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Mark Merric, JD, MT, CPA In addition to being an attorney, Mark Merric holds a Masters of Taxation and he is a Certified Public Accountant, as well as an Adjunct Professor at the University of Denver's, Law School Graduate Tax Program. He has been quoted in Forbes, Investor's News, On the Street, the Denver Business Journal, Oil and Gas Investor, and the Sioux Falls Business Journal. Mr. Merric is an international speaker presenting at over 400 seminars, and he has published over 70 national articles. Mr. Merric is the manager of the Law Firm of Mark Merric, LLC and a manager for the Alliance of International Legal Counselor, LLC. Prior to practicing as an attorney, Mark Merric developed a strong business background working for a Final Four Accounting Firm.

Mr. is honored to have spoken multiple times at the following distinguished estate planning seminars:

- Regis Campfield's Notre Dame Tax and Estate Planning Institute;
- Lonnie McGee's Southern California Tax and Estate Planning Forum; and the
- Chicago Bar Association.

He is also a co-author of the following three treatises:

- The Asset Protection Planning Guide: A State-of-the-Art Approach to Integrated Estate Planning, Commerce Clearing House (CCH) treatise, first edition;
- Asset Protection Strategies, American Bar Association (two chapters); and
- Asset Protection Strategies Volume II, American Bar Association published Apr. 2005 (MM responsible for 1/5 of the text).

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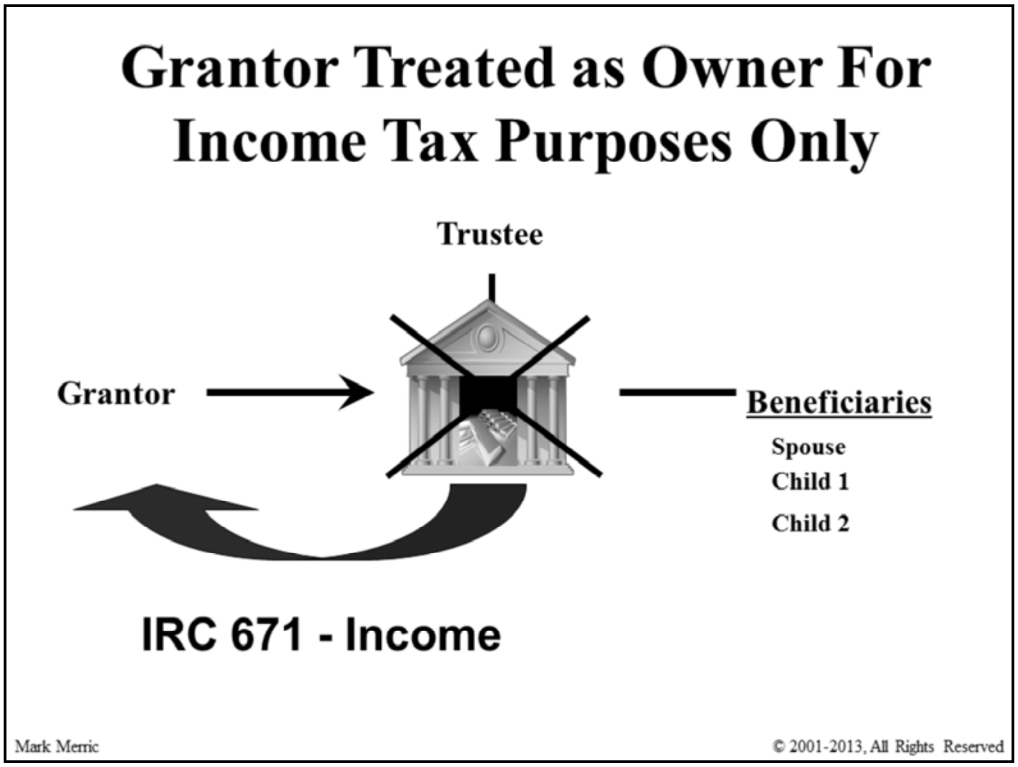
Procedures for Engagement

We would be more than happy to assist you with your request, however, let me first explain our procedures for engagement of our firm. Our firm provides advice in estate planning, international taxation, business structures and transactions, and asset protection planning. *Seldom, if ever,* are there any "simple or quick questions in these fields. Almost all questions in these areas require a review of the relevant legal documents, organizational structure, past planning, as well as the client's objectives. Further, due to the liability issues involved combined with our time commitment, we do not answer technical questions, hypothetical questions, questions on outlines or articles unless we are engaged in writing. Our minimum engagement fee is $1,000. However, we do offer wholesale pricing for accountants and attorneys that engage us directly.

For more details regarding engaging our firm go to: http://www.internationalcounselor.com then click on the "Accountants/Attorneys" Tab.

Disclaimer

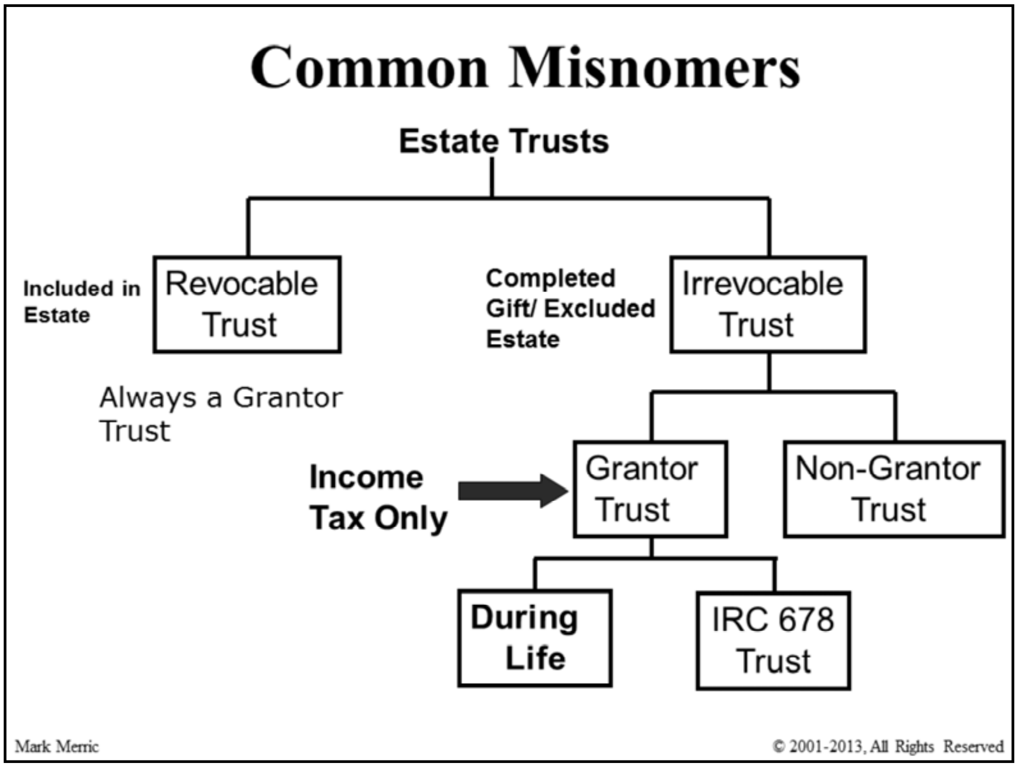
The law is constantly changing at an unprecedented pace. Also, each client's separate fact situation must be carefully examined before applying any principals of law. Furthermore, this outline is not intended to be a substitute for the practitioner's own research into this area of law and how the law applies to a client's specific situation. Therefore, the author takes no responsibility how the areas of law covered by this outline apply to the reader or the reader's clients. Finally, to ensure compliance with requirements imposed by the IRS Circular 230, we hereby inform you that any U. S. tax advice contained in this communication is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties under the Internal Revenue Code or (ii) promoting, marketing or recommending to another party any matter addressed herein.



A. Income Tax

Generally, the income of a grantor trust is taxed solely to the person who creates a grantor trust. However, there are some limited exceptions that are discussed later in this outline.

The Internal Revenue Code refers to the grantor as the owner only for income tax purposes. In this respect, the grantor trust may be viewed as disregarded solely for income tax purposes. For gift tax, estate tax, generation skipping transfer tax, and regardless of whether the trust is a domestic trust or foreign trust for tax purposes, the grantor trust is not disregarded. Rather, each of these areas of the Internal Revenue Code must be separately analyzed to determine for example whether transfers to the trust were a completed gift for gift tax purposes, excluded from the estate, whether the generation skipping transfer tax exemption may be allocated, and how the trust is classified –domestic or foreign – for tax purposes.



B. Common Misnomers

1. Living, Loving, or Revocable Trust

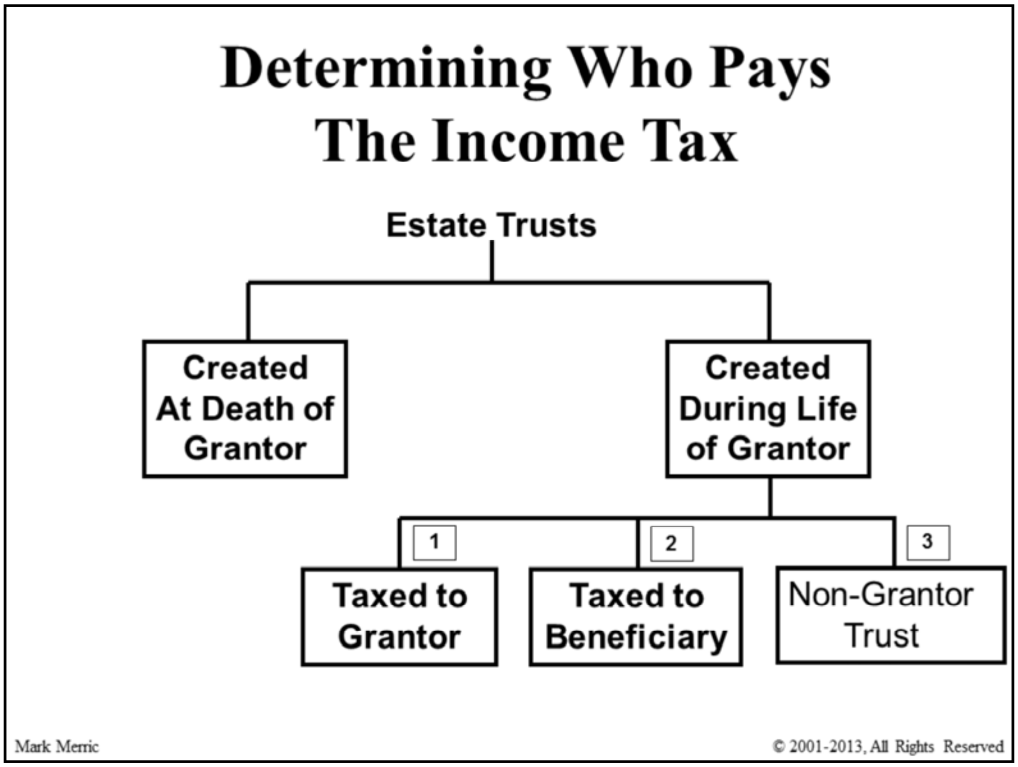
There is a common misnomer that the only grantor trust is that the revocable trust is the only grantor trust. Other synonyms for this type of trust is the living or "loving" trust. While it is true that this type of trust will always be classified as a grantor trust for income tax purposes, there are many other ways to create a grantor trust.

2. Completed Gift and Excluded From the Estate

There is a second common misnomer. This is that an irrevocable trust is always a completed gift and excluded from the estate. This misnomer is discussed in the gifting outline and the estate tax octopus outlines. However, for purposes of this outline, the author has assumed that the term "irrevocable trusts" also means that the gift is completed and the assets of the trust are excluded from the estate. From this second common misnomer follows the third common misnomer: that is an irrevocable trust cannot be classified as a grantor trust. Again, this is far from the truth.

3. Many Ways to Create a Grantor Trust

This outline discusses the many ways where an irrevocable trust may be classified as a grantor trust. The real question is whether creating a grantor trust was the objective of the drafter or, in many cases, a mere drafting error.



C. Determining Who Pays The Income Tax

1. <u>Income Taxation of Testamentary Estate Planning Trusts</u>

Generally, a testamentary trust is not a grantor trust because the grantor has passed away. However, there are some unique planning situations where part of such a trust may be taxed as a grantor trust to the beneficiary (as discussed in the IRC 678 portion of this outline).

2. <u>Income Taxation of Inter Vivos Estate Planning Trusts</u>

There is a three step process in determining who shall be taxed on the income of an estate planning trust. First, if the grantor is deemed the owner of all or a portion of the trust, this rule controls. To the extent the grantor is considered the owner of the trust, he or she pays the income tax on any income attributable to said grantor trust. (For purposes of this outline, I have assumed that if the grantor trust rules apply, he or she pays all of the income on the trust).

Second, typically when a beneficiary has an IRC § 2503(b) annual exclusion withdrawal power (i.e. Crummey power), the Crummey beneficiary may be deemed the grantor. In this case, the trust may be classified as a grantor trust pursuant to IRC § 678. However, the beneficiary, <u>not</u> the grantor, will be deemed the owner for purposes of reporting all items of income, deduction, and credit regarding the trust.

Third, if the trust is not classified as a grantor trust to the grantor, or not classified as a grantor trust to the beneficiary, then it is considered a standard estate planning trust where to the extent it accumulates income, it pays income tax on such income. To the extent it distributes income, the beneficiary receiving the income pays the income tax.

Why Do We Care?

- S Corp stock
- Sec 121 Residence Exclusion
- 5 Year Medicaid Trusts
- Moving tax to a lower bracket
- Intentionally Defective Irrevocable Trusts

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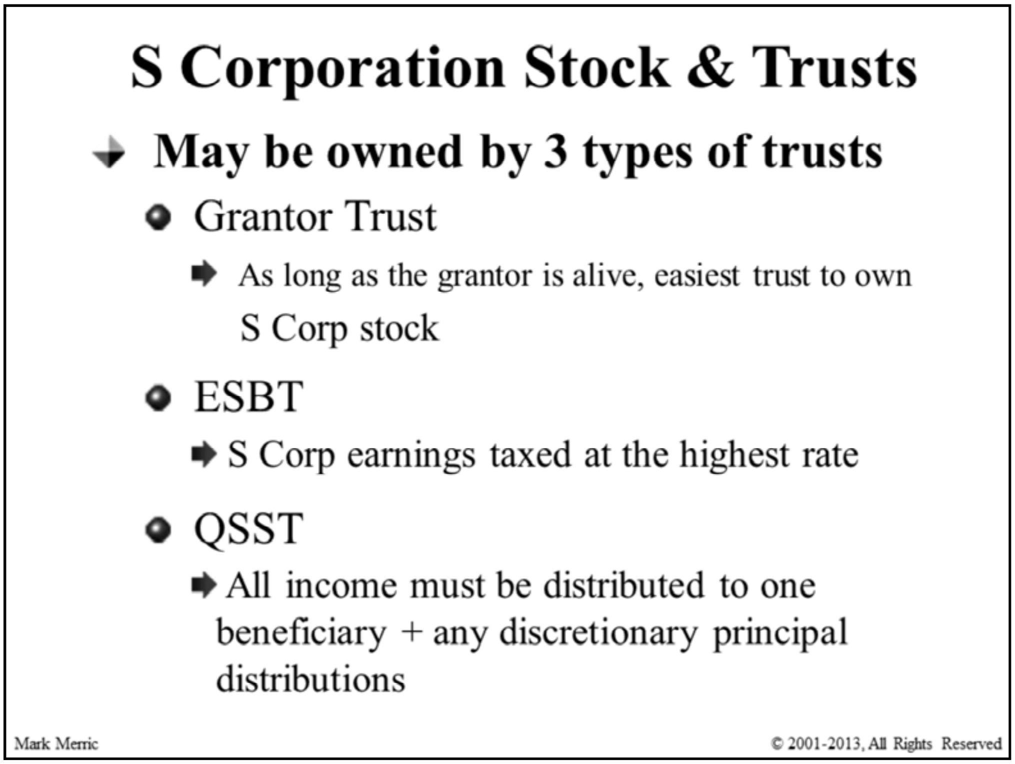
D. Why Do We Care?

Advanced estate planners use grantor trusts in many different ways. The one most frequently mentioned is the intentionally defective irrevocable trust that is discussed in detail at the end of this outline. However, there are many more reasons such as whether a trust can hold S corporation stock, whether a QPRT is able to claim the § 121 exclusion on the sale of a principal residence (some issues that many planners are seeing with five year Medicaid Trusts) and income tax planning with adult children in lower tax brackets.



E. S Corporation Stock & Trusts

Primarily three types of trusts may be owned by a grantor trust. The fourth type of grantor trust, a qualified voting trust, is not discussed in this outline.

1. <u>Grantor Trust</u>

A grantor trust may own S corporation stock. IRC § 1361(d)(3). However, upon the death of the grantor, the income tax treatment of the grantor trust ceases.

2. <u>Electing Small Business Trust ("ESBT")</u>

A trust with qualified beneficiaries (primarily individuals) makes an election to be classified as an ESBT. IRC § 1361(e). The primary disadvantage of an ESBT is that the subchapter S income is taxed at the highest individual tax rate. IRC § 641(c).

3. <u>Qualifying Subchapter S Trust ("QSST")</u>

In order for a trust to be classified as a QSST, the following requirements must be met:

(1) All trust income must be distributed currently to a single trust beneficiary;

(2) Current income beneficiary must be a U.S. citizen or resident;

(3) the trust instrument must provide that during the life of the current income beneficiary there may be only one income beneficiary;

(4) the trust instrument must restrict principal distributions made during the current income beneficiary's life to the current income beneficiary;

(5) the trust instrument must provide that the beneficiary's income interest will terminate upon the earlier of the beneficiary's death or the trust's termination; and

(6) the trust instrument must provide that if the trust terminates during the current income beneficiary's lifetime all trust assets must be distributed to the current income beneficiary.

Where Definitions Apply

- **Adverse Party –** IRC 672(a)
  - IRC 674 – Usually concerned with trustee powers
  - IRC 676 – If the spouse or grantor is a beneficiary
  - IRC 677 –If the spouse or grantor is a beneficiary
- **Related or Subordinate Party** – IRC 672(c)
  - IRC 674(c) – Discretionary trust and trustee powers
  - Also Removal/Replac. Powers over trustee – Rev. Rul. 95-58
- **Spousal Attribution Rules –** IRC 672(e)
  - IRC 673 – Spouse as a beneficiary of a discretionary trust
  - IRC 676 – Spouse as a beneficiary of any trust

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F. Definitions

IRC § 672 provides three key definitions that are needed to be mastered before proceeding to the grantor trust income tax provisions – IRC § 673 through 679. However, before learning the definitions, one must first understand that not all definitions apply to each one of the specific code sections. Adverse party applies to three grantor trust sections, the related or subordinate party only applies to the independent trustee classification in IRC § 674, and spousal attribution rules are only relevant in IRC § 673 and IRC § 674.

1. Adverse Party

- who has a beneficial interest in the trust (including a power of appointment over the trust);
- whose interest is substantial; and
- whose interest would be adversely affected by the exercise or nonexercise of the power. IRC 672(b) and Treas. Reg. 1.672(b)-1.

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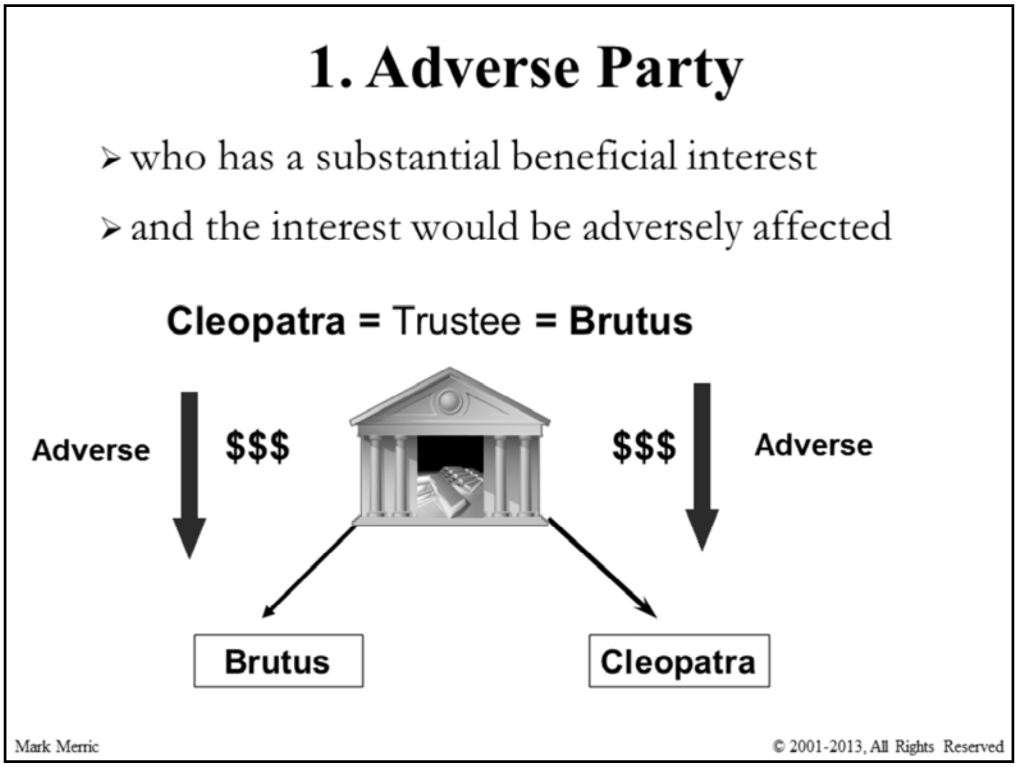
1. Adverse Party

a. Concept of the Adverse Person

The definition of an adverse party is key to understanding IRC § 674, 676, and 677. An adverse person is only someone who has a substantial interest in the trust, whose interest would be adversely affected by the exercise or non-exercise of the power. IRC § 672(b) and Treas. Reg. § 1.672(b)(1). Generally, situations involving an adverse person, refer to the situation where the adverse person is a trustee(s) of the trust. An adverse person is a trustee with whom any exercise of a distribution power to another beneficiary would result in less of the trust assets going to the adverse trustee. Therefore, if an adverse trustee is exercising a distribution power to another beneficiary (not to himself or herself), then such power is truly exercised with independence. If the adverse person/trustee has such great independence from the grantor, then the grantor should not be taxed on the income.

b. Every Other Trustee is a Non-Adverse Person

Every trustee other than a beneficiary who is also a trustee (or holds a general power of appointment) will be classified as a non-adverse person. The definition of a non-adverse party would include a bank, a trust company, the grantor's CPA, the grantor's attorney, the grantor's friend or any relative who is not a beneficiary of the trust. Right or wrong, the IRC assumes that the grantor will have more control than a trustee who is not a beneficiary than someone who is the natural object of the grantor's assets and who is a trustee/beneficiary.



c. Maybe Not the Same Adverse Person Requirements as 2041

The estate and gift tax rules provide that a co-holder of a power does not necessarily have an adverse interest merely because the co-holder had joint possession of the power nor merely because he or she is a permissible appointee. Treas. Reg. § 20.2041-3(c)(2) and § 20.2514-3(b)(2). It is uncertain whether the requirements of the estate and gift tax sections must be met for the grantor trust rules. This issue is discussed in the creating a non-grantor trust part of the outline.

On a different note, Howard Zartizky as author of the BNA grantor trust portfolio as well as some other estate planners take the position that the settlor's spouse cannot be an adverse person. It states:

"The spousal attribution rules enlarge the grantor trust rules only slightly, since the grantor's spouse was always considered a "related or subordinate" party, and often a nonadverse party under § 672(c)(1). The principal objective of the spousal attribution rule is to eliminate the so-called spousal remainder trust as an income-shifting device by taxing as a grantor trust any trust in which the grantor's spouse holds a reversionary interest worth more than 5%. This rule also prevents the grantor's spouse from ever being an adverse party, since the interest or power which would otherwise make the spouse an adverse party would be imputed to the grantor."

2. Related or Subordinate Trustee

- **Related Person - IRC 672(c)**
  - Parent;
  - Brother or Sister;
    - Includes 1/2 brothers or sisters - R.R. 58-19
  - Spouse; and
  - Issue (i.e. child or grandchild)
  - Employee but not director - R.R. 66-160

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2. <u>Related or Subordinate Person</u>

a. Concept of the Related or Subordinate Person

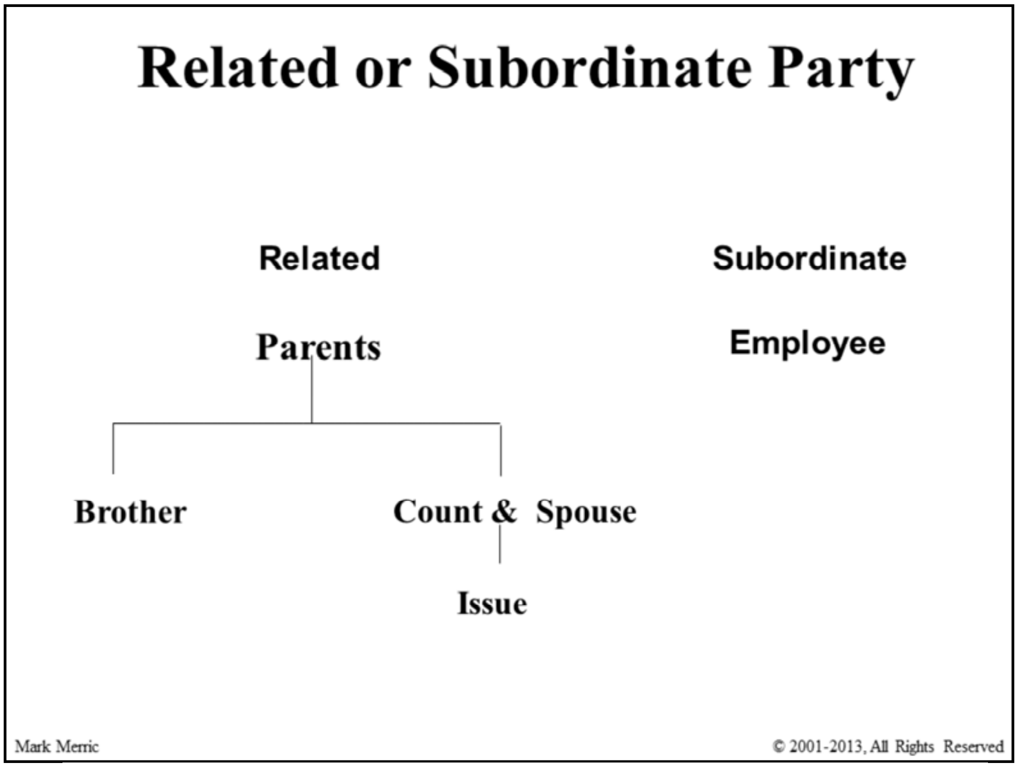
IRC § 674 generally deals with the issue whether the grantor should be taxed on the income of the trust because of a blood relationship with the trustee or a control over an employee who is the trustee. IRC § 674 almost completely embodies the estate tax inclusion issues of who can be a trustee without having the property brought back into the grantor's estate. In this respect, IRC § 674 classifies the distribution standard as either discretionary or pursuant to ascertainable standards. The related or subordinate definition of IRC § 672(c) is concerned solely with a discretionary distribution standard and a trustee who is non-adverse.

b. Related Person

A related person is generally defined as anyone who is directly related to the grantor. Looking up the family tree, a related person includes parents at the same generation it includes brothers and sisters, and looking down the family tree it includes any issue. The person's spouse is also considered a related person within the meaning of IRC § 672(c).

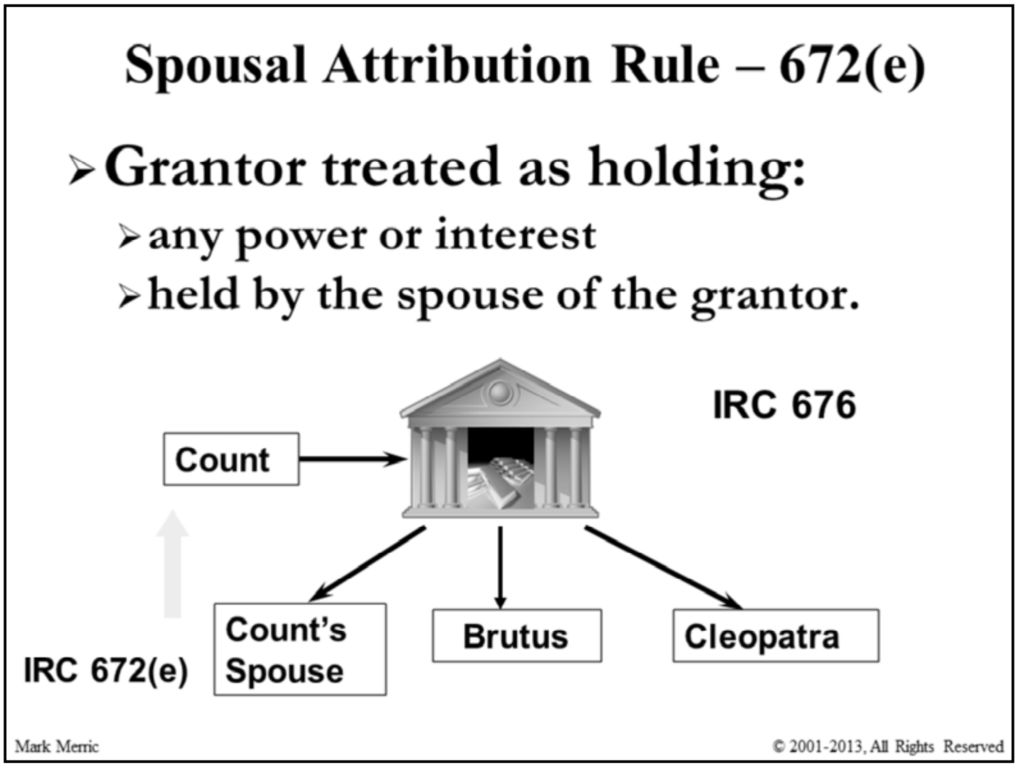
c. Employee

Any employee is considered subordinate under IRC § 672(c). However, an attorney, certified public accountant, or any other business relationship is not considered subordinate within the meaning of IRC § 672(c). Also, a director of a corporation is not considered subordinate. Rev. Rul. 66-160.



DIAGRAM

A diagram of the aforementioned rules is provided so that the reader may graphically see the related and subordinate parties under IRC § 672(c).



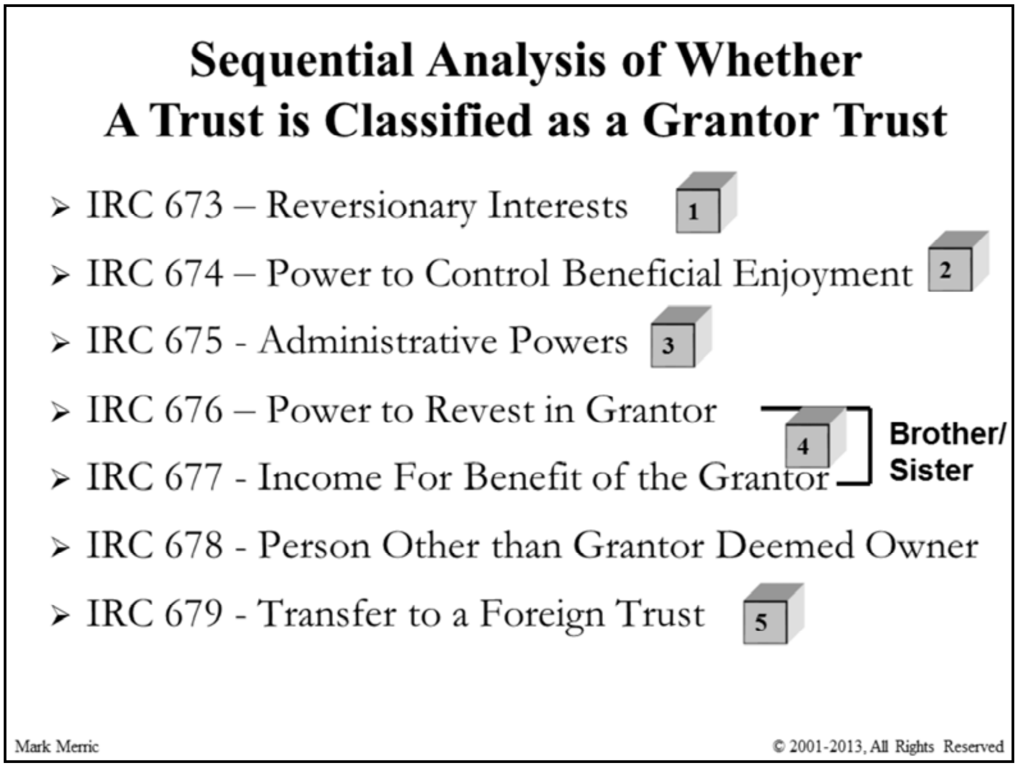
3. <u>Attribution Rules</u>

a. Concept of the Related or Subordinate Person

The grantor is treated as holding any power or interest held by the spouse of the grantor. A power generally would be if the grantor's spouse was serving as trustee or if she held a power of appointment. An interest means the spouse is a beneficiary of the trust.

b. Applicable Grantor Trust Sections

As previously noted in this outline, attribution of the grantor's spouse interest is found in IRC § 673 and IRC § 676. Attribution is not needed under IRC § 674(d) and 677 because the spouse is specifically mentioned in these code sections. Further, the concept of attribution does <u>not</u> apply to IRC § 678 and 679.



G. Sequential Anlaysis

Unfortunately, the grantor trusts are one of the most complex areas of the IRC because there is no single thread that ties them together. Most of the grantor trust rules were passed at different times for a variety of different purposes.

- IRC § 673 – reversionary interest originally dealt with the 10 year Clifford trust. However, it was modified in 1986 when the Clifford Trust rules were repealed to include any reversionary interest.
- IRC § 674 was passed so that it would parallel the estate tax inclusion rules. In other words, if a trust was brought back into the grantor's (i.e. settlors or trust makers) estate, the grantor would have been responsible for the income of the trust.
- IRC § 675 is several somewhat arbitrary rules where if the grantor retains certain administrative strings over the trust, the ability to vote stock, direct the investments, or a power to substitute property of equivalent value, the grantor would be taxed on all of the income of the trust.
- IRC § 676 and IRC § 677 were passed so the grantor would be taxed on all of the income of the trust if the grantor and his or her spouse could possibly benefit from the trust assets.
- IRC § 678 is the situation where someone other than the grantor could be taxed on the trust's income.
- IRC § 679 was enacted to prevent taxpayers from taking assets offshore to avoid paying income tax.

Reversionary Interest – IRC § 673

- To the Extent that the Grantor has a 5% or greater "<u>reversionary interest</u>" in the Trust, the Grantor is treated as the owner of the Trust.
- QPRT
- Must the "reversionary interest" be a remainder interest or GPA?

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H. Reversionary Interest

. To the extent that by any method (i.e. as a beneficiary or the person that some power may be exercised in behalf of), the grantor holds a 5% or greater interest in a trust, then the grantor is deemed the owner under IRC § 673.

1. <u>Assumed Full Exercise of a Discretionary Power</u>

Under IRC §673(c), if there is any discretion by any person (e.g. the trustee) that may be exercised to benefit the grantor, it is in fact assumed the power holder (e.g., the trustee) exercised such power to its fullest. In other words, regardless of whether the power is ever exercised, for purposes of determining whether the grantor is the owner under IRC § 673, it is as if the power was actually exercised. It should be noted that the IRC § 673(c) was amended from a ten year rule in 1986 to the deemed exercise of a trustee's discretion.

2. <u>Not the Same as the Estate Tax Inclusion Rule of IRC §2037</u>

This is the exact <u>opposite</u> of the rule under the estate tax inclusion rule of IRC § 2037. Under IRC § 2037, there is no assumption that the power is exercised unless the power (i.e., distribution to the grantor) actually in fact occurs. In this respect, the grantor trust rules depart from one of the estate tax inclusion rules.

3. <u>What's a "ReversionaryIinterest?"</u>

To date, the Service has applied IRC § 673 to a situation where the grantor held:

(a) a remainder interest greater than or equal to 5% of the trust property or
(b) the grantor held a general power of appointment. PLR 199925027

However, this begs the question. Must the "reversionary interest" be either a remainder interest or a GPA?

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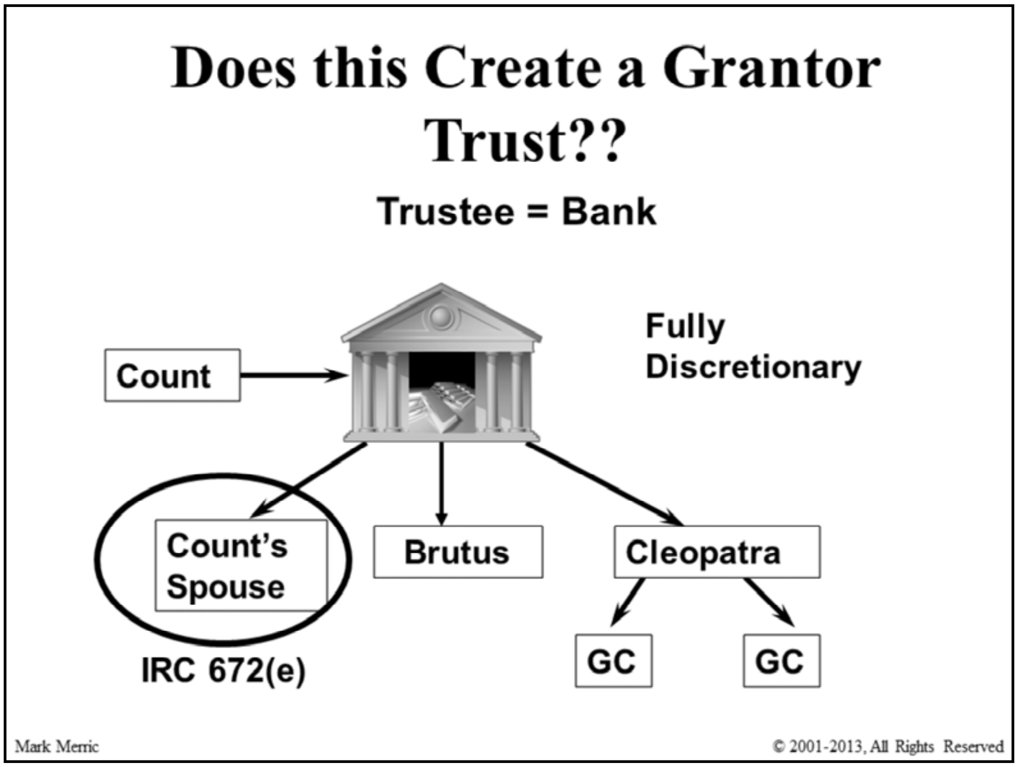

4. Does This Create A Grantor Trust?

Assuming a fully discretionary distribution standard, what if the settlor's spouse is a beneficiary of the trust?

a. Family Trust

Usually, upon the death of the settlor (i.e. grantor), the settlor creates the family trust (also known as the trust B, credit shelter trust, exemption trust, or by-pass trust). Typically, the beneficiaries are the settlor's spouse and children. Assuming that the distribution standard is a discretionary, distribution standard, would the above trust be classified as a grantor trust?

i. Testamentary Family Trust

Generally, the family trust is created at the death of the settlor (i.e. grantor). In order for a grantor trust to be classified as a grantor trust, there needs to be a living grantor. With a testamentary trust, the grantor has deceased, hence the trust may not be classified as a grantor trust with respect to the settlor.

ii. Inter Vivos Family Trust

Sometimes, an estate planner will claim that they created an inter vivos family trust (i.e., trust B, credit shelter trust, exemption trust, or by pass trust). Simply stated, the estate planner has drafted an inter vivos trust where the settlor's spouse is also a beneficiary and part (or all) of the settlor's applicable exemption amount was used to fund the inter vivos family trust. Rather than naming such a trust as an inter vivos family trust, most estate planners would refer to such a trust as an irrevocable trust, intentionally defective irrevocable trust, or a grantor retained annuity trust, as the case may be.

Reversionary Interest
IRC § 673

- **Grantor is treated as owning any interest the grantor's spouse owns. IRC 672(e)**
- **Assumed maximum exercise in favor of the grantor's spouse. IRC 673(c).**
- **PLRs to Date**
  - **Do not directly address the issue**

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b. Attribution of Spouse's Interest

If the Settlor''s spouse has an interest in an inter vivos trust created by the settlor (i.e. grantor) and the trust has discretionary distribution provisions, the spouse's interest will be attributed to the grantor under IRC § 672(e). Further, under IRC § 673(c), it is assumed that the trustee exercised all of his discretionary powers in favor of the spouse, regardless of whether or not the spouse ever received a distribution. Therefore, is the settlor deemed to own a greater than 5% reversionary power, and the trust is classified as a grantor trust to the settlor?

c. PLR's Not Directly Discussing the Issue

The author is aware of no case, ruling or PLR that directly discusses the issue of whether a discretionary distribution interest is a "reversionary interest" under IRC § 673. Further, in the following seven PLRs, a grantor and/or his spouse were beneficiaries of an inter-vivos irrevocable trust, and the Service held that the trust was not a grantor trust: 200148028; 200247013; 200502014; 200612002; 200637025; 200647001 and 200715005.

On the other hand, the Conference Report to the 1986 act (PL 99-514) .10 Grantor Trusts states, "The bill repeals the 10-year exception of present law and replaces that rule with a rule that treats a trust as a grantor trust where there is more than a 5 percent possibility that any of the proscribed powers or interests will become effective in the grantor after the transfer of property to the trust." The Conference Reports broad language may have been an indication that a "reversionary interest" would include a discretionary distribution interest.

d. Distributions Pursuant to Ascertainable Standards

Query: If IRC §673(c) applies to a discretionary distribution interest, would this result change if the distribution standard was limited by an ascertainable standard?

IRC § 674
Comparison to Estate Inclusion

- **Discretionary v. Ascertainable Standards – Who Can Be a Trustee?**
  - Settlor Holds Discretionary Power = Estate
  - Settlor Limited by Ascertainable Standard – not in estate (unless support obligation issue).
- **Settlor Holds Removal/Replacement Power**
  - Discretionary – Limited to 672(c)
  - Ascertainable Standard – Probably not limited to 672(c)

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I. Power to Control Beneficial Enjoyment IRC § 674

1. <u>Comparison To Estate Inclusion Rules</u>

IRC § 674 is primarily concerned with powers held by a trustee. If the settlor holds either too much power or too close of a relationship to the trustee, then IRC § 674 may well apply. Further, IRC § 674 may somewhat be analogized to the estate inclusion rules of who can be a trustee under IRC § 2036 & § 2038 (discussed later in this outline).

a. Discretionary v. Ascertainable Standard

If the settlor serves as a trustee of a discretionary trust, the entire trust will be included in the settlor's estate – IRC § 2036 and § 2038. Similarly, the grantor trust rule of IRC § 674 looks at retained powers of the settlor. If the settlor or a related person within the meaning of IRC § 672(c) serves as a trustee, the settlor shall be taxed on the trust's income. On the other hand, if a related person (not the settlor or the settlor's spouse) serves as trustee and the distributions may be made pursuant to an ascertainable standard, then there generally is not an estate inclusion issue. Likewise, under IRC § 674, a grantor does not pay income tax on the trust if a related person (other than the settlor or the settlor's spouse) serves as a trustee.

b. Settlor Holds Removal/Replacement Power

Generally, holding a removal/replacement power over a trustee does not result in an estate inclusion issue. Conversely, if the trust is discretionary, the Service in Rev. Rul. 95-58 has provided that the trustee should only be replaced with a party that is independent within the meaning of IRC § 672.(c). However, under IRC § 674(d), if the settlor holds a removal/replacement power and may replace the trustee with a spouse, the trust income is taxed back to the settlor.

Power to Control
Beneficial Enjoyment IRC § 674

- General Rule = if any nonadverse person has a **power of disposition**, the settlor is considered the owner of the trust (without the consent of an adverse person).
- nonadverse person includes an "independent trustee" that is not related under IRC 672(c).
- Includes "fiduciary" as well as other powers. Treas. Reg. 1.674(a)-1(a) – [i.e., Distribution Powers]
- Power to allocate income between and among trust beneficiaries is a power of disposition. Rev. Rul. 54-41
- Power of appointment

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2. General Rule

a. Definition of a Power of Disposition

The concept of a power of disposition is incredibly broad. It includes both the conceptions of a power of appointment and powers held by a trustee (i.e. fiduciary powers). Treas. Reg. § 1.674(a)-1(a); Rev. Rul. 54-41. In this respect, if any person has the ability to direct (in that person's capacity as trustee or otherwise) the disposition of any trust property, that person holds a power of disposition under IRC § 674.

b. Any Nonadverse Person

A nonadverse person is generally anyone who is not beneficiary of the trust. This means that the trust departments of Wells Fargo or Bank of America would be considered nonadverse persons, even though these bank trustees would be considered independent trustees within the meaning of IRC § 672(c).

c. Incredibly Expansive General Rule

First, many times, if not most of the time, the trustees are nonadverse persons. Second, as trustees they have the power to make distributions (i.e. a power of disposition). Therefore, at first glance, it appears that almost all trusts will be classified as grantor trusts because a nonadverse trustee has the power to make distributions (i.e. a power of disposition). Fortunately, this is not the case due to numerous exceptions.

4 Major Exceptions to the General Rule – IRC § 674(b)

- 1. **Independent Trustee Exception** – IRC 674(c)
- 2. **Reasonably Definite Standard Exception** (HEMS)
  - IRC 674(b)(5) – Corpus
  - IRC 674(d) - Income
- 3. Power exercisable solely by will – IRC 674(b)(3)
- 4. Power to allocate among charitable beneficiaries –
  - Charitable Remainder Unitrust (CRUT)

Is the Service on Steroids?

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3. <u>Four Major Exceptions</u>

There are actually eight exceptions to almost all trusts being classified as grantor trusts under IRC §674, but only four are particularly relevant for this outline.

a. Independent Trustee Exception

This is the exception that allows financial institutions as well as some others to serve as trustee without the trust being classified as a grantor trust.

b. Reasonably Definite Standard

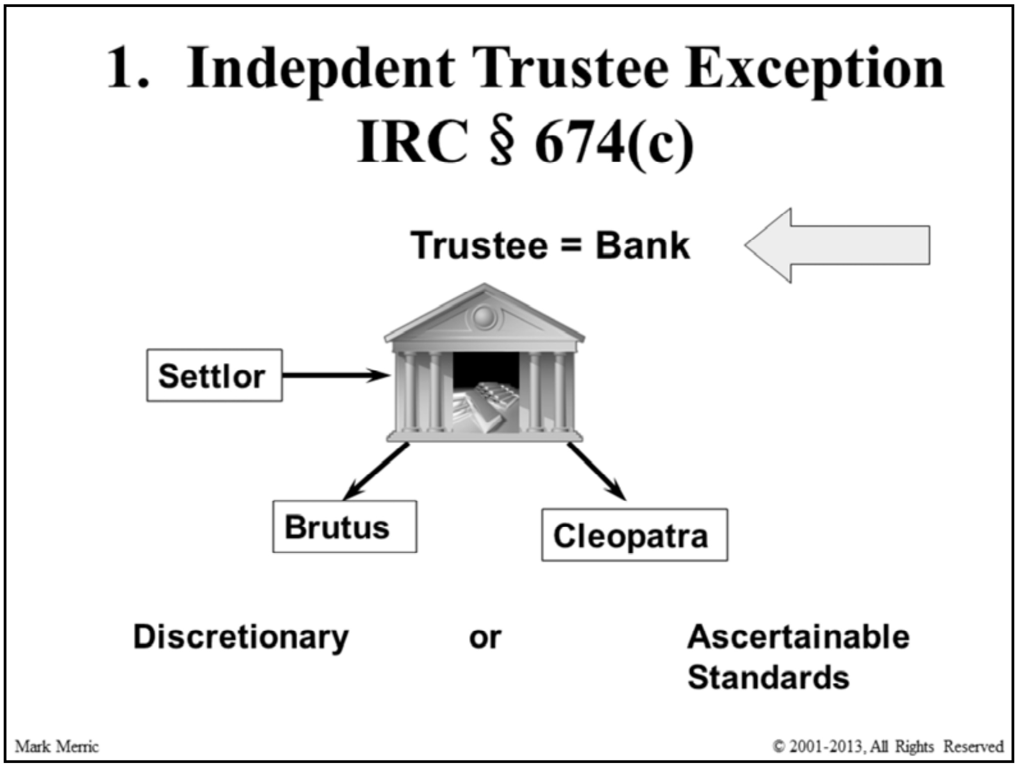
This exception allows certain related persons to serve as a trustee as long as distributions are based on ascertainable standards.

c. Power Excercisable Solely by Will

This exception allows the surviving spouse to hold a special power of appointment (i.e. a rewrite power) without the trust being classified as a grantor trust.

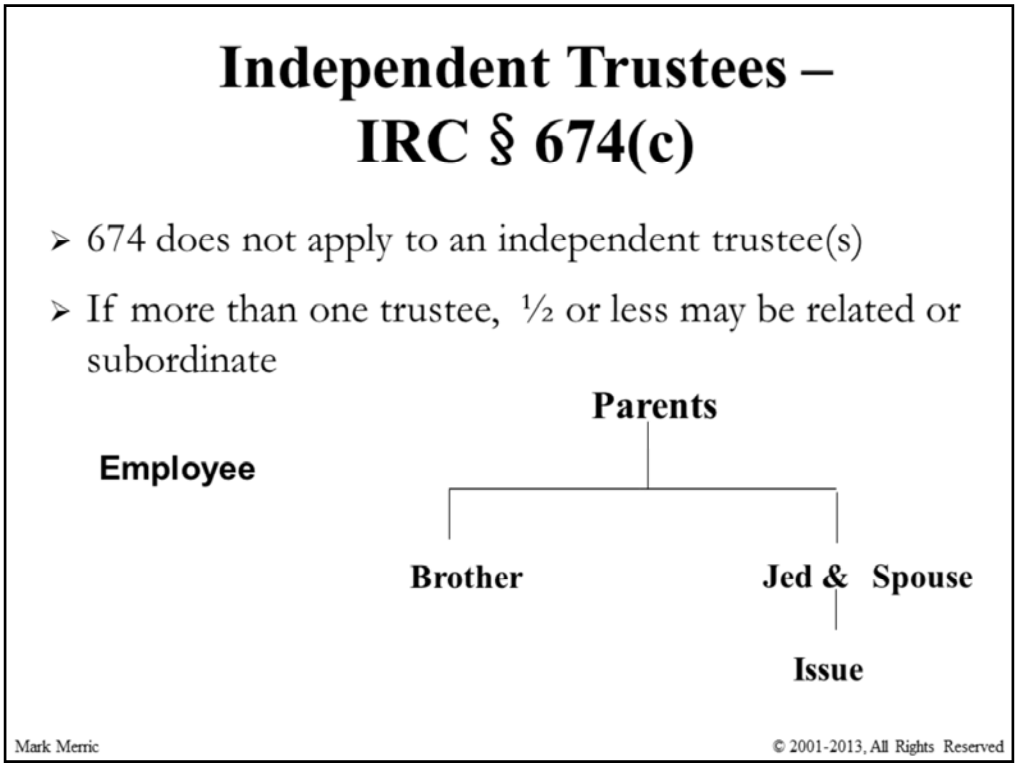
d. Power to Allocate Among Charitable Beneficiaries

This exception allows a settlor of a CRUT to be able to change charitable beneficiaries.



a. Independent Trustee Exception

IRC § 674(a) emphasizes the general rule that virtually all trusts, other than one with adverse co-trustees, will be classified as grantor trusts. However, if as an exception to this very broad rule, the trustee is independent within the meaning of IRC § 672(c), then the trust will not be classified as a grantor trust due to IRC § 674. With the independent trustee exception, it does not matter whether the distribution standard is discretionary or based on ascertainable standards.



i. Not Independent Trustees

Parents, brothers and sisters, children, and grandchildren are not independent. Also, any W-2 employee is not independent.

ii. Independent Trustees

Best friends, uncles, aunts, grandparents, brothers-in-law, sisters-in-law, best friends, certified public accountants, financial planners, and attorneys are all independent within the meaning of IRC § 672(c).

For a discussion of family owned trust companies being classified as an independent trustee see PLRs 200546052-055.

Reasonably Definite Standard Exception

- **Power to distribute <u>corpus</u> limited by "reasonably definite standard" - IRC 674(b)(5).**
  - Health, education, maintenance, and support
  - reasonable support and comfort
  - enable customary standard of living
  - to meet an emergency. Treas. Reg. 1.674(b)-1(b)(5)(i)
- The last three of these powers may create an estate inclusion issue (or the ability for certain creditors to recover from the trust) under state law.

b. *Reasonably Definite Standard Exception*

i Power Limited by a Definite Standard

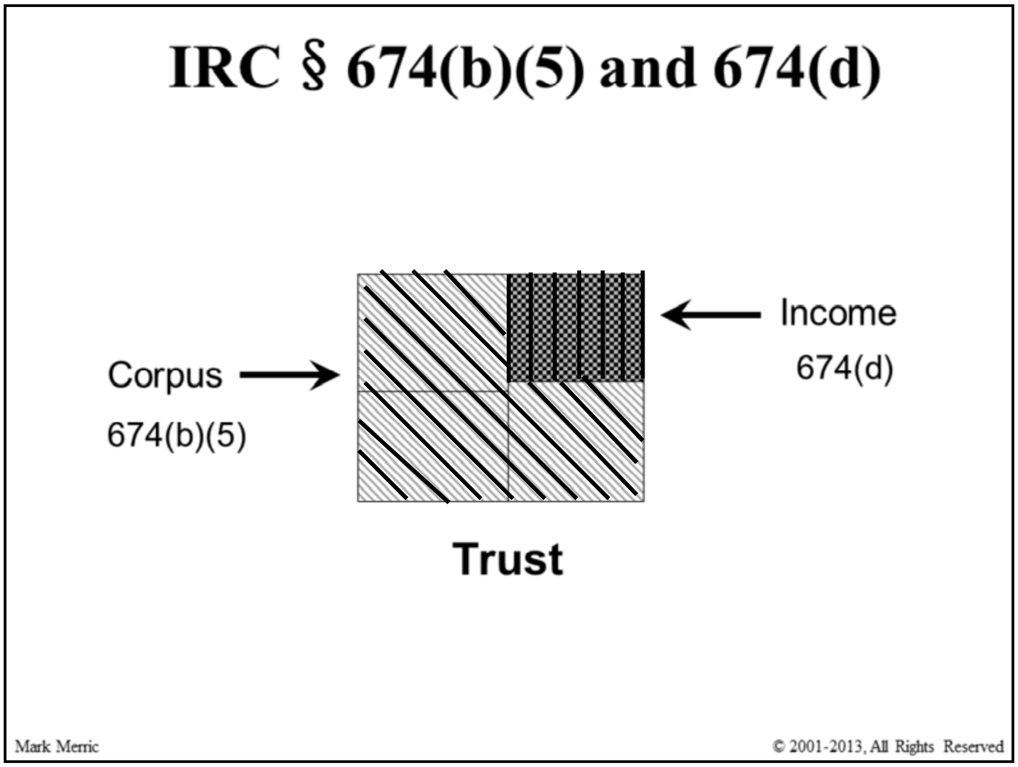
In several areas of the estate, gift, and grantor trust rules, if a <u>distribution</u> power is limited by a standard that may be interpreted by a court, then it is treated as if the grantor (i.e. settlor) does not have the prohibited power. The idea is that if the power is subject to the judicial systems review and the power is definable where most courts would come to relatively the same decision – then the there is no real "discretionary" power. The term "reasonably definite standard" is used under the grantor trust rules, "external standard" under IRC § 2036 and §2038, and an "ascertainable standard" under IRC § 2041. The most common reasonably definite standard is "The trustee shall make distributions to the beneficiaries for health, education, maintenance, and support."

ii. Problematic Language

While not being a grantor trust issue, the last three standards of distribution under Treas. Reg. § 1.674(b)-1(b)(5)(i) may create an estate inclusion issue (depending on state law), and therefore, should be avoided.

iii. IRC § 674(b)(5) Exception Limited to Corpus

The exception provided under IRC § 647(b)(5) applies only to distributions of corpus (i.e. principal). Many trusts provide that, "The trustee shall make distributions of income or principal to the beneficiaries for their health, education, support or maintenance." IRC § 674(b)(5) does not address the income issue. It only addresses the principal or corpus issue



iv. IRC § 674(b)(5) Must Be Combined With § 674(d)

(a) *Poor Drafting*

Unfortunately, the grantor trust rules in general and definitely in the area of IRC § 674(b)(5) and § 674(d) leave quite a bit of room for drafting improvement. As noted on the previous page, IRC § 674(b)(5) only applies to principal distributions. The next section is IRC § 674(c), which is the independent trustee exception that was previously discussed. After IRC § 674(c) is § 674(d), which is the "reasonably definite" exception for distributions of income.

(b) *Combining the Two Code Sections*

When IRC § 674(b)(5) is combined with IRC § 674(d), it provides a complete exception for trusts that have a distribution standard that is based on a "reasonably definite standard" (i.e. an ascertainable standard).

(c) *Net Effect*

Anyone (except for the settlor or the settlor's spouse – discussed later) may serve as a trustee of a trust when distributions are pursuant to an ascertainable standard, without the trust being classified as a grantor trust under IRC § 674.

Power to Allocate Income Limited to a Standard – IRC § 674(d)

- If a nonadverse person has the power to distribute or accumulate income limited by a "reasonably definite standard," the grantor will not be treated as the owner.
  - Non-adverse person may be related or subordinate
    - Brother, sister, parents, child
    - However, problems with the settlor's spouse as trustee
  - Corpus – IRC 674(b)(5) – ok – Grantor's Spouse
  - Income – IRC 674(d) – **not ok** Grantor's Spouse

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v. Power To Allocate Income – IRC § 674(d)

(a) Reasonably Definite Standard

A reasonably definite standard turns off grantor trust classification under IRC § 674(a) for corpus. IRC § 674(b)(5). For so long as the grantor or the grantor's spouse is not serving as a trustee (subject to removal/replacement power discussed on the next page), a reasonably definite standard also turns off IRC § 674(a) for income.

(b) Grantor or Grantor's Spouse

If either the grantor or the grantor's spouse is serving as a trustee, to the extent of trust income, the trust will be classified as a grantor trust. IRC § 674(d); Treas. Reg. § 1.674(d)-1.

Unrestricted Power to Remove and Replace Trustees – IRC § 674(c) & (d)

- Does a removal/ replacement power attribute the powers to the grantor?
- Independent Trustee under 674(c) no issue
- Reasonably Definite Standard
  - Ok for all but:
  - Grantor = grantor trust - Treas. Reg. 1.674(d)-1
    - Corning v. Commr. 24 TC 907 (1955)
  - Grantor's spouse – uncertain

Mark Merric

vi. Power To Remove/Replace Trustee

Will a removal/replacement power over a trustee cause an attribution of the trustee's powers to the grantor?

(1) Independent Trustee

A removal/replacement power that is limited to a person that is independent within IRC § 672(c) will not result in attribution of the trustee powers to the grantor. Treas. Reg. § 1.674(d)-2(a) second sentence.

(2) Reasonably Definite Standard

If the distribution standard is limited to a reasonably definite standard, a removal/replacement power will not result in attribution of the trustee's powers to the grantor, as long as the grantor may not be appointed.

(3) Grantor's Spouse

Even if the trust limits distributions to a reasonably definite standard, if the grantor may remove and replace the trustee with the grantor's trust, this may result in attribution of the trustee powers to the grantor. Neither the regs. nor the case law provide guidance in this situation.

Removal/Replacement Powers

For a Discretionary Trust Revenue Ruling 95-58

Any individual or corporate fiduciary so appointed shall not be related or subordinate to the person appointing said Trustee within the meaning of Section 672(c) of the Internal Revenue Code.

For a trust limited by an ascertainable standard when children beneficiaries are age of majority (i.e. no support obligation)

Any individual trustee shall not be me or an entity in which I have any ownership.

For a trust limited by an ascertainable standard when children beneficiaries are minors <u>or</u> to avoid grantor trust status (as to income) under Treas. Reg. § 1.674(d)-2(a).

Any individual trustee shall not be my wife, myself, or an entity in which I have any ownership.

IRC § 674 & 675's Fabulous Four

1. **Power to Add a Charitable Beneficiary**
   - IRC § 674(a) has a power of disposition = grantor trust
   - Ability to change trust beneficiaries by addition is a power of disposition
     - Exception, is after born or adopted children
   - Possible estate inclusion issue if held by the grantor
   - However, if held by a non-adverse independent person, power is not included in the settlor's estate or a beneficiary's estate

4. <u>Power to Add a Charitable Beneficiary</u>

Creating a grantor trust by adding a charitable beneficiary is a unique twist on IRC § 674(a). As previously noted, if any non-adverse person has a power of disposition, the trust is classified as a grantor trust. The ability to change trust beneficiaries results in the ability to change beneficial interests in trust. The exception to this rule is after born or adopted children. Conversely, adding a charitable beneficiary is not an exception.

The second issue is who can hold the power to add a charitable beneficiary. If the settlor holds the power, it may well be considered a power to determine who gets what by changing the beneficial interests under IRC § 2036(a)(2) or possibly a power to change the nature and manner of enjoyment under IRC § 2038. Therefore, the settlor should not hold this power. If the power is held by an adverse person (i.e. one that has a substantial interest in the trust), it may trigger an IRC § 2041 inclusion issue. Therefore, the safest alternative is to have a non-adverse independent person (usually a trust protector or trustee) to hold the power. *Mandorin v. Commr.,* 84 T.C. 667 (1985).

IRC § 674 & 675's Fabulous Four

1. **Power to Substitute Property of Equivalent Value** – IRC 675(4)(C)
   - Held in a non-fiduciary capacity – usually grantor
   - Most common method to create an IDIT
   - *Estate of Barber*
     - Retention of lien on property transferred = Grantor Trust
     - Grantor could foreclose and reacquire the property

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J. Administrative Powers IRC § 675

IRC § 675 is concerned with certain administrative powers. Should non-grantor trust status be desired, it is relatively easy to draft around these provisions. On the other hand, three of these powers are used to purposefully create a grantor trust (e.g. IDIT).

1. Power to Substitute Property of Equivalent Value

The safest method to create a grantor trust appears to be the power to substitute property of equivalent value under IRC § 675(4)(C). Since the power applies to all of the trust property, the entire trust (income and principal) is classified as a grantor trust. This power is typically held by the grantor in a non-fiduciary capacity. However, PLR 9037011 holds that it also applies when a third person holds such power in a non-fiduciary capacity. The grantor's holding of such power should not result in property being included in the estate. *Estate of Jordahl v. Commr.,* 65 TC 92 (1975), also see PLR 200606006.

An interesting tangential case is *Barber v. US,* 251 F.2d 436 (5^{th} Cir. 1948). *In Barber,* the grantor retained a lien on property he transferred to the trust. The 5^{th} Circuit concluded that the lien allowed the grantor to foreclose and re-acquire the property. Therefore, the ability to foreclose was the equivalent of a power to substitute property for equivalent value.

For Equivalent Value

Rev. Rul. 2008-22

- Trustee has a fiduciary obligation to insure property is of equivalent value
  - But not a veto power
- Substitution power cannot be utilized in a manner to shift benefits

Mark Merric

a. Rev. Rul. 2008-22

Revenue Ruling 2008-22 provides a safe harbor regarding a possible estate inclusion issue of a power to substitute property of equivalent value. However, there are a few conflicting goals that must be carefully drafted around. First, in order to qualify as a power to substitute property of equivalent value, the power must be exercised in a non-fiduciary capacity by the power holder. Conversely, the trustee has a fiduciary obligation to make sure that the trust property is of equivalent value, but this cannot rise to the level of a veto power. Therefore, should the trustee suspect that the property is not of equal value, he or she should be granted the right to have a court of competent jurisdiction to review the transaction to make sure that property of equivalent value is received.

Second, the substitution power cannot be utilized in any manner to shift benefits between beneficiaries. For example, if the trust provided for a mandatory distribution of income and non-income producing property were substituted for income producing property, then the income beneficiaries interests would be decreased.

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When to Use the Swap Power

- Elderly client
  - Loss property owned by the settlor
  - Low basis property owned by the trust
  - Life insurance and the three year rule

b. When to Use a Swap Power

In Professor Samuel A. Donaldson's outline, *Burning Questions (and Even Hotter Answers) About Grantor Trusts,* Southern California Tax and Estate Planning Forum, October 16, 2008, he discusses three situations where exercising the power to substitute property of equivalent value may be appropriate for an elderly client.

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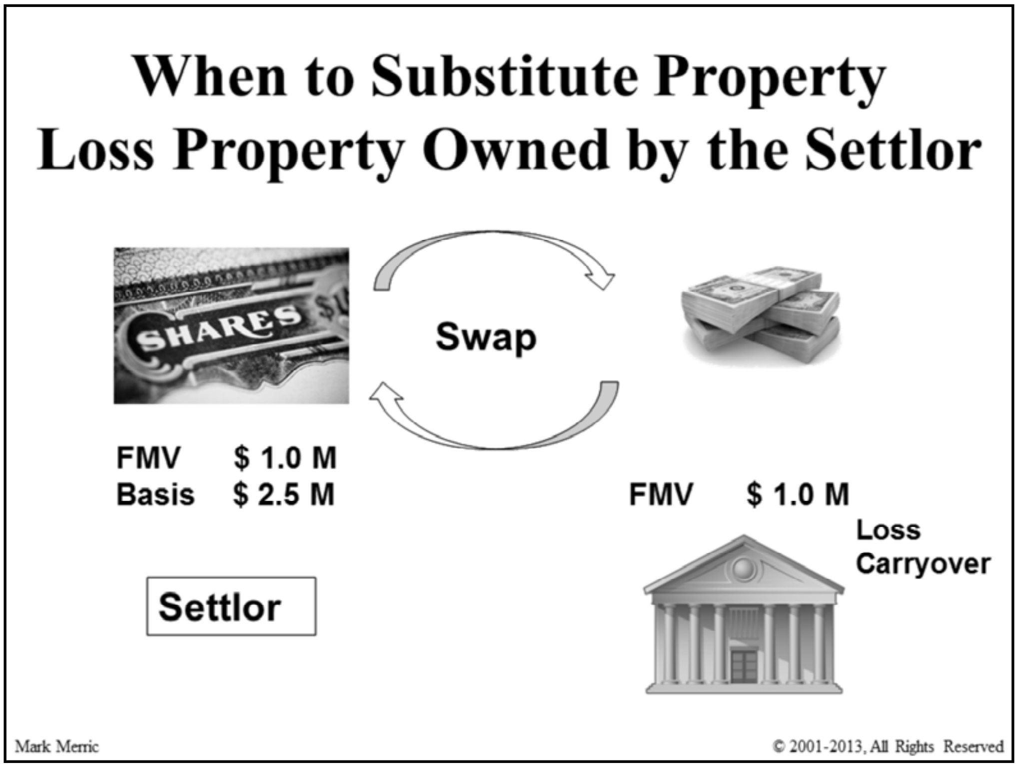
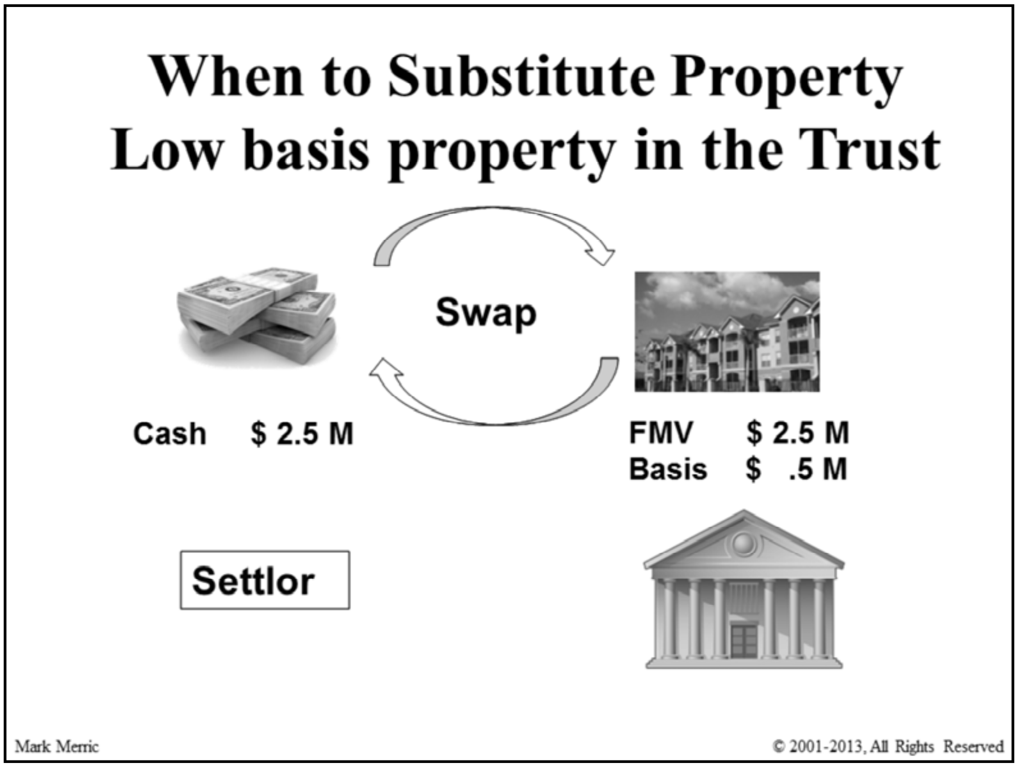


i. Moving Loss Property to the Trust

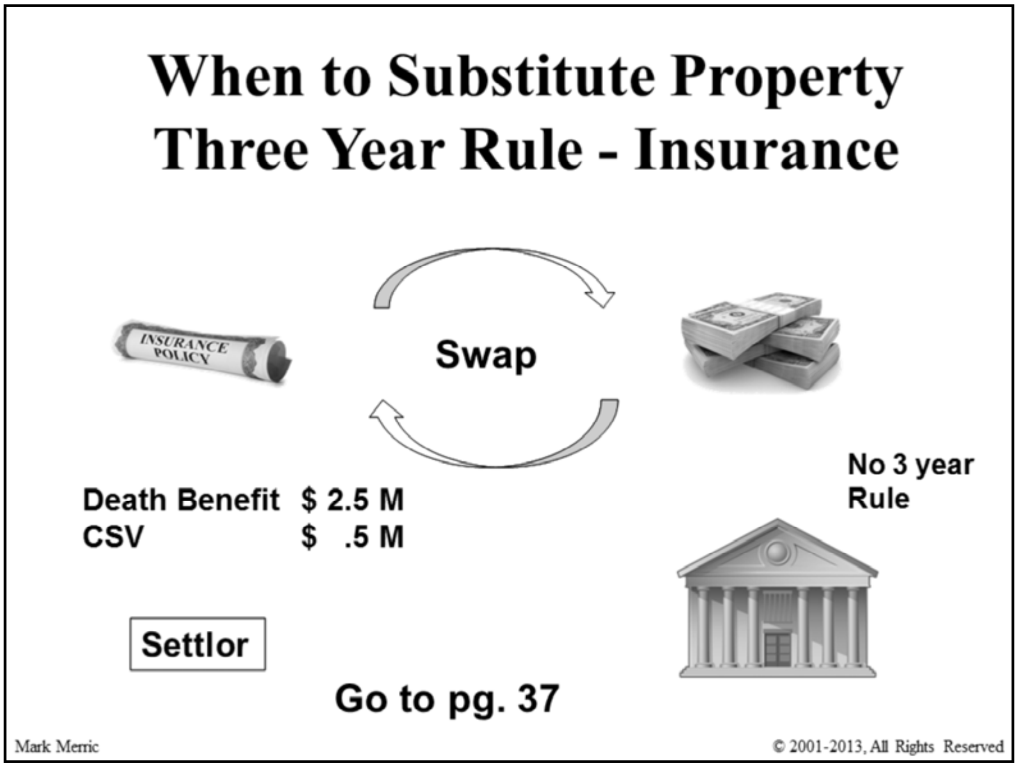
In the above example, if the settlor passes away and the stock is included in the settlor's estate, the $1.5 million capital loss will evaporate on the settlor's death (assuming there are no capital gains to offset against it). Conversely, if the settlor swaps the stock for the cash held by grantor trust, when the trust sells the stock, the capital loss will be carried forward until the trust is terminated.



ii.. Low Basis Property in the Trust

Assume the settlor has gifted $1 million of his or her $3.5 million applicable exclusion amount. At time of death, the Settlor may exclude the remaining $2.5 million applicable exclusion amount ($3.5 M - $ 1M). If the settlor holds assets where their fair market value is approximately equal to their basis, there is no or little step up of basis under IRC § 1014.

Conversely, if the apartment buildings are owned by the Settlor at time of death, they step up to fair market value. The inheritors of the apartment building may then sell the apartments without any income tax consequences.



iii. Getting Around the Three Year Rule

If a planner is worried that the settlor may not live three years and the settlor is the owner of a life insurance policy, the settlor may swap the life insurance policy for other assets held by the grantor trust. Since a grantor trust is disregarded for income tax purposes, any transactions between the settlor and the grantor are disregarded. Rev. Rul. 85-13. Since there is no transfer, the transfer for value rules are not triggered. In essence, the swap power provides an effective method to move an insurance policy from the settlor to the an irrevocable grantor trust and avoid the three year rule under IRC § 2035.

IRC § 674 & 675's Fabulous Four

2. **Power to Loan w/out Adequate Security (or Interest)**
   - Power usually vested in the grantor
   - Some planners use only w/out adequate security
   - Actual loan a below market rate may violate imputed income or gift rules.

3. **Power to dispose of trust property for less than adequate consideration**
   - Not held by the grantor
   - Held by a non-adverse person, typically the trustee

Mark Merric

2. <u>Power to Loan Without Adequate Security</u>

A second method using the administrative powers of IRC § 675 to create a grantor trust is to give the grantor the ability to borrow from the trust without adequate security. IRC § 675(2). Professor Donaldson in his outline, *The 7 Habits of Highly Effective Grantor Trusts,* Southern California Tax and Estate Planning Forum, October 19-21, 2006 notes that a general power of a trustee (other than a grantor) to make payments to <u>anyone</u> without adequate interest or security will not work. Treas. Reg. § 1.675-1(b)(2).

> From an estate perspective, it does not appear that there are any estate inclusion issues if the grantor holds a power to borrow without adequate interest or security. However, a power to borrow for less than adequate interest, if the trust actually makes such a loan, may have income or gift tax ramifications under the imputed interest rules between related parties.

3. <u>Power to Deal With Trust Property For Less Than Adequate Consideration</u>

A third, much less popular method to intentionally create a grantor trust is to give a non-adverse person (typically the trustee), who is not the grantor, a power to deal with trust property for less than full consideration Such a power is not given to the grantor because of the possible estate tax inclusion issue under IRC § 2036(a)(2), since the grantor could to some degree determine who could enjoy the trust property.

Power to Revoke – IRC § 676

- Brother/Sister
- Where did these come from?
- If a **nonadverse** person retains the power to revest property in the grantor = grantor trust. A power to revest includes:
  - to revoke,
  - alter,
  - amend,
  - or to appoint. Treas. Reg. 1.676(a)-1
- nonadverse person includes an "independent trustee" that is not related under IRC 672(c).

Mark Merric

K. Power to Revoke

Similar to IRC § 2038, the heading "a power to revoke" is a bit of a misnomer. The area covered by IRC § 676 is much more expansive.

1. Any Method Trust Property May Be Returned to the Grantor

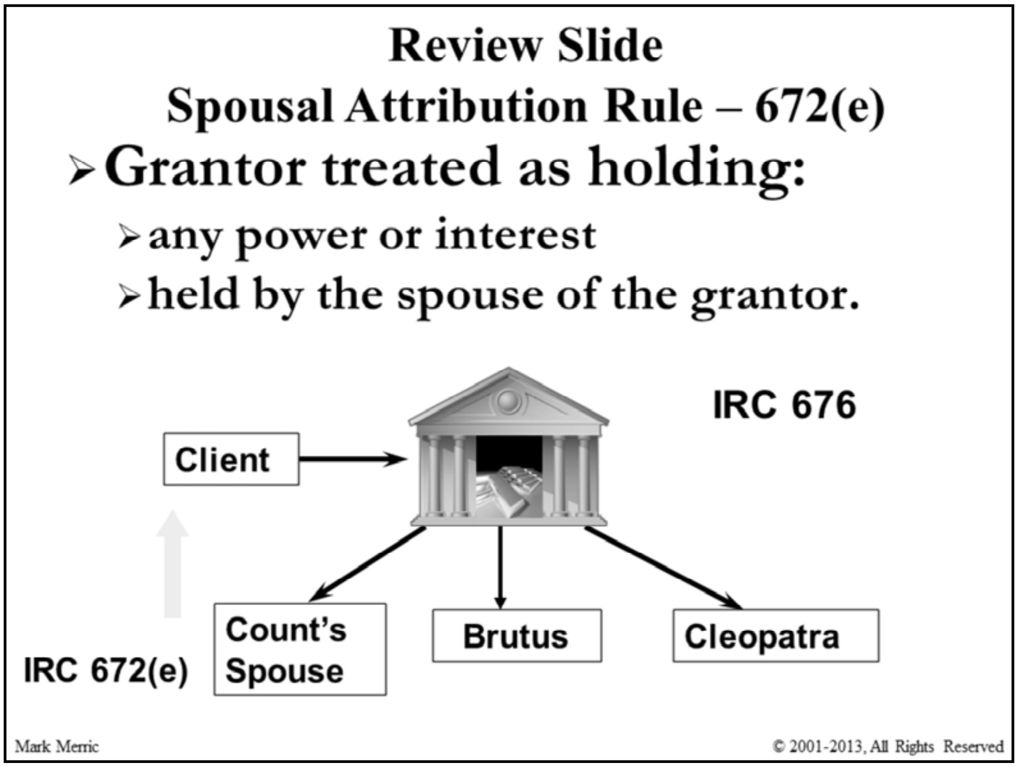
It includes any method where any non-adverse person may return property to the grantor (i.e. power to revoke), make a distribution to the grantor (i.e. the grantor is a beneficiary), or exercise a power on behalf of the grantor (i.e. a power of appointment or a power of disposition).

2. Non-Adverse Person v. Independent Trustee

As stated previously, an adverse person means a person who has a substantial interest in the trust – which in most cases will be a beneficiary. Wells Fargo, Bank of America, and Colorado State Bank are all independent trustees within the meaning of IRC § 672 (c). They are not adverse because they do not have any interest in the trust.

3. Spousal Attribution Rule

Under IRC § 672(e), any interest owned by a spouse is attributed to the grantor. Therefore, if a non-adverse person is serving as trustee and such person may make distributions to the spouse, the trust will be classified as a grantor trust under IRC § 676.



a. Concept of the Related or Subordinate Person

The grantor is treated as holding any power or interest held by the spouse of the grantor. A power generally would be if the grantor's spouse was serving as trustee or if she held a power of appointment. An interest means the spouse is a beneficiary of the trust.

b. Applicable Grantor Trust Sections

As previously noted in this outline, attribution of the grantor's spouse interest is found in IRC § 673 and IRC § 676. Attribution is not needed under IRC § 674(d) and 677 because the spouse is specifically mentioned in these code sections. Furthermore, the concept of attribution does <u>not</u> apply to IRC § 678 and 679.

Income for Benefit Of the Grantor – IRC § 677

- If a nonadverse person has any of the following three powers = Grantor Trust:
  - Income may be distributed to or for the benefit of the grantor or grantor's spouse;
  - held or accumulated for future distribution;
  - "may" be applied to the payments of premiums on policies of insurance on the life of the grantor

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L. Income For The Benefit of the Grantor

If any non-adverse person has anyone of the above mentioned powers, the trust is classified as a grantor trust.

1. <u>May Be Distributed or Accumulated For the Benefit Of</u>

If any non-adverse person has the power to either pay the income to the grantor or the grantor's spouse, or to accumulate the income on behalf of the grantor or the grantor's spouse, the trust is classified as a grantor trust.

a. No Spousal Attribution Rule is Required

Unlike IRC § 673 and § 676, IRC § 677 does not require the spousal attribution rule of IRC § 672(e), because the code specifically mentions the spouse.

b. First Party Special Needs Trust

Pursuant to Rev. Rul. 83-25, when a court creates a first party special needs trust for the benefit of an injured plaintiff, the injured plaintiff (i.e., special needs beneficiary) is deemed the grantor, and the trust is classified as a grantor trust under IRC § 677.

Income for Benefit Of the Grantor – IRC § 677

- Disagreement Among Professionals
  - Does "may" mean "may" or does it mean "shall"
  - What if the trust instrument is silent?

Mark Merric

2. Applied to Payments of Premiums on Policies of Insurance

If any non-adverse person has the ability to make premium payments on policies of insurance on the life of the grantor or the grantor's spouse, the trust is classified as a grantor trust. Estate planning professionals disagree over what the word "may" means in the code. If read literally, it would mean that any trust that could purchase life insurance on the life of the grantor or grantor's spouse, regardless of whether life insurance was ever purchased, would be classified as a grantor trust. Therefore, any express provision in the trust or granted by state law allowing the mere possibility for the trustee to purchase insurance on the life of the grantor or the grantor's spouse would trigger grantor trust status. On the other hand, many estate planners interpret the word "may" to mean that the trustee "must" buy insurance on the life of the grantor or the grantor's spouse before the trust would be classified as a grantor trust.

a. Major War Between Professionals

It would be nice to say that estate planners disagree in this area. However, estate planners alike hold this issue in contempt and to be highly controversial. Rather, estate planning audiences almost break out in fist fights over this issue.

Sample Language

My Trustee may purchase life, disability, medical, liability, long-term health care and other insurance on the behalf of and for the benefit of any trust beneficiary other than my wife or me. However, notwithstanding any other provision of this trust, my Trustee is specifically prohibited from purchasing life insurance on my wife's life or my life. My Trustee may purchase annuities and like investments for any trust beneficiary.

Mark Merric

b. Does the Code mean what it says?

On one side of the battle line, we have those estate planners who say the literal language of the code controls. The complete text of IRC § 677(a) follows:

677(a) General rule

The grantor shall be treated as the owner of any portion of a trust, whether or not he is treated as such owner under section 674 , whose income without the approval or consent of any adverse party is, or, in the discretion of the grantor or a nonadverse party, or both, **may be**—

(1) distributed to the grantor or the grantor's spouse;

(2) held or accumulated for future distribution to the grantor or the grantor's spouse; or

(3) applied to the payment of premiums on policies of insurance on the life of the grantor or the grantor's spouse (except policies of insurance irrevocably payable for a purpose specified in section 170(c) (relating to definition of charitable contributions)).

c. Trust Instrument is Silent

Under the literal interpretation, if a trust instrument is silent, there still is a problem. In such a case, whether a trustee could purchase insurance on the life of the settlor or the settlor's spouse would depend on the default rules of the state principal and income act.

d. Trustee Must Buy Insurance?

On the other side of the trenches are the estate planers that claim that the literal language does not mean what it says. These estate planners believe that the trustee must actually buy insurance in order for IRC § 677(a)(3) to apply. These estate planners rely on a predecessor tax code section and the following old cases that were interpreted under this section.

i Rand v. Commr., 40 BTA 233; 116 F.2d 929 (8th Cir. 1941);

This case was decided under old IRC § 167(a)(3) which stated:

(a) Where any part of the income of a trust . . .

(3) is, or in the discretion of the grantor or of any person not having a substantial adverse interest in the disposition of such part of the income **may be,** applied to payment of premiums upon policies of insurance on the life of the grantor …

The court held the grantor was taxed on the income of the trusts to the extent that the premiums were paid or payable. To the extent the excess trust income was over the premium amount, the income was taxed to the trust.

ii. Irersen v. Commr., 3 TC 756 (1944)

Similar to *Rand,* this case was decided under old IRC § 167(a)(3), with the same holding - the net income of the trust taxable to the grantor to the extent it was used to pay for insurance premiums. The amount of trust income in excess of the insurance was taxed to the trust.

iii. Weil v. Commr., 3 T.C. 579 (1944)

Weil has the same holding as the above two cases.

iv. Moore v. Commr., 39 BTA 808 (1939)

In *Moore* the trustee did not purchase any insurance on the life of the settlor. Rather, the Service argued the trustee could purchase insurance on the life of the settlor. The Tax Court held that:

> "While on its face section 167 might appear to apply, it has, so far as can be discovered, never been considered applicable even by the responded [i.e. Service] as broadly as it is now suggested."

While holding for the taxpayer, the plain language of the Tax Court opinion acknowledges the controversy between professionals on this issue.

e. After 60 Years of Silence – An FSA – the Word "May" is Interpreted Literally

In FSA 20062701F, the Service took the position that the word "may" should be interpreted literally. In other words, the mere ability of the owner to purchase insurance on the life of the grantor or grantor's spouse created a grantor trust. There was no requirement that the trustee actually purchase the insurance. Also see a somewhat analogous position in PLR 8014078. However, in this PLR, the trustee had actually purchased the insurance.

For a tangentially related fact pattern see PLR 200228019. In this PLR, Trust 2 owns life insurance policies and is a grantor trust. The taxpayer has stated that taxpayer (which would be the third trust - i.e., "Trust 3") is a grantor trust under IRC 677(a)(3). The PLR does not directly discuss why Trust 3 is a grantor trust under IRC 677(a)(3). Trust 3 requests a ruling on whether the sale of the life insurance policies from Trust 2 and purchase by Trust 3 will avoid the transfer for value rules of IRC Sec. 101. The only way the sale and purchase will avoid the transfer for value rules is if Trust 3 is a grantor trust. This is because the settlor will be considered the owner of both trusts, and you cannot sell property to yourself under Rev. Rul. 85-13.

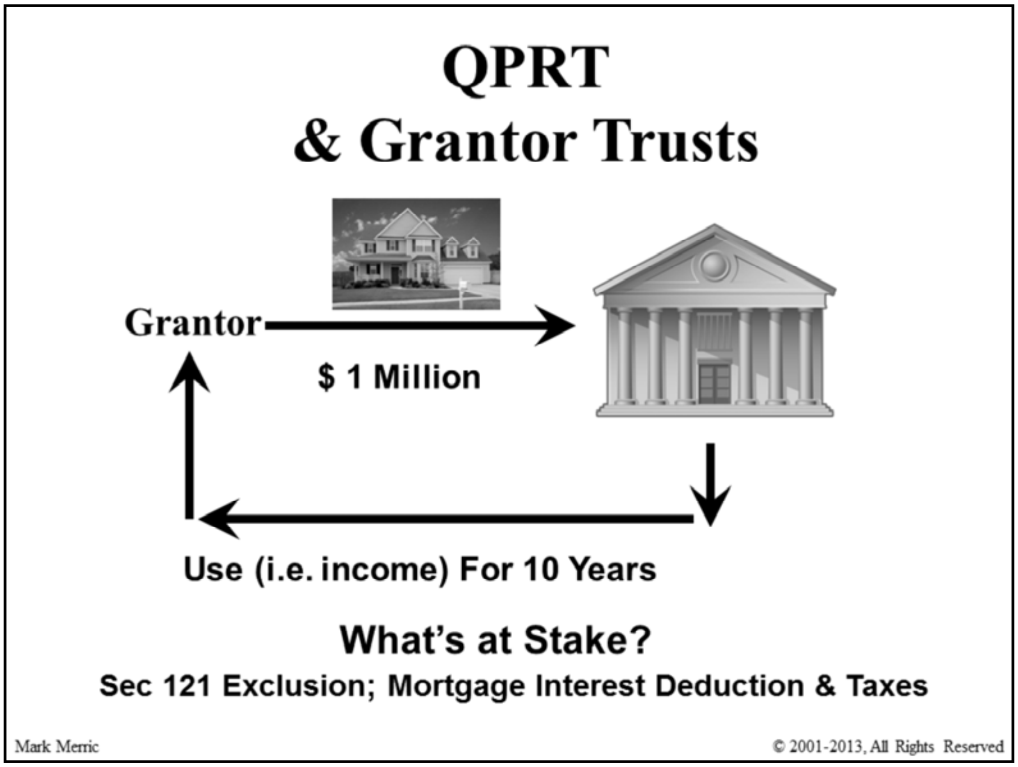
At the time of the sale/purchase, Trust 3 does not own insurance. Therefore, it is not a grantor trust under IRC 677(a)(3) by actually owning insurance, because before the sale/purchase it does not own insurance. Rather, the implied understanding, unfortunately not directly addressed in the PLR, is that Trust 3 was a grantor trust, because it "may" purchase insurance under the literal language of IRC 677(a)(3).

f. Trust Prohibits the Purchase of Insurance, But Trustee Purchases It.

On the other hand, when a trust prohibits the purchase of insurance and the trustee actually purchases it, the trust is classified as a grantor trust. PLR 8839008.

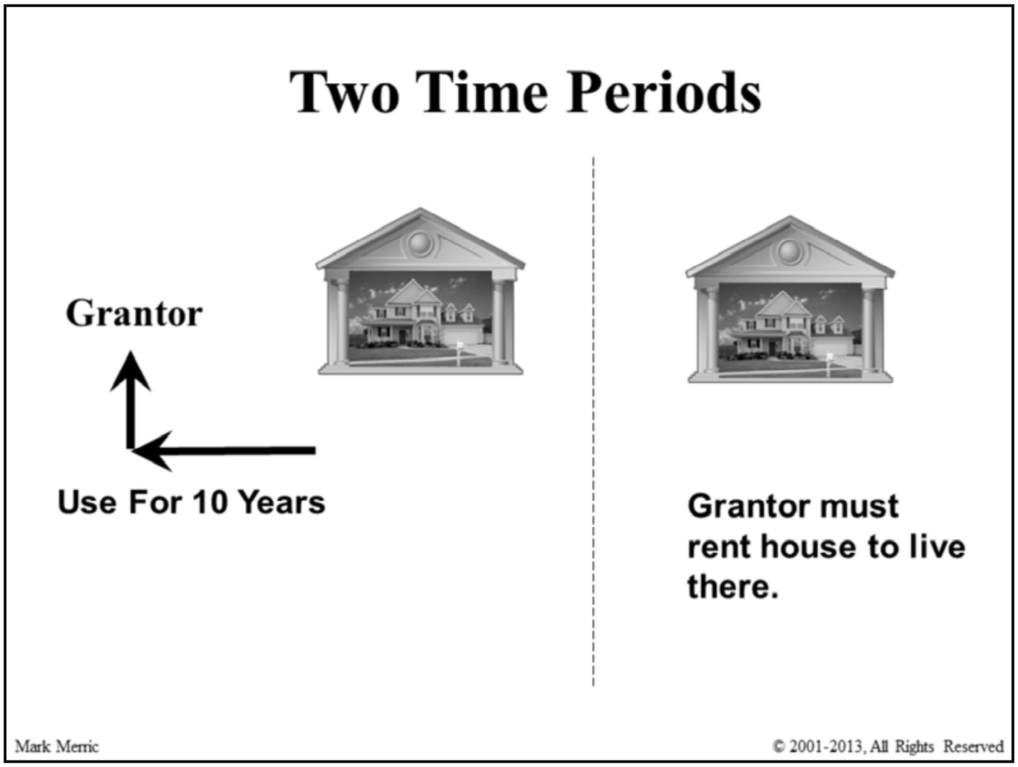
g. Conservative Position

The above language takes the position that IRC § 677(a)(3) should be interpreted literally, and it prevents the trustee from being able to purchase insurance to turn of the grantor trust status, under IRC § 677(a)(3).



3. QPRT & Grantor Trust Rules

A QPRT needs to be classified as a grantor trust, otherwise the taxpayer will lose the $250,000 exclusion (for single persons) or ½ million exclusion for married on sale. Further, the settlor(s) will lose the mortgage interest and tax deduction.



The grantor trust rules apply differently depending on either (a) the period when the grantor may use the property without paying rent (i.e. the "QPRT Term"); and (b) the period of time after the income or use interest expires and the grantor must rent the property.

a. During the Rent Free Use of the Residence Period

During the QPRT term, IRC § 673 and possibly IRC § 677 will almost always result in classification of a QPRT as a grantor trust.

i. IRC § 673 Reversionary Interest

As previously stated, if the grantor holds more than a 5% reversionary interest in a trust, the trust is classified as a grantor trust. In order to qualify as a QPRT, if the grantor dies during the QPRT term, the residence must be distributed to the grantor's estate. Treas. Reg. § 25.2702-5(c)(4) and Treas. Reg. § 25.2702-5(c)(8). In almost all cases, the reversionary interest will be greater than 5% and the QPRT will be classified as a grantor trust under IRC § 673. PLR 9606003.

ii. IRC § 677

Some practitioners take the position that IRC § 677 will automatically result in classification of a QPRT as a grantor trust. As previously discussed, IRC § 677 states that if the income (i.e. the use of the principal residence) is for the benefit of the grantor or the grantor's spouse, the trust will be classified as a grantor trust. Unfortunately, the analysis is a bit more complicated.

QPRT During the Term Interest

- IRC 673 – Reversion interest
  - If die during term must revert back to grantor
  - 5% or more interest
- IRC 677 – Income interest – probably does not work
- Right to live in the house = income interest
  - Solves problem of interest and tax deduction
  - But what about Sec 121 exclusion
  - Treas. Reg. 1.677(a)-1(g) illustrate the rule
    - Capital gain under local law allocated to principal

(1) Division Between Income and Corpus

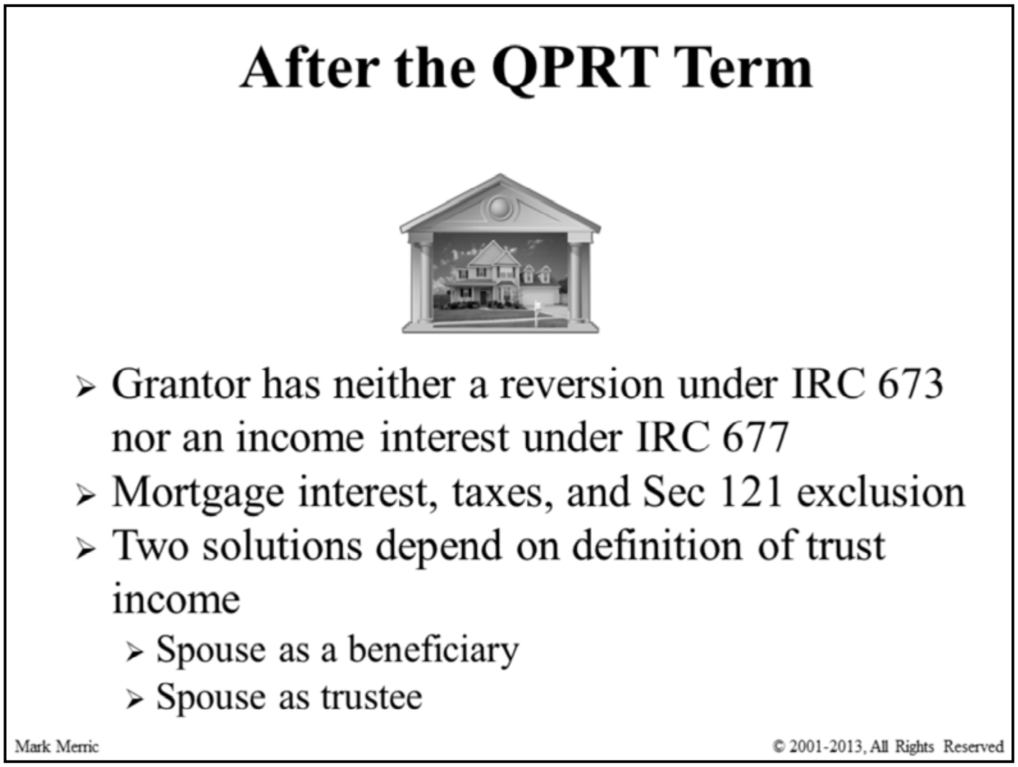
IRC § 677 discusses income that may be distributed to the grantor. IRC § 676 discusses corpus that may be distributed to the grantor. It appears that these two sections were intentionally written so that income did not mean tax accounting income as defined in Treas. Reg. § 1.671-2(b) (see discussion pg. 52). Further, both example 1 in Treas. Reg. § 1.677-(a)-1(g) and PLR 9829002 support this conclusion. The example in the Treas. Reg. specifically notes that capital gains under local law were allocated to principal; and therefore, such capital gains were taxed to the trust under IRC § 677.

(2) Solves the mortgage interest and tax problem

IRC § 677 creates a grantor trust for the fiduciary income. Therefore, it solves the mortgage interest deduction and real property tax deduction issues. However, it does not solve the § 121 exclusion.

(3) Drafting to Override the Default Rule

Generally, unless the trust instrument specifies otherwise, under local law, capital gains are allocated to corpus. A provision in the trust document allocating capital gains to income may well create a grantor trust as to the corpus so that the grantor will be able to use the § 121 exclusion. However, there is another problem. Treas. Reg. § 25.2702-5(c)(3) provides that the QPRT document must require that all income be distributed to the term holder at least annually. If capital gains are classified as income, the trust sells the personal residence; most likely the gain from the sale of the personal residence would need to be distributed to the grantor.



b. After the QPRT Term

At the end of the QPRT term, both the reversion interest and the use of the house rent free by the grantor end. Therefore, neither IRC § 673 nor IRC § 677 apply. Therefore, how is a grantor able to continue to deduct mortgage interest and taxes, and also qualify for the § 121 exclusion?

(i) IRC § 677 and IRC § 676 – Spouse as a Beneficiary

One distinguished commentator, Natalie B. Choate, has mentioned that one might consider adding the grantor's spouse as a QPRT beneficiary after the QPRT term. *The QPRT Manual,* Natalie B. Choate, Ataxplan Publications (p. 297). In the event that the spouse is a beneficiary, and the trustee has the ability to spray income and principal (i.e., a discretionary trust), this should result in a grantor trust for both income and principal. Under IRC § 677, income may be distributed to the grantor's spouse making the trust a grantor trust under IRC § 677. Also, the attribution rule of IRC § 672(e) would attribute the ability to distribute principal to the grantor's spouse to the grantor under IRC § 676. Please note that when using this method, adverse co-trustees should never serve as trustees. Otherwise they will turn off grantor trust treatment under IRC § 676 and § 677.

(ii) IRC § 674 & Reasonably Definite Standard

Another possible method to obtain grantor trust status is for the settlor's spouse to serve as the sole trustee (assuming no support obligation to other beneficiaries under IRC § 2041) pursuant to an ascertainable distribution standard. If the trust document allocates capital gains to income, this should create a grantor trust for the mortgage interest, the real estate tax deduction, and the § 121 exclusion.

Fabulous Four

- **Substitute Property of Equivalent Value**
  - Cannot use this method
  - Treas. Reg. 25.2702-5(c)(9), during the QPRT term, the trust instrument must prohibit transferring the residence to the grantor
- **Loan w/out Adequate Security or Interest**
  - May use this method
- **Power to dispose of trust property for less than adequate consideration**
  - Not held by the grantor
- **Power to add a charitable beneficiary**

Mark Merric

(iii)Terrific Three Administrative Provisions

(1) Substitute Property of Equivalent Value

Unfortunately, for so long as a residence is part of the trust property, this method cannot be used. This is because the governing QPRT instrument must contain a provision that prohibits the trust transferring the residence to the grantor. Treas. Reg. § 25.2702-5(c)(9). A power for the grantor to substitute property of equivalent value would defeat this QPRT requirement.

(2) Loan w/out Adequate Security or Interest

When the grantor holds a power to borrow without adequate security (or interest), this should create a grantor trust after the QPRT term.

(3) Power to Dispose of Property For Less Than Adequate Consideration

This method should also work. However, make sure that this power is not held by the grantor, but rather by a third person as discussed on p. 29.

Five Year Medicaid Trust

- Pay all income to grantor
  - Sec 121 exclusion, but leave proceeds from house in the trust
  - Do not care about estate inclusion issues
- Medicaid Disallows
  - Power to substitute property of equivalent value
  - Power to make any loan to grantor
  - Power to add beneficiaries
- Income to grantor
  - IRC 675(1) – power to deal for less than adequate consideration

4. Five Year Medicaid Trust

Many elder law attorneys create five year Medicaid trusts where a client transfers his or her assets into a trust and then has the right to live in his or her house as well as receive all income from the trust. Typically, the trust is designed to be a grantor trust, so that if the house is sold, the grantor receives the IRC § 121 exclusion. Usually, one of the following powers is included to insure grantor trust status:

(1) Substitute property of equivalent value;

(2) Make a loan to the grantor at a below market rate; or

(3) Add beneficiaries.

Some state agencies have disqualified five year Medicaid trusts based on any of these provisions, claiming that the grantor had an ability to get assets back or control who was to receive the ultimate benefits of the trust.

a. QPRT Methods That Don't Work Here

(i) IRC § 677 – Won't Work

Adding a spouse as a discretionary beneficiary will disqualify the person from receiving Medicaid benefits. Therefore, this QPRT solution will not work.

(ii) IRC § Spouse as a Trustee

If trust accounting income is defined to include capital gains, having the grantor's spouse serve as the sole trustee should create a grantor trust. However, then the income attributable to the sale of the house would be required to be distributed to the grantor. Therefore, this also will not work.

b. Few Remaining Methods

(1) Power to Deal For Less Than Adequate Consideration

The power of a non-adverse person, who is <u>not</u> the trustee, to deal with others for less than adequate consideration appears to be one of the remaining methods to create a grantor trust in the situation described on the previous page.

(2) South Dakota's SB 98

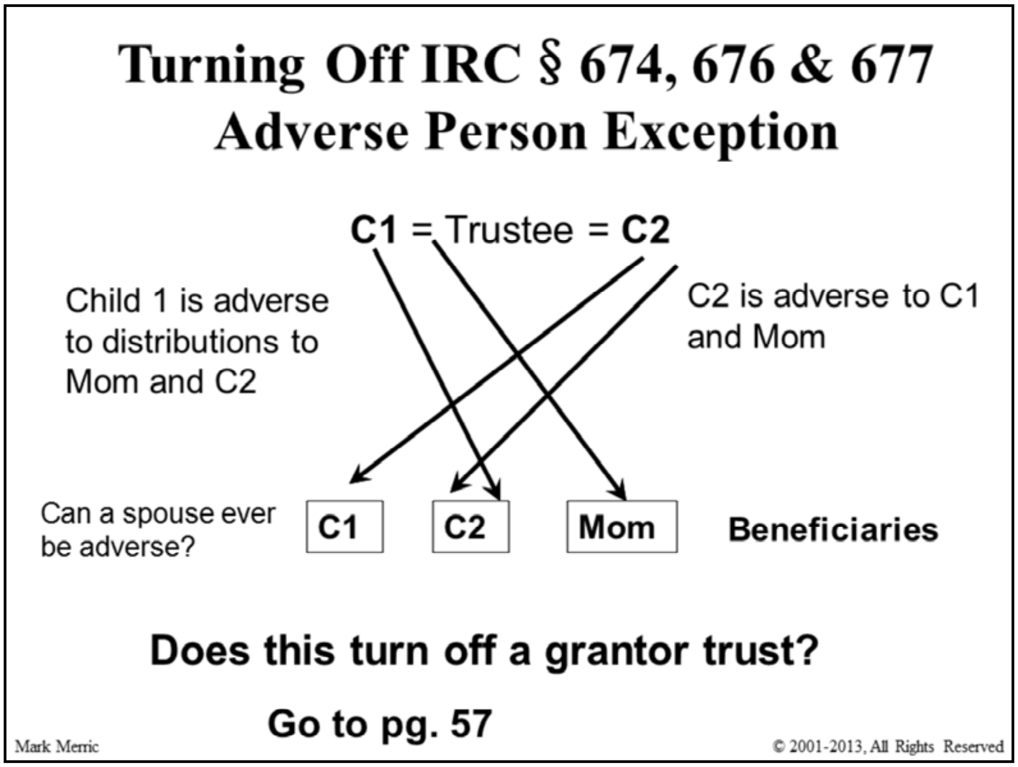
While primarily dealing with classification of trust interests, South Dakota's SB 98 also states that many retained powers are not to be considered dominion and control over the trust. In this respect, South Dakota's SB 98 pre-empts South Dakota's Medicaid Regulatory Agency from making many of the arguments that Colorado's Department has done.

Rod Goodwin's Method

- Trust Instrument
  - Capital gains must be allocated to principal in the document as well as by state law.
  - Must be allowed by local law
- Treas. Reg. 1.674(b)-1(3)
  - Last clause
  - Majority view – Grantor holds a testamentary power of appointment
  - Grantor trust as to principal
- Rod's #
  - 509-993-9253

c. Rod Goodwin's Method

With a five year Medicaid trust, since the settlor receives all of the income, it is a grantor trust as to income. IRC § 677. Conversely, if the settlor holds a limited power of appointment over the principal, Rod Goodwin takes the position that it is a grantor trust as to principal. Key to Rod Goodwin's analysis is that both capital gains must be allocated to principal under state law and capital gains must be allocated to principal in the trust document. Bernard A. Krooks and Jonathan Blattmachr agreed with this approach in *The Medicaid Trust – Cover the Costs of Long-Term Care Without Losing Significant Personal Assets,* Trusts & Estates, May 2010.



M. Turning Off IRC § 674, 676, & 677

When C1 has equal voting power with C2, then C2's vote is required before any distribution may be made to C1 and C2. As long as C1's consent is required, the adverse party exception applies. C2 is also adverse to any distributions to C1 and mom.

1. Example

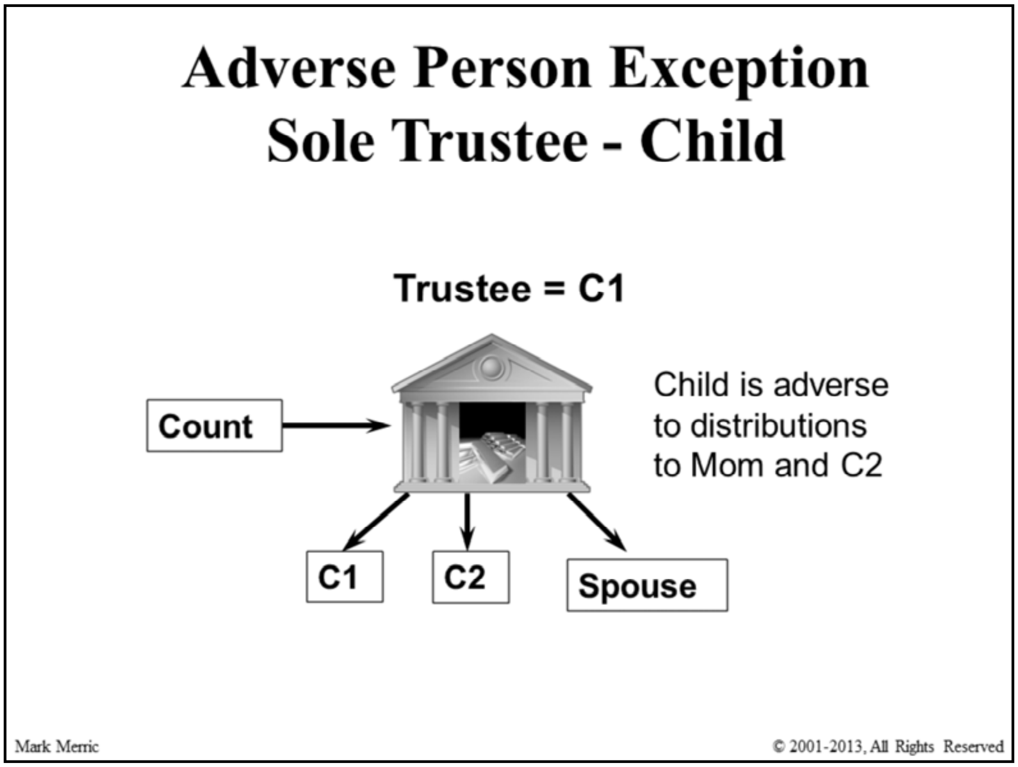
For an example, where adverse co-trustees of a self settled trust turned off the grantor trust rules for IRC § 674 and § 677 see PLR 200247013. (Please note that the author disagrees with the IRC § 673 analysis in this PLR).

2. Can a Spouse Ever Be Adverse

Howard Zaritsky, in BNA's portfolio on grantor trusts takes the position that a spouse cannot be a non-adverse person because of the spousal attribution rule. It states:

"The spousal attribution rules enlarge the grantor trust rules only slightly, since the grantor's spouse was always considered a "related or subordinate" party, and often a nonadverse party under § 672(c)(1). The principal objective of the spousal attribution rule is to eliminate the so-called spousal remainder trust as an income-shifting device by taxing as a grantor trust any trust in which the grantor's spouse holds a reversionary interest worth more than 5%. This rule also prevents the grantor's spouse from ever being an adverse party, since the interest or power which would otherwise make the spouse an adverse party would be imputed to the grantor."

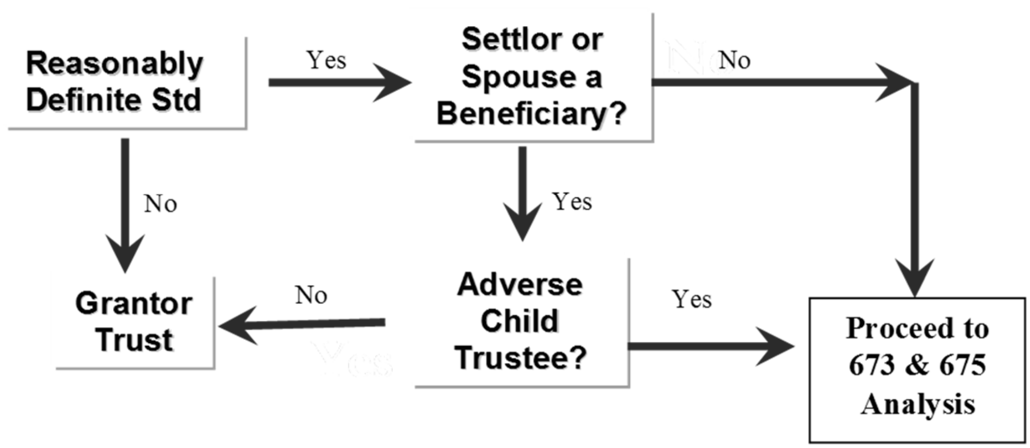
While the author is not certain that he agrees with the above spousal analysis, he does note that Howard Zaritsky's BNA Portfolio, 858-2nd T.M., Grantor Trusts: Section 671-679, is the most likely the most comprehensive treatise on grantor trusts. The author's concern deals with the purpose of an adverse party. The person is adverse because some amount is going to someone other than the adverse person. It has little to whether there is attribution of the spouse's interest to the settlor. On the other hand, Howard is seldom, if ever, incorrect with his analysis.



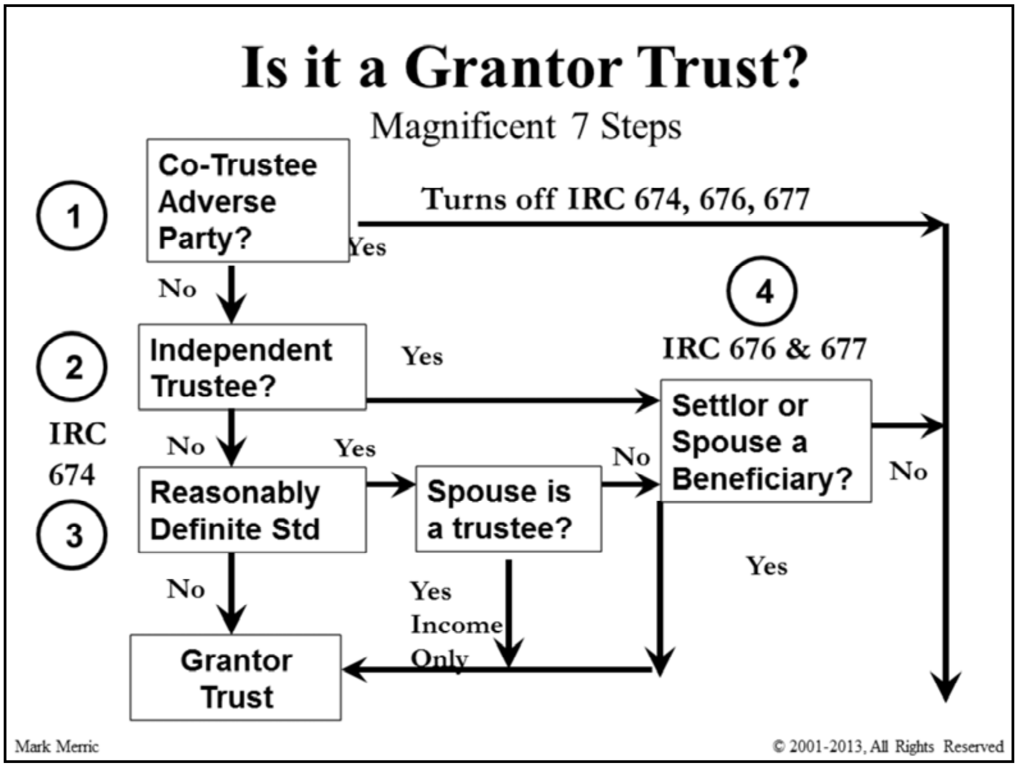
2. Child as a Trustee/Beneficiary Sole Beneficiary

A child trustee/beneficiary is adverse to any distributions to his mom in her capacity as a beneficiary as well as C2. However, the C1 is not adverse to any distributions to himself or herself. However, a sole trustee/beneficiary is not adverse to a distribution to himself or herself. At first glance, it appears that the above trust structure fails the turn off grantor trust status.

Conversely, further analysis needs to be done. One might argue that the following flow chart analysis should apply:



Since the child is adverse to any distributions to the settlor or the settlor's spouse, it is hoped that IRC §674, §676 and §677 would not apply due to the adverse person exception. To date, the author has not found any authority one way or the other on whether this would be the case.



N. Seven Steps to Determine Whether A Grantor Trust

1. Adverse Party Exception

If a distribution requires the consent of any adverse party, then the grantor trust rules of IRC §§ 674, 676, and 677 do not apply. Treas. Reg. §1.677(c). An adverse party serving as trustee will not cure an IRC § 673 grantor trust. Therefore, anytime when an inter vivos discretionary trust is created by the settlor and the settlor's spouse is a beneficiary, it will be classified as a grantor trust.

a. Requires Co-Trustee/beneficiaries to be adverse

Having the spouse/beneficiary or a child/beneficiary serve as the sole trustee will not help fulfill the adverse trustee exception. This is because a <u>sole</u> trustee/beneficiary is not adverse with respect to any distributions to herself or himself. See PLR 200247013 where all trustees were adverse to each other. Also, see PLR 200546052-55 where a family owned trust company met the adverse party exception.

b. Turns off IRC §§ 674, 676, and 677

If the adverse co-trustee/beneficiaries exception applies, then only the remaining grantor trust rules of IRC§ 673 and § 675 need to be analyzed.

2. Independent Trustee

If the adverse co-trustee/beneficiaries exception does not apply, then if there is an independent trustee, IRC § 674 will be turned off. The remaining grantor trust rules of IRC §673, 676, and 677 still need to be analyzed.

3. Reasonably Definite Standard

If the independent trustee exception does not apply, then one must check to see if the trustee's distribution powers are limited by a "reasonably definite standard." A reasonably definite standard will turn off IRC § 674(a) for almost all trusts, except if the settlor's spouse is serving as a trustee.

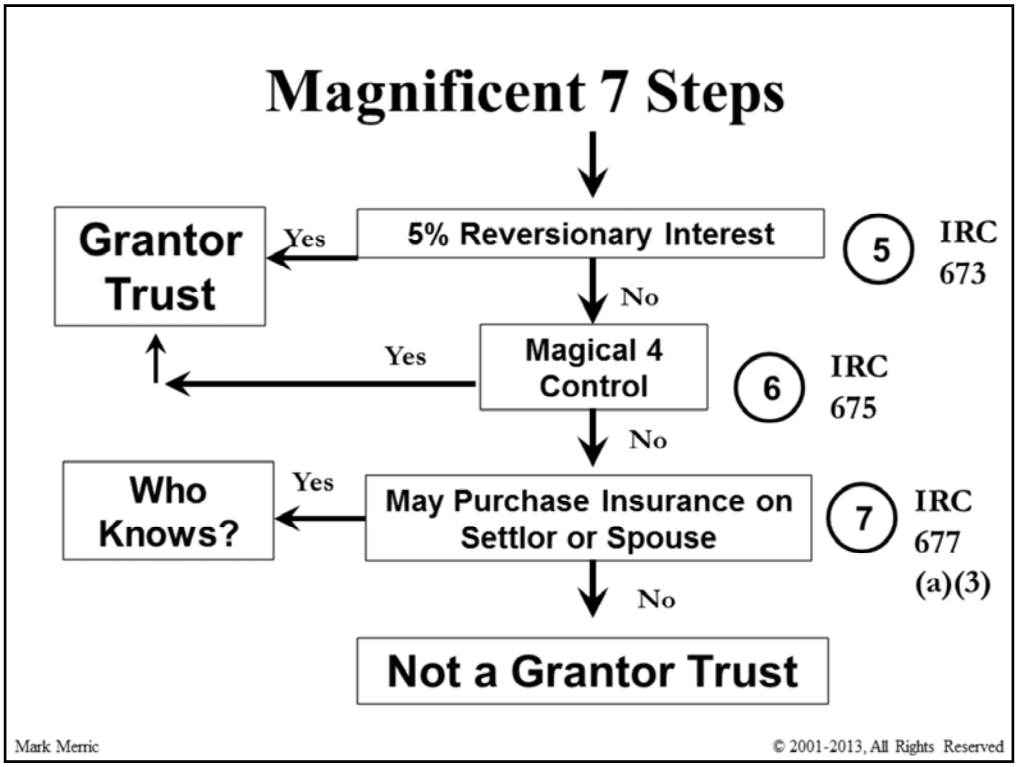
If the reasonably definite standard turns off grantor trust status under IRC § 674, IRC §§ 673, 676, and 677 still need to be analyzed to determine whether the trust is classified as a grantor trust under these sections.

4. IRC § 676 and IRC § 677

When the adverse co-trustee/beneficiary exception does not apply, the following rules apply: IRC § 676 provides that if the settlor may receive a distribution of corpus in any manner (i.e., as a beneficiary or through any power), then the trust is classified as a grantor trust. IRC § 672(e) attributes any interest a spouse has as a beneficiary to the settlor. Therefore, if a spouse is a beneficiary of the trust, to the extent of any corpus distribution, the trust is classified as a grantor trust.

IRC § 677 provides that to the extent a trustee may distribute income or accumulate to or for the benefit of the settlor or the settlor's spouse, the income interest the trust is classified as a grantor trust. No attribution rule is needed because IRC §677(a)(1) and (a)(2) specifically mention the spouse.

Generally, a trust will provide that when a spouse is a current beneficiary, the trustee may distribute income and principal to the spouse. Hence, the grantor trust rules of IRC §676 and § 677 combine so that it is a grantor trust for all purposes.



5. <u>Reversionary Interest</u>

Even if the grantor trust rules of IRC §§ 674, 676, 677 do not apply, IRC §673 must still be analyzed. Further, even if the adverse co-trustee/beneficiaries exception applies, IRC § 673 must still be analyzed. As previously discussed, at present the Service has only applied IRC § 673 to remainder interests. Unless the Service begins to apply IRC § 673 to discretionary interests, most trusts will not be classified as a grantor trust under this section.

a. What is a Discretionary Trust Under IRC 673?

There appears to be little, if any, authority on the definition of a discretionary trust. Presumably the term "discretionary" trust would be referring to the common law distinction between discretionary and support trusts. In this event, hopefully state case law would control as supplemented by the Restatement 2nd of Trusts.

b. What About the Restatement Third and UTC States

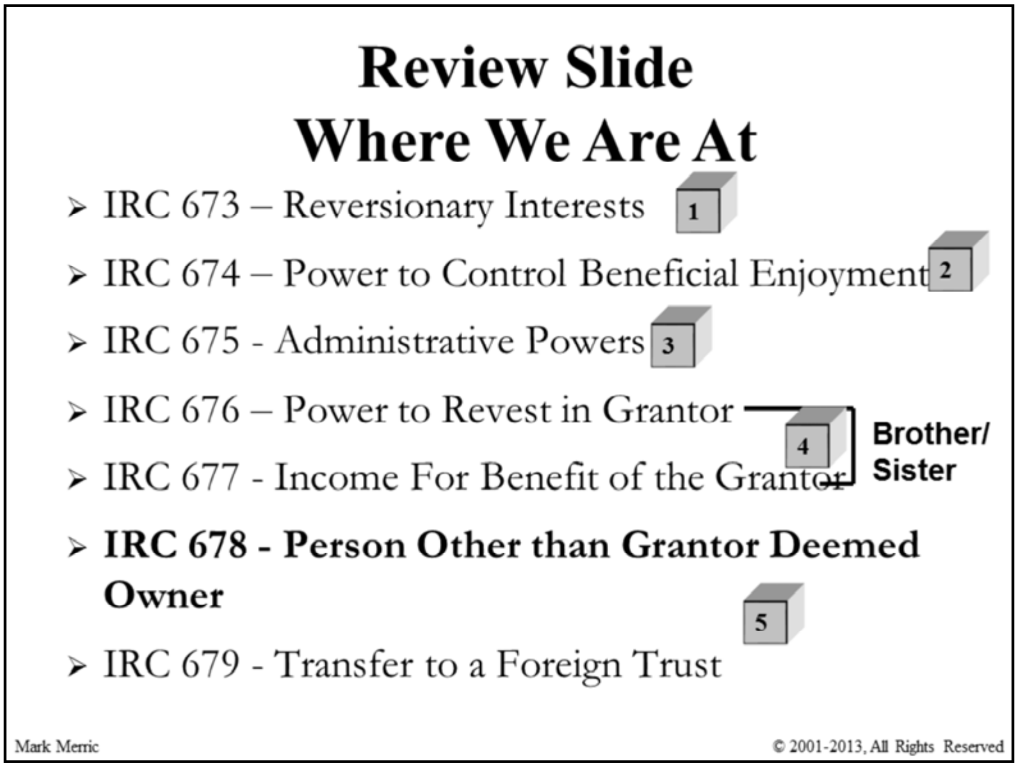
The Restatement Third arbitrarily abolished the difference between discretionary and support trusts, and now classifies all trusts on a continuum of discretionary trusts. For courts so foolish to adopt the unsupported Restatement position, this creates a grave concern where many trusts that were not grantor trusts would now be classified as grantor trusts. The UTC originally followed the Restatement Third position. However, after a 2005 mid-stream change, the amended comments to UTC state it only abolishes the distinction for creditor purposes. Whether this will effect grantor trust classification under IRC § 673 is uncertain.

6. Control Issues Under IRC § 675 or Add a Charitable Beneficiary

All of the retained powers of the settlor must be analyzed to determine whether the trust is classified as a grantor trust under IRC § 675 as whether someone may add a beneficiary (typically a charitable beneficiary).

7. "May" the Trustee Purchase Insurance on the Life of the Settlor or Spouse

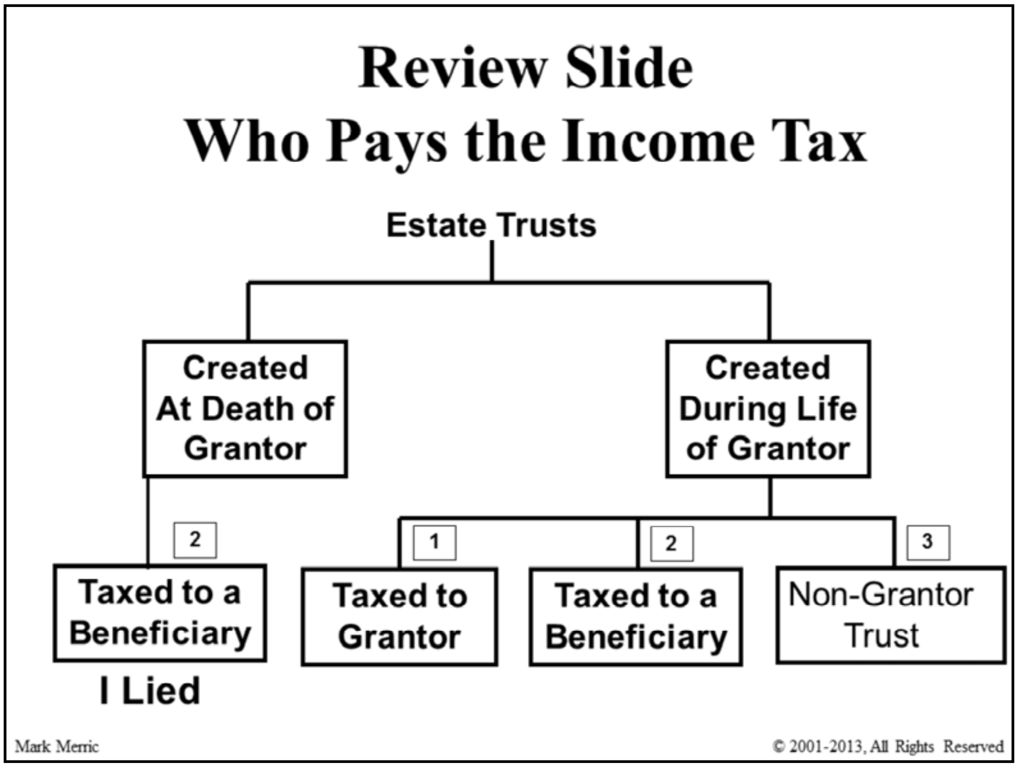
Finally, the classic question of whether the trustee must purchase insurance or whether the trustee "may" purchase insurance must be analyzed. The author prefers the conservative view to limit the trustee's power so that they may not purchase insurance.



O. Review Slides

Unfortunately, the grantor trusts are one of the most complex areas of the IRC, because there is no single thread that ties them together. Most of the grantor trust rules were passed at different times for a variety of different purposes.

- IRC 673 – reversionary interest originally dealt with the 10 year Clifford trust. However, it was modified in 1986 when the Clifford Trust rules were repealed to include any reversionary interest.
- IRC 674 - was passed so that it would parallel the estate tax inclusion rules. In other words, if a trust was brought back into the grantor's (i.e., settlor's or trust maker's) estate, the grantor would have been responsible for the income of the trust.
- IRC 675 is several somewhat arbitrary rules where if the grantor retains certain administrative strings over the trust, the ability to vote stock, direct the investments, or a power to substitute property of equivalent value, the grantor would be taxed on all of the income of the trust.
- IRC 676 and IRC 677 were passed so the grantor would be taxed on all of the income of the trust if the grantor and his or her spouse could possibly benefit from the trust assets.
- IRC 678 enlists the situation where someone other than the grantor could be taxed on the trust's income.
- IRC 679 was enacted to prevent taxpayers from taking assets offshore to avoid paying income tax.



Review Slides Continued

1. Income Taxation of Testamentary Estate Planning Trusts

In general, a testamentary trust is not a grantor trust because the grantor has passed away. Yet, there are some unique planning situations where part of such a trust may be taxed as a grantor trust to the beneficiary as discussed in the IRC § 678 portion of this outline.

2. Income Taxation of Inter Vivos Estate Planning Trusts

There is a three step process in determining who shall be taxed on the income of an estate planning trust. First, if the grantor is deemed the owner of all or a portion of the trust, this rule holds reign. To the extent the grantor is considered the owner of the trust, he or she pays the income tax on any income attributable to said grantor trust. (For purposes of this outline, the author has assumed that if the grantor trust rules apply, he or she pays all of the income on the trust).

Second, typically when a beneficiary has an IRC 2503(b) annual exclusion withdrawal power (i.e., Crummey power), the Crummey beneficiary may be deemed the grantor. In this case, the trust may be classified as a grantor trust pursuant to IRC 678. However, the beneficiary, not the grantor, will be deemed the owner for purposes of reporting all items of income, deduction, and credit regarding the trust.

Third, if the trust is not classified as a grantor trust to the grantor, nor classified as a grantor trust to the beneficiary, then it is considered a standard estate planning trust where to the extent it accumulates income, it pays income tax on such income. To the extent it distributes income, the beneficiary receiving the income pays the income tax.

Person Other Than the Grantor Treated as Owner – IRC § 678

- Person other than grantor is treated as the owner if they have a power exercisable
  - Solely by himself to vest corpus or income in himself or
  - Such a power was fully or partially released.

Mark Merric

P. Person Other Than Grantor Treated As Owner

IRC § 678 is a grantor trust rule where someone other than the grantor is deemed to be the owner, or possibly partial owner over the trust.

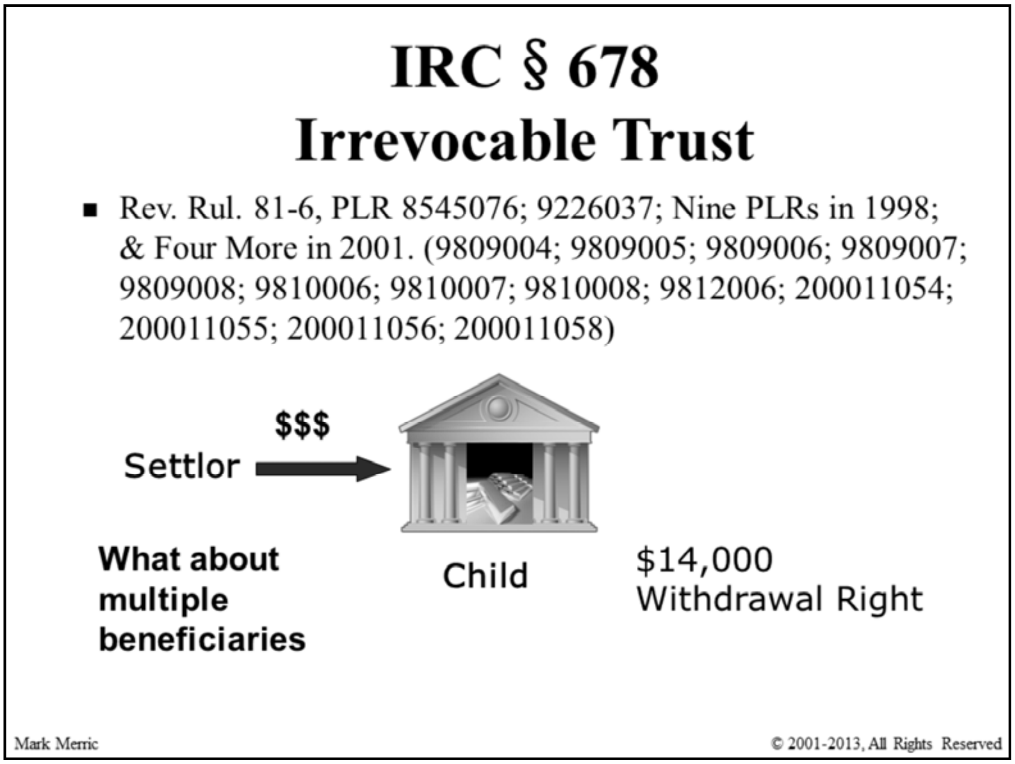
1. <u>IRC § 678</u>

(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 a power and after the release or modification retains such control as would, within the principles of sections 671 to 677, inclusive, subject to grantor of a trust to treatment as the owner thereof.*

Paragraph (1) refers to a general power of appointment. Simply stated if any person holds a GPA, the trust is classified as a grantor trust to the holder of the GPA. Remember that Crummey withdrawal powers, 5x5 powers, general power of appointment marital trusts, and non-exempt dynasty trusts all are or contain GPAs. Paragraph (2) refers to the release of a GPA. In such event, the release is treated as an exercise of the power. Therefore, even though the holder of the GPA never exercised the GPA, it is deemed that the holder exercised the GPA and contributed the property back to the trust. In that event, the holder of the GPA is now the grantor, and the principles of IRC § 671-679 apply to the holder.



2. Single Beneficiary Trust & Crummey Withdrawal Power

IRC § 678 has been a part of the Code since the 1970's. However, it appears to have been ignored by most professionals. In simple terms, IRC § 671(a)(1) and (2), state that if a beneficiary holds a Crummey withdrawal power over all contributions to a trust, the trust is classified as a grantor trust, and the beneficiary is treated as the owner for tax purposes. In this regard, if the trust is not classified as a grantor trust to the grantor (IRC § 678(b)), the trust will be classified as a grantor trust to the beneficiary.

Even though this is a straight application of the Code, most planners did not believe that this was in fact the case. As noted above, the first PLR was in 1985, and virtually no one paid attention to it. The second PLR was in 1992, and again it was for the most part ignored. In 1998 there were nine PLRs, and another four PLRs in 2001. These PLRs support the above analysis.

3. Multiple Beneficiary Trust & Crummey Withdrawal Powers

By analogy, if the grantor made contributions to a trust and the trust had multiple beneficiaries with Crummey withdrawal powers, each beneficiary would be a partial owner under the grantor trust rules. To date, the author is not aware of any IRS pronouncement on point.

4. Subchapter S Stock and Single Beneficiary Trust

Subchapter S stock may only be held by (1) a grantor trust; (2) an electing small business trust; or (3) a qualified subchapter S corporation. PLRs 200235007 through 200235009 take the position that a single beneficiary that held a right to withdraw any contributions to the trust is the grantor under IRC § 678. Also see PLR 8809043.

5. IRC § 121 Exclusion and a 5x5 Power

In PLR 200104005, the surviving spouse of a B trust had a non-cumulative 5x5 power. The family residence had been allocated to the B trust. The Service held that the B trust was a grantor trust to the surviving spouse beneficiary (to the extent of the 5x5 power). Under the PLR, the percentage of the trust that qualifies as a grantor trust is an annual increasing amount based on each year's lapsed 5x5 power. Therefore, to the extent that the trust is classified as a grantor trust, that percentage of the sale proceeds of the personal residence would qualify for IRC § 121 exclusion. Also, see Rev. Rul. 67-241 regarding the grantor trust classification status of a 5x5 power.

Grantor and Beneficiary Trigger the Grantor Trust Rules

- IRC 678 does not apply if the grantor is taxable. IRC 678(b).
  - Debate over whether this applies just to
    - "ordinary income"
    - Or all income including capital gains
  - If only "ordinary income" this could create problems in the IDIT context

6. Grantor and Beneficiary Trigger Grantor Trust Rules

There currently is a debate among planners whether the grantor will be fully taxable on all the income of the trust if IRC § 678 applies. The issue is whether the trust will be classified as a grantor trust to both the settlor and a beneficiary. Whether it is a possibility that the trust will be a grantor trust to both the settlor and the beneficiary depends on the construction of the word "income" under IRC § 678(b).

a. Trust Accounting Income

If "income" meant the standard definition of trust accounting income where capital gain is allocated to corpus, then the trust would be a grantor trust to both the settlor and the beneficiary. However, Treas. Reg. § 1.671-2(b) states that unless the context in the grantor trust rules indicates otherwise, the term "income" is income for tax purposes, not "ordinary income" that would apply to trust accounting. Also see PLR 8839008 and PLR 8736019.

b. Tax Income

If IRC § 678(b) means all taxable income, then the grantor would be fully taxable on all income, and § IRC 678(a) would not apply. IRC § 678(b) states:

"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."

Since IRC § 678(b) specifically mentions only the word "income," applying Treas. Reg. § 1.671-2(b), would most likely result in the conclusion that the entire trust is fully taxable to the grantor.

c. PLR's Holding Grantor is the "Owner" Under § 671.

The following PLRs applied a straight forward interpretation of § 678(b) – if the trust is classified as a grantor trust to the grantor, then the grantor's status as owner of the trust trumps § 678(a):

PLRs 7909031; 8103074; 8142061; 8326074; 8308033; 9141027; 9309023; 9321050; 200603040; 200606006; 200730011; 200729005; 200729007; 200729008; 200729009; 200729010; 200729011; 200729013; 200729014; 200729015; & 200729016.

For a further discussion of this issue see – Johnathan Gopman, *Grantor Treated as Owner of Entire Trust,* Steve Leimberg's Estate Planning Newsletter # 1157 (August 1, 2007).

d. IDIT Installment Sale

If an estate planner had included withdrawal rights in an IDIT during the year of the installment sale, some planners worry that the trust is a partial grantor trust to the beneficiaries due to IRC § 678. The above PLRs would mitigate this concern. However, many estate planners may wish to error on the conservative side, and refrain from including withdrawal powers in IDITs.

Foreign Trust With One or More US Beneficiaries – IRC § 679

- Special rule that only applies to foreign trusts.
- If
  - (1) a US person transfers property to
  - (2) a foreign trust with
  - (3) any U.S. beneficiary

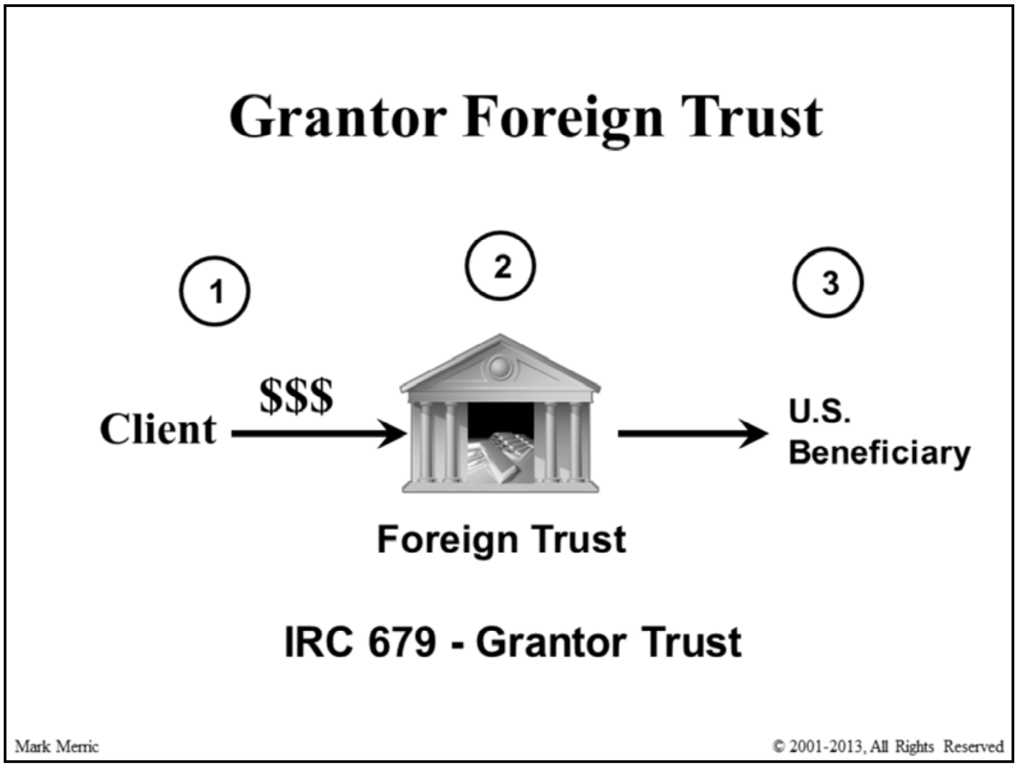
  = grantor trust.

Go to pg. 70

Q. Foreign Trust With One or More U.S. Beneficiaries

1. Purpose of IRC § 679

Even though the purposes of many of the grantor trust rules are not well articulated, the major principle of the grantor trust rules seems to be that if the person holds too much control either over the trustee, the ability to receive part of the trust property, or certain administrative powers, the grantor is treated as the owner for income tax purposes. IRC § 679 is a special rule that does not relate to any control objective. Rather, its objective is to prevent U.S. persons and resident aliens from deferring tax by transferring property to an offshore trust. Please note that an offshore trust is classified as a non-resident alien for U.S. tax purposes and therefore receives the favorable tax treatment on U.S. and foreign investments that a non-resident alien receives.



2. Three Conditions

If the following three conditions are met, the trust will be classified as a grantor trust under IRC § 679:

(1) A U.S. person (i.e., citizen or resident alien);

(2) Transfers property to a foreign trust, within the meaning of IRC § 7701(a)(30)(E);

(3) and there is any U.S. beneficiary no matter how remote or contingent

the trust will be classified as a grantor trust under IRC § 679.

Reporting Requirements

- Primarily Two Methods:
  - Using the Grantor's social security method
  - Filing a grantor form 1041
- Must file a grantor Form 1041 if:
  - (1) Trust is a foreign trust
  - (2) Trust holds foreign assets
  - (3) Trust is a QSST
- ILIT

Mark Merric

R. Filing Requirements

1. <u>Three Methods</u>

a. W-9 Method

Providing payees with the grantor's social security number is the most common method to report the grantor trust income. Some refer to this as the W-9 method. Under this method, the grantor provides the trustee with a W-9, and the trustee provides all payors with the grantor's social security number and address. Treas. Reg. § 1.671-4(b)(2)(i)(A). In the event the grantor is not serving as one of the trustees, the trustee is also obligated to provide a summary listing all income and expenses of the trust as well as all payors. This is to insure that the grantor has enough information to adequately prepare the his or her return.

b. Form 1041 Method

The second method is to file a grantor trust form 1041. In essence a grantor trust form 1041 is nothing more than four pages of blank schedules (or completed with zeros) and a summary that is very similar to a K-1. Treas. Reg. § 1.671-4(b)(6).

c. 1099 Method

With the 1099 method, the trustee provides the trust's TIN number and address to all payors. At the end of the year, the trustee sends the grantor 1099s reporting all income. In the event that the trust owns real estate directly, partnership interests, or subchapter stock, using the 1099 method becomes a bit problematic. This information still needs to be provided to the grantor.

2. Must File a Grantor Trust Form 1041

In the event that the trust is (1) a foreign trust; (2) holds foreign assets; or is a QSST, providing the grantor's social security number to payors is not an option and neither is the 1099 method an option. Rather, the trustee must file a grantor trust form 1041.

3. ILITs

The reporting regulations changed regarding grantor trusts approximately 12 years ago. Unfortunately, almost all insurance companies have not updated their requirements since then. Therefore, regardless of whether the providing the grantor's social security number would suffice, these insurance companies require the trust to obtain a taxpayer identification number. The application for the TIN results in filing the grantor trust 1041 returns.

4. Treas Reg. § 1.671-4(b):

(b) A TRUST ALL OF WHICH IS TREATED AS OWNED BY ONE OR MORE GRANTORS OR
OTHER PERSONS--

(1) IN GENERAL. In the case of a trust all of which is treated as owned by one or more grantors or other persons, and which is not described in paragraph (b)(6) or (7) of this section, the trustee may, but is not required to, report by one of the methods described in this paragraph (b) rather than by the method described in paragraph (a) of this section. A trustee may not report, however, pursuant to paragraph (b)(2)(i)(A) of this section unless the grantor or other person treated as the owner of the trust provides to the trustee a complete Form W-9 or acceptable substitute Form W-9 signed under penalties of perjury. See section 3406 and the regulations thereunder for the information to include on, and the manner of executing, the Form W-9, depending upon the type of reportable payments made.

as owned by one grantor or one other person, the trustee reporting under this paragraph (b) must either--

(A) Furnish the name and taxpayer identification number (TIN) of the grantor or other person treated as the owner of the trust, and the address of the trust, to all payors during the taxable year, and comply with the additional requirements described in paragraph (b)(2)(ii) of this section; or

(B) Furnish the name, TIN, and address of the trust to all payors during the taxable year, and comply with the additional requirements described in paragraph (b)(2)(iii) of this section.

(ii) Additional obligations of the trustee when name and TIN of the grantor or other person treated as the owner of the trust and the address of the trust are furnished to payors.

(A) Unless the grantor or other person treated as the owner of the trust is the trustee or a cotrustee of the trust, the trustee must furnish the grantor or other person treated as the owner of the trust with a statement that--

(1) Shows all items of income, deduction, and credit of the trust for the taxable year;

(2) Identifies the payor of each item of income;

(3) Provides the grantor or other person treated as the owner of the trust with the information necessary to take the items into account in computing the grantor's or other person's taxable income; and

(4) Informs the grantor or other person treated as the owner of the trust that the items of income, deduction and credit and other information shown on the statement must be included in computing the taxable income and credits of the grantor or other person on the income tax return of the grantor or other person.

(B) The trustee is not required to file any type of return with the Internal Revenue Service.