the distribution provisions of the trust are not limited by an ascertainable standard, more than just release of the power of substitution may be required. One may also need a change of trustee, so that the provisions of section 674(c) are applicable.

Other provisions of section 674, and the governing instrument must likewise be studied for impact upon whether or not the grantor will be treated as the owner of the trust under section 674(a). Those other provisions address a number of other exceptions, including powers affecting beneficial enjoyment only after an event, powers exercisable only by will, powers to allocate among charitable beneficiaries, powers to withhold income temporarily or during a disability, and powers to allocate between corpus and income, to name a few.

Section 675

Section 675 likewise addresses the grantor trust issue by specifying administrative powers that cause the grantor to be treated as the owner of the trust. In some respects, section 675 is easier to deal with because it names the troublesome powers, rather than establishing a general rule of grantor trust status and then naming exceptions, as is the case in section 674.

However, care must be exercised in the drafting of broad administrative powers, since triggers within section 675(1) and (2) include the power, exercisable by the grantor **or by a non-adverse party**:

1. to purchase, exchange or otherwise deal with or dispose of the corpus or the income therefrom for less than an adequate consideration in money or money's worth (see section 675(1)), or
2. to borrow the corpus or income, directly or indirectly, without adequate interest or security (see section 675(2), which also contains an exception for a power held by a trustee other than the grantor under a general lending power to make loans to any person without regard to interest or security).

Section 675(3) is a somewhat different provision, in that it requires an affirmative act. That section ascribes grantor trust status if the grantor has, directly or indirectly, borrowed corpus or income and has not completely repaid the loan, including interest, before the beginning of the taxable year. Again, there are further exceptions to this general rule contained in the statute, but those exceptions are heavily dependent upon the identity of the trustee. The seminal revenue ruling Rev. Rul. 85-13, 1985-1 C.B. 184 was decided in the context of a deemed borrowing triggering section 675(3).

Finally, section 675(4) is a trigger relating to general powers of administration. The final provision of 675(4) is the source of the power of substitution provisions. However, the trigger is pulled, and grantor trust status is applicable, if certain powers of administration (clearly defined therein and generally relating to voting control and the power to control investments) are held in a non-fiduciary capacity and may be exercised without the approval or consent of any person in a fiduciary capacity. These administrative powers include a power, held in a non-fiduciary capacity, to substitute property of equivalent value for assets of the trust.

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While most practitioners would not intentionally prepare a trust providing that the powers of the trustee are held in a non-fiduciary capacity, it was common, among many practitioners, prior to the recent increase in the use of grantor trusts, to include a specific section in each document negating the ability to pay premiums on insurance from income (section 677(a)(3)) and explicitly prohibiting the powers set forth in section 675(4) from being held in a non-fiduciary capacity.

Conclusion

Other provisions of 671-677 and 679 must likewise be examined. Accordingly, terminating grantor trust status will not be simply a question of turning off a power of substitution, but must also include an inquiry as to the identity of the trustee, the powers held by the trustee, and all of the "triggers" set forth in sections 671-679 that may cause the grantor to be treated as the owner of the trust, and thus create grantor trust status.

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