Grantor Trusts: The Who, the What, the Where, the Wherefore, and the Wherewithal

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In a “grantor trust,” the grantor is treated as the owner for income tax purposes. All income generated by the trust assets of a grantor trust is taxed to the grantor.¹ Essentially, the trust is ignored for income tax purposes. When an individual creates a revocable living trust and funds it with his or her own assets, for example, the trust is a grantor trust for federal income tax purposes until the grantor’s death.² These written materials summarize the history of the grantor trust rules, discuss the rules in context, and illustrate the rules in operation with an outline of the reverse grantor trust concept. These materials conclude with a discussion of attorney ethics in trustee representation matters.

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Grantor Trusts
A History (i.e., the Why)

Certain trusts can be treated as grantor trusts (in whole or in part), however, even though they are irrevocable, and even though the grantor has parted with nearly all legal rights. Why, you might ask?

The grantor trust rules only really make sense in historical context. Therefore, an outline of this history is appropriate.

The grantor trust rules – also known as “subpart E” were enacted as a way to prevent taxpayers from avoiding the progressive nature of the federal income tax system. Assuming the validity of the value judgments inherent in a progressive tax scheme – where those with higher income are subject to higher tax rates than those with lower income – the integrity of

¹ Admittedly, the term “grantor” is a loaded one, somewhat vague and potentially confusing.

² An irrevocable trust with a non-grantor trustee is required to obtain a tax identification number (TIN or EIN) by completing a form SS-4 with the IRS.
the system depends on shutting down avenues by which taxpayers can avoid it by shifting income to persons in lower tax brackets. The grantor trust rules thwart attempts to divert income from high-bracket taxpayers to lower-bracket trusts (or lower-bracket taxpayer-beneficiaries).

As Justice Oliver Wendell Holmes said, “The fruits [must not be] attributed to a different tree from that on which they grew.”

Congress saw as a potential loophole to the imposition of the progressive income tax, the ability of higher income taxpayers to transfer income-producing property to trusts. Thus, a special set of income tax consequences were enacted for certain types of trusts. The predecessors of sections 676 and 677 of the Internal Revenue Code were passed in 1924. Even though trusts are recognized under state law as separate persons, the tax rules would treat certain trusts as being indistinct from the grantor. A grantor, for example, who retained beneficial enjoyment of trust income, would be taxable on the income individually. The separate existence of the trust would simply be ignored for tax purposes, as a way to preserve the objectives of the progressive income tax system.

In 1940, the United States Supreme Court issued the decision of Helvering v. Clifford. The facts of the case involved a Mr. Clifford, who had created an irrevocable trust for the benefit of his wife with a five year term. He named himself as trustee and retained the power to determine how much income to distribute to Mrs. Clifford. At the end of the five year trust term, the trust would terminate and distribute the remaining trust estate back to Mr. Clifford (that is, a reversionary interest was retained by the grantor). The existing grantor trust rules only spoke to revocable trusts or trusts where the grantor retained an income interest.

Mr. Clifford therefore reported the trust income on a trust income tax return, as taxable to the trust. The IRS disagreed, concluding that the income should be taxable to Mr. Clifford (that is, as a “grantor trust”). The Board of Tax Appeals held for the IRS. The Eighth Circuit Court of Appeals reversed, holding for Mr. Clifford. The United States Supreme Court, in a decision authored by Justice Douglas, reversed the Eighth Circuit and reinstated the tax court holding, determining that the trust was, in fact, a grantor trust, and that trust income should be taxed to Mr. Clifford, and not the trust, nor to Mrs. Clifford.

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4 Mark L. Ascher, The Grantor Trust Rules Should be Repealed, 96 IOWA L.REV. 885, 888 (2011). This outstanding law review article was relied on for its erudite history of the grantor trust rules.

5 Revenue Act of 1924, ch. 234, section 219(g), 43 Stat. 253, 277.

6 Ascher, supr note 4 at 889.

7 Helvering v. Clifford, 309 U.S. 331 (1940).
The holding of the court rested on the predecessor to what is now section 61 of the Internal Revenue Code which states, as expansively as Congress could, that gross income includes “all income from whatever source derived.” Justice Douglas jettisoned any consideration of what he termed “[t]echnical considerations, niceties of the law of trusts or conveyances, or the legal paraphernalia which inventive genius may construct as a refuge from surtaxes.”

The spare then-existing grantor trust rules were not on point (since, as noted above, they only addressed revocable trusts and trusts whose income was dedicated to the grantor) but the Court used the sweep of section 61 to pull the trust income onto Mr. Clifford’s tax bracket. The Court’s holding can be justly criticized – and has been – as “an impressionistic assessment.”

Five years after the decision in Clifford came the so-called Clifford regulations. The Clifford regulations expanded the grantor trust rules to reach situations where the grantor had retained the ability to control the beneficial enjoyment of trust assets, or where the grantor had a reversionary interest in a short-term trust. Ten years later, the Clifford regulations were codified into law, where they remain today.

Today, in all fairness, the grantor trust rules are obsolete, although they unintentionally provide a significant estate planning opportunity for taxpayers.

The grantor trust rules are obsolete for at least four reasons:

1. **The Joint Return.** The joint marital federal income tax return was created in 1948, and its existence helps make the grantor trust rules obsolete. Mr. Clifford, for example, would have no reason to try to divert income to his wife through the use of a trust, and the IRS would have no motivation in re-characterizing trust income as his and not hers. The joint return makes income tax shifting between spouses irrelevant.

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8 IRC section 61(a).

9 Clifford, at 334.

10 Ascher, supra note 4 at 892. One commentator wrote of the Clifford holding: “[T]here was little, if anything, in the statute to support it. Nor was it the culmination of a series of decisions, slowly etching out a new ground in the law.” Erin N. Griswold, Forward to Bernard Wolfman, Jonathan L.F. Silver & Marjorie A. Silver, Dissent Without Opinion: The Behavior of William O. Douglas in Federal Tax Cases, at x (1975).


12 Ascher, supra note 4 at 895-910. In addition to these four reasons, Ascher also highlights the kiddie tax and the consolidation of multiple trusts in support of the assertion that the grantor trust rules are obsolete.
(2) **Lower Tax Rates.** In 1954, when the current grantor trust rules were codified, the highest marginal income tax rate was 91%. Even in 1980, it was 70%. Now it is 35%.

(3) **Lower Capital Gains and Qualified Dividends Taxes.** Net capital gain and qualified dividend income are generally subject to taxation at a flat rate of 15%. Even high income tax bracket individuals pay the flat 15%, so shifting this type of income to a trust has no advantage. Note: these rates are set to expire on January 1.

(4) **Trust Income Tax Bracket Compression.** While tax rates for individuals have improved, the income tax treatment of trusts has gotten much worse (i.e., more compressed) under section 1(e).\(^\text{13}\) Who wants to shift income to a trust where the highest marginal rate is reached at $11,650 in trust taxable income while individuals do not pay these rates until they reach $388,350?\(^\text{14}\) Essentially, you could say that trusts pay a flat tax rate of 35%.

“Rules that were originally conceived by Congress, wildly embellished by the Supreme Court in Clifford, rerationalized by the Treasury, and recodified by Congress, all in an effort to prevent high-bracket taxpayers from shifting income to certain types of artificial entities with lower tax brackets, are now being used by taxpayers to create trusts that will not be taxed at the trust level.”\(^\text{15}\) This is perhaps the world’s best example of income tax irony.\(^\text{16}\)

The most common use of the outdated grantor trust rules is the intentionally defective grantor trust (or IDGT). By designing a trust which intentionally runs afoul of the grantor trust rules, the trust will be ignored just like Mr. Clifford’s trust was, and all trust income will be taxed to the grantor.

IDGTs are designed to be treated as grantor trusts. For example, if the grantor retains the right to reacquire trust property by substituting other property of equivalent value, the grantor trust rule at section 674 will apply and the trust will be ignored for federal income tax purposes; all income will be taxed to the grantor as if the trust did not exist. At the same time, however, transfers to a properly drafted irrevocable trust can be treated as completed gifts for federal transfer tax purposes.

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\(^{13}\) IRC section 1(e).

\(^{14}\) Revenue Proc. 2011-52. These are adjusted for inflation annually. The impact of section 1(e) can be avoided by not accumulating income in a non-grantor trust.

\(^{15}\) Ascher, supra note 4, at 903.

\(^{16}\) Id.
Sales to IDGTs are commonly used; the sale itself is disregarded under the grantor trust rules while assets conveyed to the trustee will escape taxation in the grantor’s estate at death. The typical steps in utilizing an installment sale to an IDGT are:

1. **Create an irrevocable trust.** The trust must contain a provision (such as the power to substitute assets of equivalent value) so that it will be treated as a grantor trust. The trust will therefore be disregarded as a separate taxpayer. The grantor will not retain any rights or powers that would cause estate inclusion of the trust assets at the grantor’s death. Typically, the beneficiaries would be the grantor’s descendants.

2. **Fund the trust with at least a nominal amount.** The grantor gifts a small amount of property to the trust.

3. **Sell (appreciated) property to the trust.** The grantor then sells property to the trust in exchange for a promissory note. The sale is ignored; no gain is realized because the trust and the grantor are deemed to be the same person under the grantor trust rules.

The grantor loses control and enjoyment of trust assets, but receives an income stream back in the form of payment on the promissory note (without incurring any taxable income from payments on the note given the grantor trust treatment of the trust). And the assets sold to the trust escape taxation in the grantor’s estate (although they may not do not receive step-up in basis treatment on the grantor’s death).

Another common use of the grantor trust rules is found in irrevocable life insurance trusts (ILITs) which may contain Crummey powers in order to qualify transfers to the trust for present interest gift treatment and the $13,000/year/donee annual exclusion against the federal gift tax (scheduled to increase to $14,000 in 2013). Grantor retained annuity trusts (GRATs), grantor retained unitrusts (GRUTs) and grantor retained income trusts (GRITs) are additional examples of the benefits to be achieved from use of the grantor trust rules.

**The Grantor Trust Rules**

*An Outline (i.e., the Where and the Who)*

Sections 671-679 of the Internal Revenue Code list trust provisions or actions which will result in grantor trust status. Section 671 attributes taxable income of a grantor trust to the grantor. Section 672 defines relevant terms including who qualifies as an “adverse party.” In outline form, the grantor rules are:

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17 IRC section 675(4)(C).

18 Arguably, however, even though no gain is recognized on the sale, the trust assets receive a step up in basis to match the purchase price. *Rothstein v. United States*, 735 F.2d 704 (2nd Cir. 1984); but see Revenue Ruling 85-13.

19 See also appendix.
Revocable or Reversionary Trusts

- **Revocable Trusts.** Code § 676(a). Grantor trust status is present for any portion of a trust that the grantor (or a non-adverse party) retains a power to revoke.

- **Power to Control Beneficial Enjoyment.** Code § 673, 4. “The grantor shall be treated as the owner of any portion of a trust in respect of which the beneficial enjoyment of the corpus or the income therefrom is subject to a power of disposition, exercisable by the grantor or a nonadverse party, or both, without the approval or consent of any adverse party.”

Beneficial Rights

- **Discretionary Distribution of Income to Grantor or Spouse.** Code § 677(a).

- **Accumulation of Income for Future Distribution to Grantor or Spouse.** Code § 677. See also Insurance Trusts, infra.

- **Satisfaction of Legal Obligation of Grantor or Spouse.** Code § 677(b). To the extent that income is distributed by a trustee for the support or maintenance of child that the grantor is obligated to support, grantor trust status is triggered.

Administrative Powers (“675 Powers”)

- **The Power to Deal for Less than Adequate and Full Consideration.** Code § 675(1). Grantor trust status is achieved if the grantor can purchase, exchange, or otherwise deal with trust property for less than adequate consideration.

- **The Power to Borrow without Adequate Interest and Security.** Code § 675(2). A grantor power to borrow trust assets without adequate interest or security will cause grantor trust status.

- **The Actual Borrowing of Trust Assets.** Code § 675(3). If the grantor has borrowed trust assets and not yet completely repaid the loan, grantor trust status is achieved. An exception applies to loans made by a trustee (so long as the trustee is not the grantor or a subordinate party) for adequate security and interest.

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20 IRC section 674(a). See also exceptions at IRC section 674(b)-(d).

21 See SDCL 55-4-38 (providing that a non-grantor trustee’s power to make discretionary distributions is not exercisable to discharge any of the person’s own legal obligations).

22 Cf. SDCL 55-2-22 (imposing trustee duty to determine substituted property is of equivalent value if the grantor has retained this power).
• General Administrative Powers.
  • Power to Vote Stock and Securities. Code § 675(4)(A).
  • Power to Control Trust Investments. Code § 675(4)(B).
  • Power to Reacquire Trust Assets. Code § 675(4)(C). “[A] power to reacquire the trust corpus by substituting other property of an equivalent value” will trigger grantor trust status.

Life Insurance Trusts

• Income for Benefit of Grantor. Code § 677. The grantor is treated as the owner of the trust if income is distributed (or accumulated) for the grantor or if income is applied to a premium on life insurance on the grantor’s (or the grantor’s spouse’s) life.

Foreign Trusts


Thus, although it is relatively easy to escape grantor trust treatment by avoiding the inclusion of the list of prohibited provisions summarized above, the Code also makes it relatively easy to “flunk” the test and create an “intentionally defective” grantor trust.

Proposed Changes to the Grantor Trust Rules
Reform (the Wherewithal)

In 2012, the United States Treasury Department proposed changes to the grantor trust rules. University of South Dakota law student Beau C.T. Barrett has written an outstanding summary of some of the possible and/or pending changes to the grantor trust rules which as of the date of this presentation has yet to be published in an upcoming issue of the South Dakota Law Review. For years, commentators have been pointing out the fact that no real tax policy is advanced by virtue of the grantor trust rules.


One proposal would be to require that a GRAT have a minimum term of ten years and a maximum term of the life expectancy of the annuitant plus ten years. This would, in the words of the Administration, “require, in effect, some downside risk in the use of this technique.” In addition, the remainder interest would have to have a value greater than zero at the time the interest is created.

A second proposal is to “coordinate” certain income and transfer tax rules that apply to grantor trusts. To the extent that a trust is characterized as a grantor trust, the assets would be included in the grantor’s gross estate for purposes of the federal estate tax. The rule would eliminate the use of ILITs and IDGTs (or, alternatively, transfer to them would be subject to the federal gift tax if distributed to a beneficiary while the grantor was living. The “toggling” of grantor trust status would be effectively brought to an end.

The Reverse Defective Grantor Trust

*The What?!?*

The concept of the reverse defective grantor trust (or reverse DGT) was outlined and analyzed with clarity and depth in the October issue of Trusts & Estates magazine. The planning steps to this planning strategy are:

1. **Create an irrevocable trust.** The trust must contain a provision such as the power of an independent person to add charitable beneficiaries so that it will be treated as a grantor trust. The grantor and the trust will therefore be treated as one individual for income tax purposes under the grantor trust rules. However, the grantor should not retain distribution rights or powers of appointment, so that transfers to the trust will be treated as completed gifts. Typically, the beneficiaries would be the grantor’s descendants.

2. **Gift assets to the trust.** The grantor then transfers assets to the trust. Typically, an amount less than the grantor’s remaining gift tax exemption (currently $5.12 million) would be transferred.

3. **Purchase assets from the trust.** The grantor then purchases the assets (or some of them) from the trustee on an installment note basis. The purchase should be for fair market value. The promissory note might provide for interest-only payments with a balloon of principal in 30 years using the lowest applicable federal rate (AFR).

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26 Greenbook, supra note 23 at 80.

27 Id. at 83; see also Barrett, supra note 24. A third proposal is to limit the GST exemption to trusts with 90 year terms. Greenbook, supra note 23 at 81-82.


29 IRC section 674(a).
Higher interest rates may also be used. The loan may or may not be secured (for example with a mortgage).

The grantor’s assets will receive a full step-up in basis treatment at his death since they are returned to his/her ownership. The grantor’s net worth will be decreased by the outstanding balance of the promissory note at death. And the grantor retains full use, control, and enjoyment of assets (including any income produced by those assets) which were purchased back from the trust.

This technique does consume a portion of the grantor’s gift tax credit (unless and to the extent the applicable exclusion amount offsets credit erosion), and it does not “freeze” the value of assets as does the traditional sale to an IDGT. All future appreciation of the property – as well as all income produced therefrom – is retained by the grantor. At the conclusion of the plan, however, the grantor’s net worth has been significantly reduced on account of the newly created bona fide debt owed to the irrevocable trust.

**Afterword**

*Ethics (the Wherefore)*

A recent Nebraska Ethics Advisory Opinion (no.12-08)\(^{30}\) published last month provides an instructive discussion relative to the representation of fiduciaries.

The facts involved a lawyer who engaged in a joint representation for estate planning of a husband and wife with four children who created his-and-her revocable trusts. Following this representation, the wife died and the widower engaged a different attorney to make an amendment to his trust. The trust amendment reduced the shares of two of the children (hereinafter, “the bad children”). The other two children (hereinafter, “the good children”)\(^{31}\) – those whose shares were not reduced – were named successor co-trustees.

The opinion suggests that the two good children had their trust shares increased by virtue of the two bad children having their shares decreased. “Presumably,” the opinion states, “a decrease in [the bad children’s] share of the trust produces an increase in the shares to be received by the trustees in their capacities as beneficiaries.” In other words, this was not a situation where the two bad children had their shares reduced by virtue of diverting part of those bequests to a charity.

\(^{30}\) Nicole Ogan cites the total number of South Dakota attorneys (i.e., residing in South Dakota and members of the South Dakota Bar Association) at 1,906. Kathryn Bellman quotes the total number of Nebraska licensed attorneys holding South Dakota licenses at 203, about half of whom are Nebraskans and half of whom are South Dakotans. Thus, of the 1906 South Dakota attorneys, about 101 are dual licensed in Nebraska. One in twenty South Dakota lawyers hold dual licenses in Nebraska. So the opinion is directly relevant to about 5% of South Dakota lawyers with Nebraska licenses and indirectly relevant to the rest of us.

\(^{31}\) Or perhaps more accurately, “the happy children.”
The widower then passed away. The co-trustees retain the lawyer who drafted the original trust instrument.

One of the bad children retains counsel to dispute the validity of the trust amendment which reduced her inheritance. She also asserts (a) that the trustees have a conflict of interest; and (b) that the lawyer representing the trustees has a conflict of interest “because of the asserted conflict of interest that the trustees have.”

The lawyer, by the way, never previously represented any of the children/trust beneficiaries.

The question posed was how the conflict of interest rules apply in these circumstances? Must the lawyer withdraw from the representation?

The Nebraska Disciplinary Board turned to the applicable rule of professional conduct, section 3-501.7, governing conflict of interest; current clients. The South Dakota analogue can be found at rule 1.7. It and the relevant comments are identical to the Nebraska rule.

The lawyer then submits the question to the Nebraska Disciplinary Board. Before answering the question, the opinion quotes comment 27 to the applicable rule which states, rather cryptically:

[C]onflict questions may arise in estate planning and estate administration. A lawyer may be called upon to prepare wills for several family members, such as husband and wife, and depending upon the circumstances, a conflict of interest may be present. In estate administration the identity of

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32 The Nebraska rule provides:
(a) Except as provided in paragraph (b), a lawyer shall not represent a client if the representation involves a concurrent conflict of interest. A concurrent conflict of interest exists if:
   (1) the representation of one client will be directly adverse to another client; or
   (2) there is a significant risk that the representation of one or more clients will be materially limited by the lawyer’s responsibilities to another client, a former client, or a third person or by a personal interest of the lawyer.
(b) Notwithstanding the existence of a concurrent conflict of interest under paragraph (a), a lawyer may represent a client if:
   (1) the lawyer reasonably believes that the lawyer will be able to provide competent and diligent representation to each affected client;
   (2) the representation is not prohibited by law;
   (3) the representation does not involve the assertion of a claim by one client against another client represented by the lawyer in the same litigation or other proceeding before a tribunal; and
   (4) each affected client gives informed consent, confirmed in writing.
Nebraska Rules of Professional Conduct section 3-501.7.
the client may be unclear under the law of a particular jurisdiction. Under one view, the client is the fiduciary; under another view the client is the estate or trust, including its beneficiaries. In order to comply with conflict of interest rules, the lawyer should make clear the lawyer’s relationship to the parties involved.\footnote{Id. cmt. 27.}

The answer to the question – like so many ethical questions - depends on who is the client: “[T]he answer to this inquiry requires identification of the client or clients whose interest may be affected by a conflict of interest.” So who’s the client?

The trustees are the clients, and there’s no conflict between them.\footnote{The opinion neatly skirts the issue raised in the ethical rule’s comments that suggests that when a lawyer represents a trustee, the client is either the trustee or the trust and all of its beneficiaries, but the rule drafters aren’t sure which.}

Nor is there any suggestion that the trustees are adverse to any of the lawyer’s other clients.

Nor that the lawyer’s duty to the trustees would be materially limited by his (the opinion uses the masculine pronoun) personal interests or any third party that the lawyer has duties to or any special affection for.

Thus, there’s no conflict of interest that would disqualify the lawyer. That was relatively easy, the opaque comments to the rule notwithstanding. Then the opinion turns to the more interesting issue and opines:

Neither is the lawyer in a conflict of interest simply because he represents trustees who are also beneficiaries of the trust. Under [trust law] the trustees are under a duty to administer the trust according to its terms. The terms of the trust prevail except on specified topics, none of which is presented in this request. And there is no doubt that the trustees are allowed to employ the attorney of their choosing to obtain advice and representation in their management of the trust. With that being the case, the lawyer employed by the trustees has no conflict of interest simply because his clients seek to enforce the trust according to its terms contrary to the desires of one of the beneficiaries.\footnote{Nebraska Ethics Advisory Opinion 12-09 (internal citations omitted).}

The opinion’s holding is based on the trustee’s duty to uphold and honor the terms of their trust agreement. The trustees have no conflict of interest by virtue of wearing the hats of both trustee and beneficiary. As beneficiaries it is in the good children’s interests to uphold the trust terms (as amended) which give them a greater share of their father’s estate. As trustees, it is their duty to uphold the trust terms (as amended) because that is a duty.
imposed on trustees by the law. There’s clearly no conflict of interest here since the good children want to uphold the trust as beneficiaries and as trustees.

Would a different result be reached if the trustees were the bad children? No. A conflict of interest for the fiduciary does not create a conflict of interest for the attorney representing the fiduciary. A conflict of interest that the trustees have cannot be imputed to their attorney.

Notwithstanding the conclusion that a conflict of interest of the client’s fiduciary obligations cannot be imputed to disqualify the fiduciary’s counsel, a fiduciary with a conflict of interest presents among the most challenging representations for the attorney. If the trustees are the bad children, they have a duty as trustees to defend the trust amendment disinherit ing themselves as beneficiaries. The attorney can represent the trustees as trustees insofar as advocating for the validity of the trust amendment, but he cannot represent the children as beneficiaries, nor advocate for the invalidity of the trust amendment.36

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APPENDIX
Subpart E of Subchapter J of the Internal Revenue Code
Sections 671-679

→ § 671. Trust income, deductions, and credits attributable to grantors and others as substantial owners

Where it is specified in this subpart that the grantor or another person shall be treated as the owner of any portion of a trust, there shall then be included in computing the taxable income and credits of the grantor or the other person those items of income, deductions, and credits against tax of the trust which are attributable to that portion of the trust to the extent that such items would be taken into account under this chapter in computing taxable income or credits against the tax of an individual. Any remaining portion of the trust shall be subject to subparts A through D. No items of a trust shall be included in computing the taxable income and credits of the grantor or of any other person solely on the grounds of his dominion and control over the trust under section 61 (relating to definition of gross income) or any other provision of this title, except as specified in this subpart.

→ § 672. Definitions and rules

(a) Adverse party.--For purposes of this subpart, the term “adverse party” means any person having a substantial beneficial interest in the trust which would be adversely affected by the exercise or nonexercise of the power which he possesses respecting the trust. A person having a general power of appointment over the trust property shall be deemed to have a beneficial interest in the trust.

36 A different situation might be present where it’s clear that the trust amendment is unquestionably invalid.
(b) Nonadverse party.--For purposes of this subpart, the term “nonadverse party” means any person who is not an adverse party.

(c) Related or subordinate party.--For purposes of this subpart, the term “related or subordinate party” means any nonadverse party who is--

(1) the grantor's spouse if living with the grantor;

(2) any one of the following: The grantor's father, mother, issue, brother or sister; an employee of the grantor; a corporation or any employee of a corporation in which the stock holdings of the grantor and the trust are significant from the viewpoint of voting control; a subordinate employee of a corporation in which the grantor is an executive.

For purposes of subsection (f) and sections 674 and 675, a related or subordinate party shall be presumed to be subservient to the grantor in respect of the exercise or nonexercise of the powers conferred on him unless such party is shown not to be subservient by a preponderance of the evidence.

(d) Rule where power is subject to condition precedent.--A person shall be considered to have a power described in this subpart even though the exercise of the power is subject to a precedent giving of notice or takes effect only on the expiration of a certain period after the exercise of the power.

(e) Grantor treated as holding any power or interest of grantor's spouse.--

(1) In general.--For purposes of this subpart, a grantor shall be treated as holding any power or interest held by--

(A) any individual who was the spouse of the grantor at the time of the creation of such power or interest, or

(B) any individual who became the spouse of the grantor after the creation of such power or interest, but only with respect to periods after such individual became the spouse of the grantor.

(2) Marital status.--For purposes of paragraph (1)(A), an individual legally separated from his spouse under a decree of divorce or of separate maintenance shall not be considered as married.

(f) Subpart not to result in foreign ownership.--

(1) In general.--Notwithstanding any other provision of this subpart, this subpart shall apply only to the extent such application results in an amount (if any) being currently taken into account (directly or through 1 or more entities) under this chapter in computing the income of a citizen or resident of the United States or a domestic corporation.

(2) Exceptions.--

(A) Certain revocable and irrevocable trusts.--Paragraph (1) shall not apply to any portion of a trust if--

(i) the power to revest absolutely in the grantor title to the trust property to which such portion is attributable is exercisable solely by the grantor without the approval or consent of any other person or with the consent of a related or subordinate party who is subservient to the grantor, or

(ii) the only amounts distributable from such portion (whether income or corpus) during the lifetime of the grantor are amounts distributable to the grantor or the spouse of the grantor.
(B) **Compensatory trusts.**--Except as provided in regulations, paragraph (1) shall not apply to any portion of a trust distributions from which are taxable as compensation for services rendered.

(3) **Special rules.**--Except as otherwise provided in regulations prescribed by the Secretary--

(A) a controlled foreign corporation (as defined in section 957) shall be treated as a domestic corporation for purposes of paragraph (1), and

(B) paragraph (1) shall not apply for purposes of applying section 1297.

(4) **Recharacterization of purported gifts.**--In the case of any transfer directly or indirectly from a partnership or foreign corporation which the transferee treats as a gift or bequest, the Secretary may recharacterize such transfer in such circumstances as the Secretary determines to be appropriate to prevent the avoidance of the purposes of this subsection.

(5) **Special rule where grantor is foreign person.**--If--

(A) but for this subsection, a foreign person would be treated as the owner of any portion of a trust, and

(B) such trust has a beneficiary who is a United States person,

such beneficiary shall be treated as the grantor of such portion to the extent such beneficiary has made (directly or indirectly) transfers of property (other than in a sale for full and adequate consideration) to such foreign person. For purposes of the preceding sentence, any gift shall not be taken into account to the extent such gift would be excluded from taxable gifts under section 2503(b).

(6) **Regulations.**--The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this subsection, including regulations providing that paragraph (1) shall not apply in appropriate cases.

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§ 673. Reversionary interests

(a) **General rule.**--The grantor shall be treated as the owner of any portion of a trust in which he has a reversionary interest in either the corpus or the income therefrom, if, as of the inception of that portion of the trust, the value of such interest exceeds 5 percent of the value of such portion.

(b) **Reversionary interest taking effect at death of minor lineal descendant beneficiary.**--In the case of any beneficiary who--

(1) is a lineal descendant of the grantor, and

(2) holds all of the present interests in any portion of a trust,

the grantor shall not be treated under subsection (a) as the owner of such portion solely by reason of a reversionary interest in such portion which takes effect upon the death of such beneficiary before such beneficiary attains age 21.

(c) **Special rule for determining value of reversionary interest.**--For purposes of subsection (a), the value of the grantor's reversionary interest shall be determined by assuming the maximum exercise of discretion in favor of the grantor.
(d) Postponement of date specified for reacquisition.--Any postponement of the date specified for the reacquisition of possession or enjoyment of the reversionary interest shall be treated as a new transfer in trust commencing with the date on which the postponement is effective and terminating with the date prescribed by the postponement. However, income for any period shall not be included in the income of the grantor by reason of the preceding sentence if such income would not be so includible in the absence of such postponement.

§ 674. Power to control beneficial enjoyment

(a) General rule.--The grantor shall be treated as the owner of any portion of a trust in respect of which the beneficial enjoyment of the corpus or the income therefrom is subject to a power of disposition, exercisable by the grantor or a nonadverse party, or both, without the approval or consent of any adverse party.

(b) Exceptions for certain powers.--Subsection (a) shall not apply to the following powers regardless of by whom held:

(1) Power to apply income to support of a dependent.--A power described in section 677(b) to the extent that the grantor would not be subject to tax under that section.

(2) Power affecting beneficial enjoyment only after occurrence of event.--A power, the exercise of which can only affect the beneficial enjoyment of the income for a period commencing after the occurrence of an event such that a grantor would not be treated as the owner under section 673 if the power were a reversionary interest; but the grantor may be treated as the owner after the occurrence of the event unless the power is relinquished.

(3) Power exercisable only by will.--A power exercisable only by will, other than a power in the grantor to appoint by will the income of the trust where the income is accumulated for such disposition by the grantor or may be so accumulated in the discretion of the grantor or a nonadverse party, or both, without the approval or consent of any adverse party.

(4) Power to allocate among charitable beneficiaries.--A power to determine the beneficial enjoyment of the corpus or the income therefrom if the corpus or income is irrevocably payable for a purpose specified in section 170(c) (relating to definition of charitable contributions) or to an employee stock ownership plan (as defined in section 4975(e)(7)) in a qualified gratuitous transfer (as defined in section 664(g)(1)).

(5) Power to distribute corpus.--A power to distribute corpus either--

(A) to or for a beneficiary or beneficiaries or to or for a class of beneficiaries (whether or not income beneficiaries) provided that the power is limited by a reasonably definite standard which is set forth in the trust instrument; or

(B) to or for any current income beneficiary, provided that the distribution of corpus must be chargeable against the proportionate share of corpus held in trust for the payment of income to the beneficiary as if the corpus constituted a separate trust.

A power does not fall within the powers described in this paragraph if any person has a power to add to the beneficiary or beneficiaries or to a class of beneficiaries designated to receive the income or corpus, except where such action is to provide for after-born or after-adopted children.

(6) Power to withhold income temporarily.--A power to distribute or apply income to or for any current income beneficiary or to accumulate the income for him, provided that any accumulated income must ultimately be payable--
(A) to the beneficiary from whom distribution or application is withheld, to his estate, or to his appointees (or persons named as alternate takers in default of appointment) provided that such beneficiary possesses a power of appointment which does not exclude from the class of possible appointees any person other than the beneficiary, his estate, his creditors, or the creditors of his estate, or

(B) on termination of the trust, or in conjunction with a distribution of corpus which is augmented by such accumulated income, to the current income beneficiaries in shares which have been irrevocably specified in the trust instrument.

Accumulated income shall be considered so payable although it is provided that if any beneficiary does not survive a date of distribution which could reasonably have been expected to occur within the beneficiary's lifetime, the share of the deceased beneficiary is to be paid to his appointees or to one or more designated alternate takers (other than the grantor or the grantor's estate) whose shares have been irrevocably specified. A power does not fall within the powers described in this paragraph if any person has a power to add to the beneficiary or beneficiaries or to a class of beneficiaries designated to receive the income or corpus except where such action is to provide for after-born or after-adopted children.

(7) Power to withhold income during disability of a beneficiary.--A power exercisable only during--

(A) the existence of a legal disability of any current income beneficiary, or

(B) the period during which any income beneficiary shall be under the age of 21 years,

to distribute or apply income to or for such beneficiary or to accumulate and add the income to corpus. A power does not fall within the powers described in this paragraph if any person has a power to add to the beneficiary or beneficiaries or to a class of beneficiaries designated to receive the income or corpus, except where such action is to provide for after-born or after-adopted children.

(8) Power to allocate between corpus and income.--A power to allocate receipts and disbursements as between corpus and income, even though expressed in broad language.

(c) Exception for certain powers of independent trustees.--Subsection (a) shall not apply to a power solely exercisable (without the approval or consent of any other person) by a trustee or trustees, none of whom is the grantor, and no more than half of whom are related or subordinate parties who are subservient to the wishes of the grantor--

(1) to distribute, apportion, or accumulate income to or for a beneficiary or beneficiaries, or to, for, or within a class of beneficiaries; or

(2) to pay out corpus to or for a beneficiary or beneficiaries or to or for a class of beneficiaries (whether or not income beneficiaries).

A power does not fall within the powers described in this subsection if any person has a power to add to the beneficiary or beneficiaries or to a class of beneficiaries designated to receive the income or corpus, except where such action is to provide for after-born or after-adopted children. For periods during which an individual is the spouse of the grantor (within the meaning of section 672(e)(2)), any reference in this subsection to the grantor shall be treated as including a reference to such individual.

(d) Power to allocate income if limited by a standard.--Subsection (a) shall not apply to a power solely exercisable (without the approval or consent of any other person) by a trustee or trustees, none of whom is
the grantor or spouse living with the grantor, to distribute, apportion, or accumulate income to or for a beneficiary or beneficiaries, or to, for, or within a class of beneficiaries, whether or not the conditions of paragraph (6) or (7) of subsection (b) are satisfied, if such power is limited by a reasonably definite external standard which is set forth in the trust instrument. A power does not fall within the powers described in this subsection if any person has a power to add to the beneficiary or beneficiaries or to a class of beneficiaries designated to receive the income or corpus except where such action is to provide for after-born or after-adopted children.

§ 675. Administrative powers

The grantor shall be treated as the owner of any portion of a trust in respect of which--

(1) Power to deal for less than adequate and full consideration.--A power exercisable by the grantor or a nonadverse party, or both, without the approval or consent of any adverse party enables the grantor or any person to purchase, exchange, or otherwise deal with or dispose of the corpus or the income therefrom for less than an adequate consideration in money or money's worth.

(2) Power to borrow without adequate interest or security.--A power exercisable by the grantor or a nonadverse party, or both, enables the grantor to borrow the corpus or income, directly or indirectly, without adequate interest or without adequate security except where a trustee (other than the grantor) is authorized under a general lending power to make loans to any person without regard to interest or security.

(3) Borrowing of the trust funds.--The grantor has directly or indirectly borrowed the corpus or income and has not completely repaid the loan, including any interest, before the beginning of the taxable year. The preceding sentence shall not apply to a loan which provides for adequate interest and adequate security, if such loan is made by a trustee other than the grantor and other than a related or subordinate trustee subservient to the grantor. For periods during which an individual is the spouse of the grantor (within the meaning of section 672(e)(2)), any reference in this paragraph to the grantor shall be treated as including a reference to such individual.

(4) General powers of administration.--A power of administration is exercisable in a nonfiduciary capacity by any person without the approval or consent of any person in a fiduciary capacity. For purposes of this paragraph, the term “power of administration” means any one or more of the following powers: (A) a power to vote or direct the voting of stock or other securities of a corporation in which the holdings of the grantor and the trust are significant from the viewpoint of voting control; (B) a power to control the investment of the trust funds either by directing investments or reinvestments, or by vetoing proposed investments or reinvestments, to the extent that the trust funds consist of stocks or securities of corporations in which the holdings of the grantor and the trust are significant from the viewpoint of voting control; or (C) a power to reacquire the trust corpus by substituting other property of an equivalent value.

§ 676. Power to revoke

(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 any other provision of this part, where at any time the power to revest in the grantor title to such portion is exercisable by the grantor or a non-adverse party, or both.

(b) Power affecting beneficial enjoyment only after occurrence of event.--Subsection (a) shall not apply to a power the exercise of which can only affect the beneficial enjoyment of the income for a period commencing after the occurrence of an event such that a grantor would not be treated as the owner under section 673 if the power were a reversionary interest. But the grantor may be treated as the owner after the occurrence of such event unless the power is relinquished.

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§ 677. Income for benefit of grantor

(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)).

This subsection shall not apply to a power the exercise of which can only affect the beneficial enjoyment of the income for a period commencing after the occurrence of an event such that the grantor would not be treated as the owner under section 673 if the power were a reversionary interest; but the grantor may be treated as the owner after the occurrence of the event unless the power is relinquished.

(b) Obligations of support.--Income of a trust shall not be considered taxable to the grantor under subsection (a) or any other provision of this chapter merely because such income in the discretion of another person, the trustee, or the grantor acting as trustee or co-trustee, may be applied or distributed for the support or maintenance of a beneficiary (other than the grantor's spouse) whom the grantor is legally obligated to support or maintain, except to the extent that such income is so applied or distributed. In cases where the amounts so applied or distributed are paid out of corpus or out of other than income for the taxable year, such amounts shall be considered to be an amount paid or credited within the meaning of paragraph (2) of section 661(a) and shall be taxed to the grantor under section 662.

§ 678. Person other than grantor treated as substantial owner

(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 a grantor of a trust to treatment as the owner thereof.

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

(c) Obligations of support.--Subsection (a) shall not apply to a power which enables such person, in the capacity of trustee or co-trustee, merely to apply the income of the trust to the support or maintenance of a person whom the holder of the power is obligated to support or maintain except to the extent that such income is so applied. In cases where the amounts so applied or distributed are paid out of corpus or out of other than income of the taxable year, such amounts shall be considered to be an amount paid or credited within the meaning of paragraph (2) of section 661(a) and shall be taxed to the holder of the power under
section 662.

(d) Effect of renunciation or disclaimer.--Subsection (a) shall not apply with respect to a power which has been renounced or disclaimed within a reasonable time after the holder of the power first became aware of its existence.

(e) Cross reference.--

For provision under which beneficiary of trust is treated as owner of the portion of the trust which consists of stock in an S corporation, see section 1361(d).

§ 679. Foreign trusts having one or more United States beneficiaries

(a) Transferor treated as owner.--

(1) In general.--A United States person who directly or indirectly transfers property to a foreign trust (other than a trust described in section 6048(a)(3)(B)(ii)) shall be treated as the owner for his taxable year of the portion of such trust attributable to such property if for such year there is a United States beneficiary of any portion of such trust.

(2) Exceptions.--Paragraph (1) shall not apply--

(A) Transfers by reason of death.--To any transfer by reason of the death of the transferor.

(B) Transfers at fair market value.--To any transfer of property to a trust in exchange for consideration of at least the fair market value of the transferred property. For purposes of the preceding sentence, consideration other than cash shall be taken into account at its fair market value.

(3) Certain obligations not taken into account under fair market value exception.--

(A) In general.--In determining whether paragraph (2)(B) applies to any transfer by a person described in clause (ii) or (iii) of subparagraph (C), there shall not be taken into account--

(i) except as provided in regulations, any obligation of a person described in subparagraph (C), and

(ii) to the extent provided in regulations, any obligation which is guaranteed by a person described in subparagraph (C).

(B) Treatment of principal payments on obligation.--Principal payments by the trust on any obligation referred to in subparagraph (A) shall be taken into account on and after the date of the payment in determining the portion of the trust attributable to the property transferred.

(C) Persons described.--The persons described in this subparagraph are--

(i) the trust,

(ii) any grantor, owner, or beneficiary of the trust, and

(iii) any person who is related (within the meaning of section 643(i)(2)(B)) to any grantor, owner, or beneficiary of the trust.
(4) Special rules applicable to foreign grantor who later becomes a United States person.--

(A) In general.--If a nonresident alien individual has a residency starting date within 5 years after directly or indirectly transferring property to a foreign trust, this section and section 6048 shall be applied as if such individual transferred to such trust on the residency starting date an amount equal to the portion of such trust attributable to the property transferred by such individual to such trust in such transfer.

(B) Treatment of undistributed income.--For purposes of this section, undistributed net income for periods before such individual's residency starting date shall be taken into account in determining the portion of the trust which is attributable to property transferred by such individual to such trust but shall not otherwise be taken into account.

(C) Residency starting date.--For purposes of this paragraph, an individual's residency starting date is the residency starting date determined under section 7701(b)(2)(A).

(5) Outbound trust migrations.--If--

(A) an individual who is a citizen or resident of the United States transferred property to a trust which was not a foreign trust, and

(B) such trust becomes a foreign trust while such individual is alive,

then this section and section 6048 shall be applied as if such individual transferred to such trust on the date such trust becomes a foreign trust an amount equal to the portion of such trust attributable to the property previously transferred by such individual to such trust. A rule similar to the rule of paragraph (4)(B) shall apply for purposes of this paragraph.

(b) Trusts acquiring United States beneficiaries.--If--

(1) subsection (a) applies to a trust for the transferor's taxable year, and

(2) subsection (a) would have applied to the trust for his immediately preceding taxable year but for the fact that for such preceding taxable year there was no United States beneficiary for any portion of the trust,

then, for purposes of this subtitle, the transferor shall be treated as having income for the taxable year (in addition to his other income for such year) equal to the undistributed net income (at the close of such immediately preceding taxable year) attributable to the portion of the trust referred to in subsection (a).

(c) Trusts treated as having a United States beneficiary.--

(1) In general.--For purposes of this section, a trust shall be treated as having a United States beneficiary for the taxable year unless--

(A) under the terms of the trust, no part of the income or corpus of the trust may be paid or accumulated during the taxable year to or for the benefit of a United States person, and

(B) if the trust were terminated at any time during the taxable year, no part of the income or corpus of such trust could be paid to or for the benefit of a United States person.
For purposes of subparagraph (A), an amount shall be treated as accumulated for the benefit of a United States person even if the United States person's interest in the trust is contingent on a future event.

(2) Attribution of ownership.--For purposes of paragraph (1), an amount shall be treated as paid or accumulated to or for the benefit of a United States person if such amount is paid to or accumulated for a foreign corporation, foreign partnership, or foreign trust or estate, and--

(A) in the case of a foreign corporation, such corporation is a controlled foreign corporation (as defined in section 957(a)),

(B) in the case of a foreign partnership, a United States person is a partner of such partnership, or

(C) in the case of a foreign trust or estate, such trust or estate has a United States beneficiary (within the meaning of paragraph (1)).

(3) Certain United States beneficiaries disregarded.--A beneficiary shall not be treated as a United States person in applying this section with respect to any transfer of property to foreign trust if such beneficiary first became a United States person more than 5 years after the date of such transfer.

(4) Special rule in case of discretion to identify beneficiaries.--For purposes of paragraph (1)(A), if any person has the discretion (by authority given in the trust agreement, by power of appointment, or otherwise) of making a distribution from the trust to, or for the benefit of, any person, such trust shall be treated as having a beneficiary who is a United States person unless--

(A) the terms of the trust specifically identify the class of persons to whom such distributions may be made, and

(B) none of those persons are United States persons during the taxable year.

(5) Certain agreements and understandings treated as terms of the trust.--For purposes of paragraph (1)(A), if any United States person who directly or indirectly transfers property to the trust is directly or indirectly involved in any agreement or understanding (whether written, oral, or otherwise) that may result in the income or corpus of the trust being paid or accumulated to or for the benefit of a United States person, such agreement or understanding shall be treated as a term of the trust.

(6) Uncompensated use of trust property treated as a payment.--For purposes of this subsection, a loan of cash or marketable securities (or the use of any other trust property) directly or indirectly to or by any United States person (whether or not a beneficiary under the terms of the trust) shall be treated as paid or accumulated for the benefit of a United States person. The preceding sentence shall not apply to the extent that the United States person repays the loan at a market rate of interest (or pays the fair market value of the use of such property) within a reasonable period of time.

(d) Presumption that foreign trust has United States beneficiary.--If a United States person directly or indirectly transfers property to a foreign trust (other than a trust described in section 6048(a)(3)(B)(ii)), the Secretary may treat such trust as having a United States beneficiary for purposes of applying this section to such transfer unless such person--

(1) submits such information to the Secretary as the Secretary may require with respect to such transfer, and

(2) demonstrates to the satisfaction of the Secretary that such trust satisfies the requirements of subparagraphs (A) and (B) of subsection (c)(1).
(e) **Regulations.**—The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this section.