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Tax Planning with Nongrantor Trusts

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Tax Cuts and Jobs Act of 2017

- Under the Tax Cuts and Jobs Act of 2017, the federal gift and estate tax exclusion amounts in 2019 increased to \$11,400,000 per person, or \$22,800,000 for a married couple
- Clients with estates worth less than that (and no lifetime gifts) no longer have Federal taxable estates
- Increased exclusion amounts scheduled to sunset on December 31, 2025

Role of Income Tax Planning

- Income tax planning may now be just as if not more important than estate tax planning for many clients
- Nongrantor trusts can be effective income tax planning tools in addition to estate planning benefits

What Is a Nongrantor Trust?

- A trust treated as a separate taxpayer from the grantor for income tax purposes
- Guiding principle of the grantor trust rules: income of a trust over which the grantor has retained substantial dominion or control should be taxed to the grantor
- Where the grantor has released sufficient control over the trust property, the trust is a nongrantor trust

2019 Trust Federal Income Tax Rates

Taxable Income Over	But Not Over	Ordinary Income Tax Rate
\$0	\$2,600	10%
\$2,600	\$9,300	24%
\$9,300	\$12,750	35%
\$12,750	---	37%

Nongrantor Trusts as Tax Planning Tools

- Nongrantor trusts can play an important role in a number of income tax planning strategies:
 - Incomplete gift nongrantor trusts (INGs)
 - Qualified small business stock (QSBS)
 - Qualified business income (QBI) deduction
 - Qualified opportunity zone investments
 - Charitable and state and local tax deductions

Roadmap

- Key principles
- How to structure a nongrantor trust
- Tax planning strategies
- Additional nongrantor trust issues

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Key Principles

Who Is the Grantor?

- Any person who either creates, or directly or indirectly makes a “gratuitous transfer” of property to, a trust
 - A gratuitous transfer is any transfer not for FMV
- If a person creates or funds a trust on behalf of someone else, both are treated as grantors of the trust
- A person who creates a trust but makes no gratuitous transfers to it is not treated as an owner of any portion of the trust
- A person who funds a trust but is directly reimbursed within a reasonable period of time is not treated as an owner of any portion of the trust

Business Entities as Grantors

- If a business entity makes a gratuitous transfer to a trust for a business purpose, the entity will be treated as the grantor of the trust
- Gratuitous transfers to a trust for the personal purposes of one or more of an entity's owners are treated as a constructive distribution to the owners, who are treated as the grantors

Trusts as Grantors

- If a trust makes a gratuitous transfer to another trust, the grantor of the transferor trust generally will be treated as the grantor of the transferee trust
- If a person exercises a general power of appointment over a trust in favor of another trust, he or she will be treated as the grantor of the transferee trust

Trusts as Grantors (cont.)

- **Example:** G creates and funds Trust 1 for the benefit of G's descendants. After G's death, the trustees of Trust 1 transfer a portion of its assets of to Trust 2 and retain a power to revoke Trust 2 and revest its assets in Trust 1.
- G is the grantor of Trust 1 and Trust 2
- Because the trustees of Trust 1 have retained a power to revest the assets of Trust 2 in Trust 1, Trust 1 is treated as the owner of Trust 2 for income tax purposes under Section 678(a)

Treatment as Owner of Part of a Trust

- A grantor can be treated as owner of only a portion of the trust. This can include being treated as an owner of:
 - Fractional or pecuniary share of all items of income and principal
 - Trust income or trust principal only
 - Income and principal attributable to specific trust assets

Important Definitions

- **Adverse party**
 - Any person with a substantial beneficial interest in the trust that would be adversely affected by the exercise or nonexercise of the power held
 - Underlying assumption is that the adverse party is likely to act in his or her own best interest when making decisions related to trust property rather than acting on grantor's behalf

Important Definitions (cont.)

- **Adverse party (cont.)**
 - An interest is a “substantial interest” if its value in relation to the total value of the property subject to the power is “not insignificant”
 - A beneficial interest is not substantial if the beneficiary has no right to distributions, the trustees can unilaterally terminate the income interest, and the beneficiary has only a remote contingent remainder interest
 - Can include a general power of appointment

Important Definitions (cont.)

- **Adverse party (cont.)**
 - A trustee is not an adverse party merely by virtue of being trustee
 - A beneficiary can be an adverse party as to only part of a trust. The interest of a remainderman is adverse to the exercise of any power over the corpus of a trust, but not to the exercise of a power over any income interest preceding their remainder.
 - Relatives and employees of the grantor may be adverse parties if the facts indicate that they are truly incentivized to act in their own self-interest

Important Definitions (cont.)

- **Nonadverse party:** Any person who is not an adverse party
- **Related or subordinate party:** Any nonadverse party who is:
 - The grantor's spouse if living with the grantor
 - The grantor's parent, issue, or sibling
 - The grantor's employee
 - A corporation (or its employee) 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

Key Principles: Assignment of Income Doctrine

- Under the assignment of income doctrine, taxpayers cannot exclude gain from gross income by assigning the gain in advance to another party
- Gain from property under contract to sell at the time it is contributed to a nongrantor trust is generally taxed to the grantor

Key Principles: Powers Held by Grantor's Spouse

- A grantor is treated as holding any power or interest held by an individual who:
 - Was the grantor's spouse at the time of the creation of such power or interest, or
 - Became the grantor's spouse after the creation of such power or interest, but only with respect to periods after they became the grantor's spouse

Key Principles: Powers Held by Grantor's Spouse (cont.)

- An individual legally separated from their spouse under a decree of divorce or of separate maintenance at the time the power is created is not considered married for these purposes
- A grantor who is married when the transfer in trust occurs is deemed to hold a spouse's powers even if they later divorce
- Effect of an annulment not clear but arguably prevents a power held by the spouse from being attributed to the grantor

Key Principles: Powers Subject to Condition Precedent

- A person is considered to have a power 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
- Even if a person is considered to have such a power, the grantor will not be considered the tax owner of the trust as a result if the power's exercise can only affect beneficial enjoyment of income received after the expiration of a period of time such that, if the power were a reversionary interest, the grantor would not be treated as an owner under Section 673

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Structuring Nongrantor Trusts

Section 673: Reversionary Interests

- A trust is a grantor trust with respect to any portion in which the grantor has a 5% or greater reversionary interest in either the corpus or income, as of the inception of that portion of the trust
- (Prior to 1986, grantor trust status applied if the reversion could reasonably be expected to take place within 10 years of the initial transfer)

Section 673: Reversionary Interests (cont.)

- “Reversion” ordinarily means a right to receive corpus (and accumulated income, if any) on the trust’s termination
- In practice, a reversion should exist only if trust assets will return to the grantor or the grantor’s estate upon the occurrence of a specified event or after a term of years

Section 673: Reversionary Interests (cont.)

- Value of a reversionary interest determined assuming the maximum exercise of discretion in favor of the grantor
- Valuations generally made based on the 7520 tables but can become more complicated when:
 - Subject is in poor health or dies within 18 months of the creation of the power, or
 - The reversion must be calculated with reference to an occurrence not subject to actuarial tables

Section 673: Reversionary Interests (cont.)

- Trust will not be treated as a grantor trust if:
 - Sole current beneficiaries are the grantor's minor descendants, and
 - Reversion only takes effect on the death of those descendants before they reach age 21
- Postponement of the date of the reversion treated as a new transfer in trust:
 - Transfer starts the effective date of the postponement
 - Transfer ends the date prescribed by the postponement
 - Income for this period not included in the grantor's income if it would not be includible absent any postponement

Section 673: Reversionary Interests (cont.)

- **Example:** G places property in trust for the benefit of his son B. Upon the earlier of 20 years or the death of B, the property is to be paid over to G or his estate. The actuarial value of this reversion is less than 5% of the value of the trust property.
- After 17 years G extends the term of the trust for an additional 2 years. G is considered to have made a new transfer in trust for a term of 5 years (the remaining 3 years of the original transfer plus the 2-year extension). The actuarial value of this 5-year period is more than 5% of the value of the trust property.
- G is not treated as the owner of the trust for the first 3 years of the new term because he would not be so treated absent the 2-year extension. G is treated as the owner of the trust, however, for the remaining 2 years.

Section 673: Reversionary Interests (cont.)

- **Example:** G places property in trust for the benefit of his son B. The trust grants G's cousin, C, the power to terminate the trust, in which case the trust property reverts to G. C has complete discretion with respect to the exercise of this power.
 - Section 673 assumes the maximum exercise of discretion in favor of the grantor, so the power is assumed for these purposes to be exercised immediately, causing the trust to be a grantor trust
- **Example:** G places property in trust for the benefit of his son B. If the Mariners win the World Series, the trust property is to be paid over to G or his estate.
 - Query how to evaluate the likelihood that this reversion will be triggered

Section 674: Power to Control Beneficial Enjoyment

- A trust is a grantor trust as to any portion in respect of which the beneficial enjoyment of the corpus or income 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

Section 674: Power to Control Beneficial Enjoyment (cont.)

- A power to control beneficial enjoyment includes:
 - Power to add or eliminate beneficiaries
 - Power to distribute or withhold corpus or income
 - Power of appointment
 - Potentially, any other power
- Generally, any power to control who receives distributions, when they receive them, and of what those distributions consist

Section 674: Exceptions

- Section 674 is subject to numerous exceptions: powers to control the beneficial enjoyment of trust property that nevertheless do not cause grantor trust status

Section 674(b)(1) Exception: Powers Described in Section 677(b)

- A trust is not a grantor trust solely because of a power described in Section 677(b) (a power to apply or distribute income for the support or maintenance of a dependent of the grantor) to the extent that the grantor would not be subject to tax under that section
- Exception does not apply if the grantor holds this power and is not acting as trustee

Section 674(b)(2) Exception: Power Subject to Condition Precedent

- A trust is not a grantor trust solely because of 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
- **Example:** A power to distribute trust corpus and income exercisable only once a current beneficiary reaches age 65, where the actuarial value of such power given the beneficiary's age is less than 5% of the value of the trust property

Section 674(b)(3) Exception: Power Exercisable Only by Will

- A trust is not a grantor trust solely because of a power exercisable only by will
- Exception does not apply to a power of the grantor to appoint trust income by will 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
 - **Example:** A trust providing that the nonadverse trustee has discretion to distribute income to the grantor's children for the grantor's life, with the grantor holding a testamentary power of appointment over the remainder

Section 674(b)(4) Exception: Power to Allocate Among Charitable Beneficiaries

- A trust is not a grantor trust solely because of a power to determine the beneficial enjoyment of trust corpus or income if it is irrevocably payable for a purpose specified in Section 170(c), or to an employee stock ownership plan, in a qualified gratuitous transfer as defined in Section 664(g)(1)
- **Example:** A power of the grantor over a charitable remainder trust to name one or more charities as remainder beneficiaries and to determine the proportion of their beneficial interests

Section 674(b)(5) Exception: Power to Distribute Corpus

- A trust is not a grantor trust solely because of a power to distribute corpus either:
 - To or for beneficiaries or a class of beneficiaries, provided that the power is limited by a reasonably definite standard set forth in the trust
 - 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

Section 674(b)(5) Exception: Power to Distribute Corpus (cont.)

- “Reasonably definite standard” includes any clearly measurable standard under which the holder of a power is legally accountable (e.g., a HEMS distribution power)
- Exception does not apply if any person has a power to add to the beneficiaries or to a class of beneficiaries designated to receive income or corpus, except to provide for after-born or after-adopted children
 - This exception to the exception does not apply to a power held by a beneficiary to substitute others to succeed to his or her own interest in the trust, or to testamentary powers that qualify under Section 674(b)(3)

Section 674(b)(5) Exception: Power to Distribute Corpus (cont.)

- **Example 1:** Nonadverse trustee's power to distribute trust corpus for the beneficiaries' health, education, maintenance, and support
- **Example 2:** Nonadverse trustee's power to distribute trust corpus to a current income beneficiary, where:
 - The trust provides that all current income beneficiaries are to receive an equal share of the trust's income annually, and
 - Following the distribution, the recipient beneficiary's share of trust income is reduced as though his or her share of trust corpus generating income were reduced by the value of the distribution

Section 674(b)(6) Exception: Power to Temporarily Withhold Income

- A trust is not a grantor trust solely because of a power to distribute or apply ordinary income (but not capital gains) to or for any current income beneficiary, or to accumulate the income for such beneficiary, provided that any accumulated income must ultimately be payable:
 - To the beneficiary from whom it was withheld, their estate, or their appointees under a power of appointment held by the beneficiary that 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

Section 674(b)(6) Exception: Power to Temporarily Withhold Income (cont.)

- To the beneficiary from whom it was withheld, or if they do not survive a date of distribution that could reasonably be expected to occur within their lifetime, to their appointees under any power of appointment, or if they have no power of appointment to one or more designated alternate takers (other than the grantor or the grantor's estate) whose shares have been irrevocably specified in the trust, or
- On termination of the trust, or in conjunction with a distribution of corpus augmented by such accumulated income, to the current income beneficiaries in shares irrevocably specified in the trust

Section 674(b)(6) Exception: Power to Temporarily Withhold Income (cont.)

- Exception does not apply if any person has a power to add to the beneficiaries or to a class of beneficiaries designated to receive income or corpus, except to provide for after-born or after-adopted children
 - This exception to the exception does not apply to a power held by a beneficiary to substitute others to succeed to his or her own interest in the trust, or to testamentary powers that qualify under Section 674(b)(3)

Section 674(b)(6) Exception: Power to Temporarily Withhold Income (cont.)

- **Examples:** A power to withhold income if:
 - (For a trust of which Brother and Sister are income beneficiaries): Income withheld from Brother is paid to Brother on the trust's termination when Sister dies, or if Brother dies before then, to his estate or appointees under a broad limited power of appointment
 - (For a trust of which Son is the sole income beneficiary): Income withheld from Son is paid to Son on the trust's termination when Parent dies, or if Son dies before then, to his estate or appointees under a narrow limited power of appointment

Section 674(b)(7) Exception: Power to Withhold Income During Beneficiary's Disability

- A trust is not a grantor trust solely because of a power exercisable only during:
 - The existence of a legal disability of any current income beneficiary, or
 - The period during which any income beneficiary is 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
- “Legal disability” not defined – unclear whether a court determination is necessary
 - ADA defines a person with a disability as a person who has a physical or mental impairment that substantially limits one or more major life activity

Section 674(b)(7) Exception: Power to Withhold Income During Beneficiary's Disability (cont.)

- Exception does not apply if any person has a power to add to the beneficiaries or to a class of beneficiaries designated to receive income or corpus, except to provide for after-born or after-adopted children
 - This exception to the exception does not apply to a power held by a beneficiary to substitute others to succeed to his or her own interest in the trust, or to testamentary powers that qualify under Section 674(b)(3)
- Unlike the exception for a power to withhold income under Section 674(b)(6), it is not necessary that withheld income ultimately be payable to the beneficiary from whom it was withheld or his or her estate or appointees

Section 674(b)(8) Exception: Power to Allocate Between Income & Principal

- A trust is not a grantor trust solely because of a power to allocate receipts and disbursements between corpus and income
 - Some commentators question whether this is true where the power to allocate between corpus and income is held in a nonfiduciary capacity

Section 674(c) Exception: Distributions by Independent Trustees

- A trust is not a grantor trust solely because of 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 of the grantor or the grantor's spouse:
 - To distribute, apportion, or accumulate income to or for a beneficiary or beneficiaries, or to, for, or within a class of beneficiaries, or
 - To pay out corpus to or for a beneficiary or beneficiaries or to or for a class of beneficiaries (whether or not income beneficiaries)

Section 674(c) Exception: Distributions by Independent Trustees (cont.)

- This exception does not apply if any person has a power to add to the beneficiaries or to a class of beneficiaries designated to receive income or corpus, except to provide for after-born or after-adopted children
 - This exception to the exception does not apply to a power held by a beneficiary to substitute others to succeed to his or her own interest in the trust, or to testamentary powers that qualify under Section 674(b)(3) (discussed above)

Section 674(c) Exception: Distributions by Independent Trustees (cont.)

- A power in the grantor or grantor's spouse to remove, substitute, or add trustees may prevent a trust from qualifying for this exception
- Regulations give the example of an unrestricted power to remove an independent trustee and substitute any person including the grantor as trustee. However, a power in the grantor to remove or discharge an independent trustee on the condition that he substitute another independent trustee should not prevent a trust from qualifying under Section 674(c).

Section 674(d) Exception: Power to Allocate Income Subject to Standard

- A trust is not a grantor trust solely because of 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 class of beneficiaries, if such power is limited by a reasonably definite external standard set forth in the trust instrument
 - Again, “reasonably definite external standard” not defined but should include HEMS distributions
 - Unclear whether the requirement that the spouse be living with the grantor overrides the language of Section 672(e)

Section 674(d) Exception: Power to Allocate Income Subject to Standard (cont.)

- This exception does not apply if any person has a power to add to the beneficiaries or to a class of beneficiaries designated to receive income or corpus, except to provide for after-born or after-adopted children
 - This exception to the exception does not apply to a power held by a beneficiary to substitute others to succeed to his or her own interest in the trust, or to testamentary powers that qualify under Section 674(b)(3) (discussed above)

Section 674(d) Exception: Power to Allocate Income Subject to Standard (cont.)

- A power in the grantor or grantor's spouse to remove, substitute, or add trustees may prevent a trust from qualifying for this exception
- Here, if the grantor has the power to remove and replace the trustee, it may be sufficient to prohibit the grantor from replacing a removed trustee with any of the grantor, the grantor's spouse (if living with the grantor), and perhaps any related or subordinate party to the grantor or grantor's spouse

Section 675: Administrative Powers

- A trust is a grantor trust if any of certain administrative powers are present
- Intended to trigger grantor trust status where administrative control is exercisable primarily for the benefit of the grantor rather than the beneficiaries

Section 675: Administrative Powers: Power to Deal for Less Than Adequate Consideration

- A trust is a grantor trust as to any portion in respect of which a power exercisable by the grantor or a nonadverse party, or both, without the approval or consent of any adverse party enables any person to deal with or dispose of trust corpus or income for less than adequate consideration in money or money's worth
- **Examples:** Grantor's power to:
 - Purchase property at less than FMV
 - Sell property at more than FMV
 - Borrow from the trust interest free

Section 675: Administrative Powers: Power to Borrow Without Adequate Interest or Security

- A trust is a grantor trust as to any portion in respect of which 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 adequate security
- Exception 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
- Lending powers granted to trustees read in light of the actual circumstances of the trust administration
- Indirect borrowings include a sale by the trust to the grantor for a note

Section 675: Administrative Powers: Actual Borrowing from Trust

- A trust is a grantor trust as to any portion in respect of which the grantor has directly or indirectly borrowed the corpus or income and has not completely repaid the loan, including any interest, before the beginning of the following taxable year
- Exception where the loan provides for adequate interest, adequate security, and is made by a trustee other than the grantor or a related or subordinate trustee
- Indirect borrowing includes a trust's purchase of notes issued by the grantor, a grantor's assignment of a note he issued to a trust, and a trust's loan to a partnership of which the grantor is a general partner

Section 675: Administrative Powers: Actual Borrowing from Trust (cont.)

- IRS view is that grantor trust status is triggered for the entirety of any year in which the grantor borrows trust assets, even if the loan is repaid in the same year
- Grantor trust status may apply to part or all of the trust property:
 - If a grantor borrows all of the trust income for a given year, he is treated as the owner of the entire trust
 - Where a grantor borrows less than all of the trust income, he is treated as the owner of a fractional share of the trust income

Section 675: Administrative Powers: Actual Borrowing from Trust (cont.)

- The portion of the trust as to which the grantor is treated as the income tax owner is the greater of:
 - The proportion the current year's borrowings bear to the current year's income, and
 - The proportion total borrowings bear to total income from the trust's inception through the end of the taxable year
- **Example:** Trust has income of \$50,000 in 2019. Grantor borrows \$50,000 from Trust for zero interest in an unsecured loan on 12/31/19. The entire loan remains outstanding for all of 2020.
 - Grantor is treated as the owner of the entire trust income and corpus for all of 2019
 - In 2020, absent additional borrowing, Grantor is treated as the owner of a fraction of trust property equal to \$50,000 over the aggregate income of the trust since its inception

Section 675: Administrative Powers: Power to Vote Certain Securities

- A trust is a grantor trust as to any portion in respect of which any person, acting in a nonfiduciary capacity without the approval or consent of any person in a fiduciary capacity, may exercise 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
- No definition of “significant” holdings

Section 675: Administrative Powers: Power to Control Investment of Trust Funds

- A trust is a grantor trust as to any portion in respect of which any person, acting in a nonfiduciary capacity without the approval or consent of any person in a fiduciary capacity, may exercise a power to control the investment of the trust funds either by directing or 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
- No definition of “significant” holdings

Section 675: Administrative Powers: Power to Reacquire Trust Corpus

- A trust is a grantor trust as to any portion in respect of which any person, acting in a nonfiduciary capacity without the approval or consent of any person in a fiduciary capacity, may exercise a power to reacquire the trust corpus by substituting other property of equivalent value
 - Power must be exercised in a nonfiduciary capacity
 - Swap power exercisable by a trustee presumed to be in a fiduciary capacity

Section 675: Administrative Powers: Power to Amend Administrative Trust Provisions

- If a grantor retains a power to amend the administrative provisions of a trust that is broad enough to permit an amendment causing the grantor to be treated as the owner of a portion of the trust under Section 675, the grantor will be treated as the owner of that portion from its inception

Section 676: Power to Revoke

- A trust is a grantor trust as to any portion subject to a power to revest title in the grantor, exercisable by the grantor or a nonadverse party, or both, regardless of whether the power is a power to revoke, terminate, alter, amend, or appoint
- Includes straightforward revocation powers, but can also include the right to reacquire trust corpus for less than FMV, demand loans to the trust by a grantor, or the grantor's right to receive trust distributions
- A trust is not a grantor trust under Section 676 solely because of 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

Section 677(a): Trust Income Distributable to Grantor or Spouse

- The grantor is treated as the owner of any portion of a trust, whether or not they are treated as 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:
 - Distributed to the grantor or the grantor's spouse, or
 - Held or accumulated for future distribution to the grantor or the grantor's spouse, even if such distributions are never made
- Extends to payments satisfying the obligations of the grantor or grantor's spouse or made at their direction
- Section 677(b): Mere possibility of payments made to a dependent of the grantor or grantor's spouse does not trigger Section 677

Section 677(a):

Trust Income Distributable to Grantor or Spouse (cont.)

- A sale of property by a grantor to a trust for less than the property's FMV, or with respect to which the trust's payment obligation is tied to the trust's income, may be viewed as a gift by the grantor with a retained income interest, triggering grantor trust status and inclusion in the grantor's estate
- Exception for 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
 - Exception does not apply merely because the grantor or spouse must await the expiration of a period of time before he or she can receive or exercise discretion over previously accumulated income of the trust

Section 677(a): Trust Income Distributable to Grantor or Spouse (cont.)

- Section 677 does not apply when the income of a trust is taxable to a grantor's spouse under Section 71 (relating to alimony and separate maintenance payments) or Section 682 (relating to income of an estate or trust in case of divorce, etc.)

Section 677(a)(3): Trust Income Used to Pay Insurance Premiums

- The grantor is treated as the owner of any portion of a trust 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 applied to the payment of premiums on policies of insurance on the life of the grantor or the grantor's spouse
- Exception for policies irrevocably payable for a purpose specified in Section 170(c)

Section 678: Beneficiary as Income Tax Owner

- A beneficiary of a trust is treated as the owner for income tax purposes of any portion of a trust with respect to which:
 - The beneficiary has a power exercisable solely by himself or herself to vest the corpus or income in the beneficiary, or
 - The beneficiary has previously partially released or otherwise modified such a power, and after the release or modification retains a power or interest that would trigger grantor trust status for a grantor under Sections 671 through 677

Section 678: Beneficiary as Income Tax Owner (cont.)

- **Examples:**
 - Crummey power of a beneficiary to withdraw an annual exclusion gift made to the trust
 - Beneficiary's power to withdraw the greater of \$5,000 or 5% of the trust property each year

Section 678: Beneficiary as Income Tax Owner (cont.)

- Beneficiary will not be treated as income tax owner of trust property:
 - If the grantor is already treated as owner under Sections 671 through 677
 - Due to a power enabling the beneficiary, as trustee, to apply the income of the trust to the support or maintenance of a person whom he or she is obligated to support or maintain, except to the extent that such income is so applied
 - If the beneficiary renounces an offending power within a reasonable time of becoming aware of it

Section 678: Beneficiary as Income Tax Owner (cont.)

- A beneficiary is generally treated as the owner of that portion of a trust that consists of S corporation stock for income tax purposes if the trust is a qualified subchapter S trust (QSST)

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Tax Planning Strategies

Incomplete Gift Nongrantor Trusts (INGs)

- State income tax planning strategy often created under Delaware (DINGs) or Nevada (NINGs) law
- Grantor gives up enough control that the trust is not a grantor trust, but not so much that they are deemed to have made a completed gift

Incomplete Gift Nongrantor Trusts (INGs): Considerations

- Trust structure:
 - Grantor must give up enough control that the trust is not a grantor trust, but not so much as to make a completed gift
 - Additional complexity if grantor or grantor's spouse is a beneficiary
 - May require a local trustee
 - See Section IV.C.5 of Sam Donaldson's seminar presentation for considerations arising out of the recent *Kaestner* case
- Effect of state law:
 - Some states have declared their intention not to respect an ING as a state income tax avoidance device
 - State income tax may apply to income sourced to the state of the grantor's domicile
 - Creditor protection afforded by state of trust situs

Qualified Small Business Stock (QSBS)

- Stock that meets the requirements of Section 1202 is eligible for significant tax benefits, including up to 100% exclusion of gain on sale and the option to defer gain by reinvesting in other QSBS companies
- While generally limited to a maximum of \$10M of gain exclusion per taxpayer, per issuer, it may be possible to use one or more nongrantor trusts to take advantage of \$10M+ of additional exclusion

Qualified Small Business Stock (cont.)

- QSBS requirements:
 - Company is a domestic C corporation
 - Stock issued after August 10, 1993
 - Stock acquired by taxpayer directly from the company for money, property (other than stock), or services (limited exceptions to this rule)
 - Aggregate gross assets of the corporation at all times from August 10, 1993 until immediately after the issuance of stock less than \$50 million
 - Stock held for 5+ years, during which the company is an active business

Qualified Small Business Stock (cont.)

- Holding period requirement subject to tacking rules for QSBS received by gift or inheritance
- Gain exclusion limited to the greater of \$10M or 10 times aggregate adjusted basis per taxpayer, per issuer
- Gift of QSBS to one or more nongrantor trusts may allow multiple exclusions of \$10M gain
 - But see Reg. 1.643(f)-1: multiple trusts treated as a single trust if they have substantially the same grantor and primary beneficiary(ies), and if a principal purpose for establishing or contributing additional property to such trusts is the avoidance of Federal income tax
 - New Section 199A regulations contain a similar anti-avoidance rule

Qualified Small Business Stock (cont.)

- Though more complex, additional exclusion may be possible using a partial grantor trust, or a trust a portion of which is owned by the beneficiary under Section 678

Charitable Giving Structure

- Clients who do not expect to receive an income tax benefit from their charitable contributions could fund a nongrantor trust for the benefit of descendants and one or more charities
- Trust receives a charitable deduction under Section 642(c) for amounts distributed to charity
- DNI is calculated taking into account this deduction, so additional distributions to noncharitable beneficiaries may carry out little or no DNI

State and Local Tax (SALT) Deduction

- Under current law, the deduction permitted to an individual for personal SALT paid is limited to \$10,000, or \$5,000 for a married individual filing separately
- As a separate taxpayer, a nongrantor trust would be eligible for its own \$10,000 SALT deduction separate from that of the grantor
- Again, see Reg. 1.643(f)-1

Qualified Business Income (QBI) Deduction

- Section 199A permits a deduction of up to 20% of the qualified business income of a domestic business operated as a sole proprietorship or through a partnership or S corporation
- QBI deduction may be taken by individuals, estates, and nongrantor trusts
- For taxpayers whose taxable income exceeds a statutorily-defined amount or “threshold amount,” the deduction may be limited, or even lost, based on the type of business, the amount of wages paid by the business, or the unadjusted basis of assets used in the business

Qualified Business Income (QBI) Deduction (cont.)

- Transfers to nongrantor trusts can be structured in such a way as to maximize QBI deduction. These rules are extremely complicated and estate planners and CPAs should conduct a thorough analysis before recommending such transfers.
- Again, see Reg. 1.643(f)-1
- Reg. 1.199A-6(d)(3)(vii) provides that a trust formed or funded with a principal purpose of abusing Section 199A will not be respected

Qualified Opportunity Zone Investments

- Opportunity Zones are designed to spur economic development by providing tax benefits to investors in economically distressed geographic areas
- Investors can defer tax on prior gains invested in a Qualified Opportunity Fund (QOF) until the earlier of the date on which the QOF investment is sold or exchanged, or December 31, 2026
- If the QOF investment is held for longer than 5 years, there is a 10% exclusion of the deferred gain. If held for more than 7 years, the 10% becomes 15%.

Qualified Opportunity Zone Investments (cont.)

- Investors holding QOF interests for at least 10 years receive an increase in basis equal to the interest's FMV on the date that the investment is sold or exchanged
- Proposed regulations treat a transfer of a QOF interest to a nongrantor trust as an "inclusion event" subjecting deferred capital gains to immediate tax
- A nongrantor trust with its own capital gains may invest those gains in a QOF and take advantage of deferral and a possible basis step-up

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Other Issues

Toggling Grantor Trust Status

- Grantor trust status can be “turned off” or “turned on” in any number of ways (release of grantor trust powers by the holder, change of trustee, modification of trust terms, etc.)
- Changes in grantor trust status generally take effect prospectively
 - Exception for conversions to grantor trust status where grantor actually borrows from the trust, which triggers grantor trust status for the entire year even if the loan is repaid that year

Toggling Grantor Trust Status: Income Tax Treatment

- Conversion to nongrantor trust treated as a transfer from the grantor to the trust and can trigger gain in certain circumstances (e.g., where trust holds assets subject to debt that exceeds the grantor's basis or holds an interest in a QOF)
- Conversion to grantor trust is generally not a transfer for income tax purposes requiring gain recognition
 - But query whether the trust would recognize gain in the circumstances described above

Toggling Grantor Trust Status: Notice 2007-73

- Notice 2007-73 identifies certain transactions toggling grantor trust status as reportable transactions
- Transactions described in the Notice created an artificial tax loss and may not be relevant in the more standard estate planning context
- Notice makes clear that merely terminating grantor trust status without a subsequent “turning on” of that status does not constitute a reportable transaction
- Be cautious toggling grantor trust status more than once

Toggling Grantor Trust Status: Hypothetical

- Trust 1 is a nongrantor trust holding stock in a family-owned company with significant built-in gain
 - Grantor is dead
 - Trust contains antiquated and restrictive terms and is expected to terminate in the next 10 years and distribute stock outright to beneficiaries
 - Trust situated in a state with state income tax
- Family would like to transfer trust assets to a new trust with more favorable terms and a longer lifetime in a no-tax jurisdiction

Toggling Grantor Trust Status: Hypothetical (cont.)

- Trust 1 is modified to grant Beneficiary a withdrawal right over the trust's capital gains
- Beneficiary is treated as the income tax owner of those capital gains
- If Trust 1 cannot be modified, it might instead create and fund a new trust that provides the beneficiary with this withdrawal right, being careful not to retain any powers that cause Trust 1 to be deemed the income tax owner of the new trust
- Beneficiary has previously created and funded Trust 2, a dynasty trust with the family's desired terms located in a no-tax jurisdiction. Trust 2 is a grantor trust as to Beneficiary.

Toggling Grantor Trust Status: Hypothetical (cont.)

- Trust 1 sells its stock to Trust 2 for FMV. Because Beneficiary is the income tax owner of Trust 1's capital gains and all of Trust 2's income and corpus, the sale does not generate capital gains—the sale is treated as by Beneficiary to Beneficiary for income tax purposes
- Caveat emptor: gift, estate, and GST tax issues would need to be considered

Trusts Creating Other Trusts

- A trust can be treated as the grantor of a second trust to which the first trust makes a gratuitous transfer of property
- Structured properly, the first trust may be treated as the owner of the second trust's property for income tax purposes
- IRS has approved a structure in which a trust created and funded a charitable remainder unitrust (CRUT)
- Presumably a trust could also create a grantor retained annuity trust or charitable lead trust as well, though this would only provide estate tax benefits to the extent that the original trust was an incomplete gift trust

Section 672(f): Trusts with Foreign Grantors

- Where the grantor is a nonresident alien, Sections 671-679 will cause grantor trust status only as to that portion of the trust with respect to which:
 - Grantor holds the power to revest trust assets in himself or herself exercisable 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
 - The only amounts distributable from such portion during the grantor's lifetime are distributable to the grantor or the grantor's spouse
- Nuanced rule that encourages attribution of trust income to a U.S. person

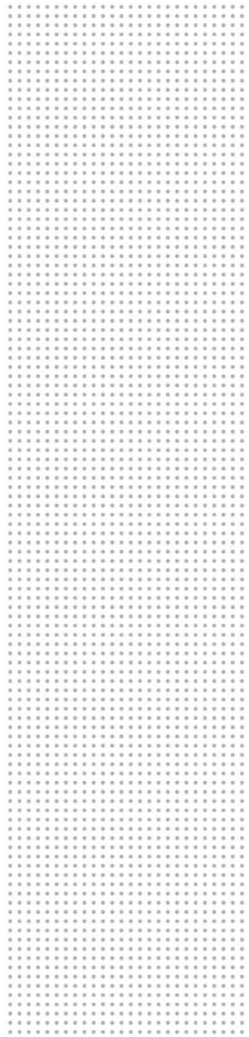
Section 679: Foreign Trusts with U.S. Beneficiaries

- A U.S. person who directly or indirectly transfers property to a foreign trust is generally treated as the income tax owner of such property if there is a U.S. beneficiary of any portion of such trust
- Another nuanced rule that applies regardless of the trust's terms or any powers or interests held with respect to trust property

Divorce Settlement Trusts

- Trusts created in connection with a divorce or separation are likely to be grantor trusts as they often contain reversionary interests, give the grantor powers over distributions or investment, etc.
- If transferor and transferee spouses are still married to each other when the trust is created, Section 677 may apply even if the marriage is terminated immediately afterward
- Section 682 was repealed effective January 1, 2019. It provided that if spouses were divorced or separated, income one of them received or was entitled to receive from a trust was included in his or her gross income regardless of Sections 671-679.

Questions?



CHAPTER THIRTEEN
TAX PLANNING WITH NONGRANTOR TRUSTS

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Tax Planning with Nongrantor Trusts

I. What Is a Nongrantor Trust? The principle guiding the grantor trust rules is that income of a trust over which the grantor or another person has retained substantial dominion or control should be taxed to the grantor or other person rather than to the trust that receives the income or to the beneficiary to whom the income may be distributed. Reg. 1.671-2(b). Where the grantor has released sufficient dominion and control over the trust property so as not to be treated as the owner of trust property for income tax purposes, the trust is a nongrantor trust.

II. Who Is the Grantor: A grantor includes any person to the extent such person either creates, or directly or indirectly makes a “gratuitous transfer” of property to, a trust. If a person creates or funds a trust on behalf of another person, both persons are treated as grantors of the trust. However, a person who creates a trust but makes no gratuitous transfers to the trust is not treated as an owner of any portion of the trust unless Section 678 applies. Also, a person who funds a trust with an amount that is directly reimbursed to such person within a reasonable period of time and who makes no other transfers to the trust that constitute gratuitous transfers is not treated as an owner of any portion of the trust (again, unless Section 678 applies). Reg. 1.671-2(e)(1).

A. Definition of Gratuitous Transfer: A gratuitous transfer is any transfer other than a transfer for fair market value. A transfer of property to a trust may be considered a gratuitous transfer without regard to whether the transfer is treated as a gift for gift tax purposes. A transfer is for fair market value only to the extent of the value of property received from the trust, services rendered by the trust, or the right to use property of the trust. Reg. 1.671-2(e)(2).

B. Business Entities as Grantors: If a gratuitous transfer is made by a partnership or corporation to a trust and is for a business purpose of the partnership or corporation, the partnership or corporation will generally be treated as the grantor of the trust. However, if an entity makes a gratuitous transfer to a trust that is not for a business purpose of the entity but is for the personal purposes of one or more of the owners, the gratuitous transfer will be treated as a constructive distribution to such owners under federal tax principles and the owners will be treated as the grantors of the trust. Reg. 1.671-2(e)(4).

C. Trusts as Grantors: If a trust makes a gratuitous transfer of property to another trust, the grantor of the transferor trust generally will be treated as the grantor of the transferee trust. However, if a person with a general power of appointment over the transferor trust exercises that power in favor of another trust, he or she will be treated as the grantor of the transferee trust, even if the grantor of the transferor trust is treated as the owner of the transferor trust under the grantor trust rules. Reg. 1.671-2(e)(5).

1. Example: G creates and funds a trust, T1, for the benefit of G’s children and grandchildren. After G’s death, under authority granted to the trustees in the trust instrument, the trustees of T1 transfer a portion of the assets of T1 to another trust, T2, and retain a power to revoke T2 and revest the assets of T2 in T1. G is the grantor of T1 and T2. In addition, because the trustees of T1 have retained a power to revest the assets of T2 in T1, T1 is treated as the owner of T2 under section 678(a). Reg. 1.671-2(e)(6), Example (8).

D. Grantors Treated as Owner of Part of a Trust: A grantor may be treated as owner for income tax purposes of only a portion of the trust. This can include being treated as an owner of a pro rata share of a trust's principal and income (for instance, if two persons have made gratuitous transfers to a trust), of just the trust income or trust principal, of a fractional or pecuniary share of all items of income and principal, or of all items of income and principal attributable to specific trust assets. Reg. 1.671-3; Reg. 1.677(a)-1(e), -(g).

III. Key Definitions

A. Adverse Party: An "adverse party" means any person having a substantial beneficial interest in the trust (including a general power of appointment) that would be adversely affected by the exercise or nonexercise of the power that he or she holds. Section 672(a); Reg. 1.672(a)-1. The underlying assumption is that the adverse party is likely to act in his or her own best interest when making decisions related to trust property and distributions, rather than acting on behalf of the grantor. For a helpful summary of this rule, see Miller & Behn, *Adverse Enough to Be a Nongrantor Trust*, 164 TAX NOTES FEDERAL 1019 (Aug. 12, 2019).

1. Definition of Substantial Interest: An interest is a substantial interest if its value in relation to the total value of the property subject to the power is not insignificant. Reg. 1.672(a)-1(a). This unhelpful definition does not provide much in the way of guidance as to whether an interest is substantial. Courts have held a beneficial interest not to be substantial where a beneficiary had no right to distributions and the trustees could unilaterally terminate her income interest, and where a beneficiary had a remote contingent interest that would vest only if the issue of the grantor and beneficiary all died before reaching age 35. *Water Resource Control v. Comm'r*, T.C. Memo. 1991-104, *aff'd memo sub nom. Whitehouse v. Comm'r*, 972 F.2d 1328 (2d Cir. 1992); *Chase Nat'l Bank v. Comm'r*, 225 F.2d 621 (8th Cir. 1955), *aff'g D.G. McDonald Trust*, 19 T.C. 672 (1953).

2. Trustees as Adverse Parties: A trustee is not an adverse party merely because of his or her role as trustee. Reg. 1.672(a)-1(a).

3. Beneficiaries of a Portion of a Trust as Adverse Parties: If a beneficiary's right to share in the income or corpus of a trust is limited to only a part, that beneficiary is an adverse party only as to that part. Reg. 1.672(a)-1(b)-(c).

4. Remaindermen as Adverse Parties: The interest of a remainderman is adverse to the exercise of any power over the corpus of a trust, but not to the exercise of a power over any income interest preceding their remainder. Reg. 1.672(a)-1(d).

5. Related or Subordinate Parties as Adverse Parties: The Code and Regulations do not prohibit a related or subordinate party from being an adverse party. A number of private letter rulings have approved structures in which children of the grantor qualified as adverse parties with respect to distributions made to the grantor. See, e.g., Priv. Ltr. Rul. 201310002. Where the facts indicate that the purportedly adverse party may not truly be incentivized to act in his or her own self-interest, however, a related or subordinate party may not qualify as an adverse party. See *Cox v. Comm'r*, 110 F.2d 934 (10th Cir. 1940).

B. Nonadverse Party: A “nonadverse party” means any person who is not an adverse party. Section 672(b); Reg. 1.672(b)-1.

C. Related or Subordinate Party: A “related or subordinate party” means any nonadverse party who is (1) the grantor’s spouse if living with the grantor, (2) the grantor’s parent, issue, or sibling, (3) the grantor’s employee, (4) a corporation or any employee of a corporation in which the stock holdings of the grantor and the trust are significant from the viewpoint of voting control, or (5) a subordinate employee of a corporation in which the grantor is an executive. Section 672(c); Reg. 1.672(c)-1.

IV. Key Principles

A. Grantor Trust Rules Cannot Avoid Assignment of Income Doctrine: A grantor is taxed on trust income under the assignment of income doctrine regardless of whether the trust would otherwise qualify as a nongrantor trust. Reg. 1.671-1(c).

B. Powers Subject to Condition Precedent: For purposes of the grantor trust rules, a person is considered to have a power 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. However, although a person may be considered to have such a power, the grantor will nevertheless not be treated as an owner by reason of the power if its exercise can only affect beneficial enjoyment of income received after the expiration of a period of time such that, if the power were a reversionary interest, he would not be treated as an owner under section 673. Section 672(d); Reg. 1.672(d)-1.

1. Example 1: A grantor creates a trust for the benefit of his son and retains a power to revoke that takes effect only after the expiration of 2 years from the date of exercise. The actuarial value of this potential reversion exceeds 5% of the value of the trust property. The grantor is treated as an owner from the inception of the trust. *See* Reg. 1.672(d)-1.

2. Example 2: A grantor retains a power to revoke, exercisable at any time, that can only affect the beneficial enjoyment of the ordinary income of a trust received after the death of the income beneficiary. The income beneficiary is sufficiently young that the actuarial value of this potential reversion is less than 5% of the value of the trust property. The power does not cause the grantor to be treated as an owner with respect to the trust income. *See id.*

C. Powers Held by Grantor’s Spouse: For purposes of the grantor trust rules, a grantor is treated as holding any power or interest held by an individual who was his or her spouse at the time of the creation of such power or interest, or an 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. An individual legally separated from their spouse under a decree of divorce or of separate maintenance at the time the power is created is not considered as married for purposes of this rule. Section 672(e).

1. Effect of Divorce: A grantor who is married when the transfer in trust occurs is deemed to hold the powers of his or her spouse even if they later divorce. S. Rep. No. 313, 99th Cong., 2d Sess. 871 (1986). The effect of an annulment is not clear but should arguably prevent a power held by the spouse from being attributed to the grantor. *See* Danforth

& Zaritsky, 819-2nd T.M., *Grantor Trusts (Sections 671-679)* at ¶ IV.C [hereafter, “Grantor Trust TMP”].

V. Nongrantor Trust Requirements

A. Grantor and Spouse Cannot Have a Reversionary Interest: The trust is a grantor trust with respect to any portion of the trust in which the grantor (or, under Section 672(e), the grantor’s spouse) has a 5% or greater reversionary interest in either the corpus or income, as of the inception of that portion of the trust. Section 673(a). For an example of a contingent reversion that the IRS determined caused grantor trust status, see Priv. Ltr. Rul. 201642019 (revoking in part Priv. Ltr. Rul. 201426014).

1. Old 10-Year Rule: Prior to 1986, grantor trust status applied if the reversion could reasonably be expected to take place within 10 years of the initial transfer. This has since been replaced by the 5% test described above, but the regulations do not yet reflect the change to the statute. *See* Section 673(d) and the regulations relating to Section 673.

2. Definition of Reversion: A “reversion” ordinarily means a right to receive the corpus (and accumulated income, if any) on the trust’s termination. *See* Bittker & Lokken, *Fed. Tax’n of Income, Estates & Gifts* at ¶ 80.2.1. In practice, a reversion should exist only if trust assets will return to the grantor upon the occurrence of a specified event, after a term of years, or upon the grantor’s demand. *See* Miller & Behn, *Adverse Enough to Be a Nongrantor Trust*, 164 TAX NOTES FEDERAL 1019 (Aug. 12, 2019).

3. Reversion to Grantor’s Estate: Grantor trust status will apply if the reversion is to the grantor’s estate; however, for these purposes, the possibility of an interest returning to the grantor or spouse under intestacy laws is ignored. Rev. Ruls. 73-251 and 87-127; Staff of Joint Comm. Tax’n, 99th Cong., 2d Sess., *General Explanation of the Tax Reform Act of 1986* at 1249 (Comm. Print 1987).

4. Valuation of Reversionary Interest: The value of the grantor’s reversionary interest is determined by assuming the maximum exercise of discretion in favor of the grantor. Section 673(c). Valuations are generally made based on the 7520 tables but can become more complicated when a subject is in poor health or dies within 18 months of the creation of the power, or when the reversion must be calculated with reference to an occurrence not subject to actuarial tables. *See* Grantor Trust TMP at ¶ V.B.

5. Exception Where Minor Descendants Are Sole Current Beneficiaries: The trust will not be treated as a grantor trust if the sole current beneficiaries are minor descendants of the grantor, and the grantor’s reversionary interest in the trust only takes effect on the death of such beneficiaries before they attain age 21. Section 673(b).

6. Effect of Postponement of Date for Reversion: Any postponement of the date specified for the reversion is 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 a period is not included in the grantor’s income by reason of this rule if such income would not be includible in the absence of the postponement. Section 673(d); Reg. 1.673(d)-1.

a. Example: G places property in trust for the benefit of his son B. Upon the expiration of 20 years or the earlier death of B the property is to be paid over to G or his estate. The actuarial value of this reversion is less than 5% of the value of the trust property. After 17 years G extends the term of the trust for an additional 2 years. G is considered to have made a new transfer in trust for a term of 5 years (the remaining 3 years of the original transfer plus the 2-year extension). However, he is not treated as the owner of the trust under section 673 for the first 3 years of the new term because he would not be so treated if the term of the trust had not been extended. G may be treated as the owner of the trust, however, for the remaining 2 years. *See* Reg. 1.672(d)-1.

7. Beware Section 677: Even if a grantor with a reversionary interest is not treated as the owner of the trust for income tax purposes under Section 673, grantor trust status may still apply under Section 677 (see below). Reg. 1.673(a)-1(a).

B. Grantor, Spouse, and Nonadverse Parties Cannot Have Power to Control Beneficial Enjoyment of Trust Property: A trust is a grantor trust as to any portion in respect of which the beneficial enjoyment of the corpus or income is subject to a power of disposition, exercisable by the grantor (or, under Section 672(e), the grantor's spouse) or a nonadverse party, or both, without the approval or consent of any adverse party. Section 674(a); Reg. 1.674(a)-1(a). This rule is subject to numerous exceptions described below.

1. What Constitutes a "Power of Disposition" Over "Beneficial Enjoyment": Examples include the power to add or eliminate beneficiaries or to distribute or withhold corpus or income, regardless of whether the power is a fiduciary power, a power of appointment, or any other power. This power reaches every case in which the grantor or a nonadverse party can affect the beneficial enjoyment of a portion of a trust, unless the power qualifies for one of the many exceptions. Reg. 1.674(a)-1(a).

2. Exception for Power to Apply Income to Support of a Dependent: A trust is not a grantor trust under Section 674(a) solely because of a power described in Section 677(b) to the extent that the grantor would not be subject to tax under that section. Section 674(b)(1). This exception does not apply if the grantor holds this power and is not acting as trustee. Reg. 1.674(b)-1(b)(1).

3. Exception for Power Affecting Beneficial Enjoyment Only After Occurrence of an Event: A trust is not a grantor trust under Section 674(a) solely because of 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. The grantor may be treated as the owner after the occurrence of the event unless the power is relinquished. Section 674(b)(2); Reg. 1.674(a)-1(b)(1)(i); Reg. 1.674(b)-1(b)(2).

4. Exception for Power Exercisable Only by Will: A trust is not a grantor trust under Section 674(a) solely because of a power exercisable only by will. Section 674(b)(3); Reg. 1.674(a)-1(b)(1)(ii); Reg. 1.674(b)-1(b)(3).

a. Exception to the Exception: The exception for testamentary powers does not apply to income accumulated for testamentary disposition by the grantor, or to income that may be accumulated for such distribution in the discretion of the grantor or a nonadverse party, or both, without the approval or consent of any adverse party. The regulations give the example of a trust providing that income is payable to another person for the grantor's life, with the grantor holding a testamentary power of appointment over the remainder. If under the trust instrument and local law capital gains are added to corpus, the grantor would be treated as the owner of a portion of the trust and capital gains and losses would be included in that portion. Reg. 1.674(b)-1(b)(3). However, the IRS has ruled that a trust was not a grantor trust in situations where the grantor was a beneficiary and retained a testamentary power of appointment over trust property but the trustee or a distribution committee (who had the power to distribute or accumulate income and principal) was an adverse party. *See, e.g.*, Priv. Ltr. Ruls. 201832005, 2017420006, 201718004, 201628010.

5. Exception for Power to Allocate Among Charitable Beneficiaries: A trust is not a grantor trust under Section 674(a) solely because of a power to determine the beneficial enjoyment of trust corpus or income if it is irrevocably payable for a purpose specified in Section 170(c), or to an employee stock ownership plan, in a qualified gratuitous transfer as defined in Section 664(g)(1). Section 674(b)(4); Reg. 1.674(a)-1(b)(1)(iii); Reg. 1.674(b)-1(b)(4).

6. Exception for Certain Powers to Distribute Corpus: A trust is not a grantor trust under Section 674(a) solely because of a power to distribute corpus either (a) to or for beneficiaries or a class of beneficiaries (whether or not income beneficiaries), provided that the power is limited by a reasonably definite standard 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. Section 674(b)(5); Reg. 1.674(a)-1(b)(2)(i); Reg. 1.674(b)-1(b)(5).

a. Reasonably Definite Standard: This would most commonly be satisfied by limiting the trustee's power to make distributions to those necessary for the beneficiary's health, education, maintenance, and support. Any clearly measurable standard under which the holder of a power is legally accountable is deemed a reasonably definite standard for this purpose. Reg. 1.674(b)-1(b)(5)(i), -(iii).

b. Exception Does Not Apply If Anyone Holds the Power to Add Beneficiaries: This exception does not apply if any person has a power to add to the beneficiaries or to a class of beneficiaries designated to receive income or corpus, except where such action is to provide for after-born or after-adopted children. This does not apply to a power held by a beneficiary to substitute others to succeed to his or her own interest in the trust, or to testamentary powers that qualify under Section 674(b)(3). Section 674(b)(5); Reg. 1.674(d)-2(b).

7. Exception for Power to Withhold Income Temporarily: A trust is not a grantor trust under Section 674(a) solely because of a power to distribute or apply ordinary income (but not capital gains) to or for any current income beneficiary, or to accumulate the

income for such beneficiary, provided that any accumulated income must ultimately be payable (a) to the beneficiary from whom it was withheld, his or her estate, or his or her appointees (or persons designated as alternate takers in default of appointment) under a power of appointment held by the beneficiary that 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, (b) to the beneficiary from whom it was withheld, or if he or she does not survive a date of distribution that could reasonably be expected to occur within his or her lifetime, to his or her appointees (or alternate takers in default of appointment) under any power of appointment, general or special, or if he or she has no power of appointment to one or more designated alternate takers (other than the grantor or the grantor's estate) whose shares have been irrevocably specified in the trust instrument, or (c) 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 that have been irrevocably specified in the trust instrument. Section 674(b)(6); Reg. 1.674(b)-1(b)(6).

a. Exception Does Not Apply If Anyone Holds the Power to Add Beneficiaries: See above. Section 674(b)(6); Reg. 1.674(d)-2(b).

8. Exception for Power to Withhold Income During a Beneficiary's Disability: A trust is not a grantor trust under Section 674(a) solely because of 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 is 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. To qualify under this exception, it is not necessary that the income ultimately be payable to the income beneficiary from whom it was withheld, or to his or her estate or appointees. Section 674(b)(7); Reg. 1.674(a)-1(b)(2)(ii)(c); Reg. 1.674(b)-1(b)(7).

a. Definition of Legal Disability: No definition is provided, so conservative planners may wish to require that the beneficiary be determined by a court to lack capacity or be unable to manage his or her affairs.

b. Exception Does Not Apply If Anyone Holds the Power to Add Beneficiaries: See above. Section 674(b)(7); Reg. 1.674(d)-2(b).

9. Exception for Power to Allocate Between Corpus and Income: A trust is not a grantor trust under Section 674(a) solely because of a power to allocate receipts and disbursements between corpus and income. Section 674(b)(8); Reg. 1.674(a)-1(b)(1)(iv); Reg. 1.674(b)-1(b)(8). However, it has been suggested that this power could in fact trigger grantor trust status if held in a nonfiduciary capacity. *See* Grantor Trust TMP at ¶ VI.C.8.

10. Exception for Certain Powers of Independent Trustees: A trust is not a grantor trust under Section 674(a) solely because of 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, under Section 672(e), the grantor's spouse), and no more than half of whom are related or subordinate parties who are subservient to the wishes of the grantor or the grantor's spouse (a) to distribute, apportion, or accumulate income to or for a beneficiary or beneficiaries, or to, for, or within a class of beneficiaries; or (b) to pay out corpus to or for a beneficiary or beneficiaries or

to or for a class of beneficiaries (whether or not income beneficiaries). Section 674(c); Reg. 1.674(a)-1(b)(3); Reg. 1.674(b)-1(c); Reg. 1.674(c)-1.

a. Exception Does Not Apply If Anyone Holds the Power to Add Beneficiaries: See above. Section 674(c); Reg. 1.674(d)-2(b).

b. Exception May Not Apply If Grantor Has Power to Remove, Add, or Substitute Trustee: A power in the grantor or grantor's spouse to remove, substitute, or add trustees may prevent a trust from qualifying for the exceptions under Section 674(c) and -(d). The regulations give the example of an unrestricted power to remove an independent trustee and substitute any person including the grantor as trustee. However, a power in the grantor to remove or discharge an independent trustee on the condition that he substitute another independent trustee would not prevent a trust from qualifying under Section 674(c). Reg. 1.674(d)-2.

11. Power to Allocate Income If Limited by a Standard: A trust is not a grantor trust under Section 674(a) solely because of 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 Section 674(b)(6) or -(7) (dealing with certain powers to withhold income) are satisfied, if such power is limited by a reasonably definite external standard set forth in the trust instrument. Section 674(d); Reg. 1.674(a)-1(b)(3); Reg. 1.674(b)-1(d)(1); Reg. 1.674(d)-1.

a. Reasonably Definite External Standard: This would most commonly be satisfied by limiting the trustee's power to make distributions to those necessary for the beneficiary's health, education, maintenance, and support.

b. Spouse Living with the Grantor: It is not clear whether the requirement that the spouse be living with the grantor in Section 674(d) overrides the language of Section 672(e), which attributes to the grantor any power held by his or her spouse regardless of whether they are then living together. An argument could be made that the more specific language of Section 674(d) should control, but there is no express support for this position.

c. Exception Does Not Apply If Anyone Holds the Power to Add Beneficiaries: This exception does not apply if any person has a power to add to the beneficiaries or to a class of beneficiaries designated to receive income or corpus, except where such action is to provide for after-born or after-adopted children. Section 674(d); Reg. 1.674(d)-2(b).

d. Exception May Not Apply If Grantor Has Power to Remove, Add, or Substitute Trustee: See above. In this case, a power to name the grantor or grantor's spouse (or possibly any person related or subordinate to them) as trustee would seem to trigger this exception to the exception. Reg. 1.674(d)-2.

C. Certain Administrative Powers Cannot Be Present: A trust is a grantor trust if any of certain administrative powers are present. This is intended to trigger grantor trust status where under the terms of the trust or circumstances attendant on its operation, administrative

control is exercisable primarily for the benefit of the grantor rather than the beneficiaries of the trust. Section 675; Reg. 1.675-1(a).

1. Power to Deal for Less Than Adequate and Full Consideration: A trust is a grantor trust as to any portion in respect of which 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 adequate consideration in money or money's worth. Section 675(1); Reg. 1.675-1(b)(1).

2. Power to Borrow Without Adequate Interest or Security: A trust is a grantor trust as to any portion in respect of which 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. Section 675(2); Reg. 1.675-1(b)(2). Lending powers granted to trustees should be read in light of the actual circumstances of the trust administration—the mere existence of a lending power does not necessarily trigger grantor trust status. Reg. 1.675-1(c); *see also* Grantor Trust TMP at ¶ VII.B.1.

a. Indirect Borrowing: This includes a sale of trust assets to the grantor in exchange for a promissory note. *See Rothstein v. U.S.*, 735 F.2d 704 (2nd Cir. 1984), *nonacq.* Rev. Rul. 85-13, 1985-1 C.B. 184; *Holdeen v. C.I.R.*, T.C. Memo. 1975-29.

3. Actual Borrowing of Trust Funds: A trust is a grantor trust as to any portion in respect of which the grantor has directly or indirectly borrowed the corpus or income and has not completely repaid the loan, including any interest, before the beginning of the following taxable year, unless the loan provides for adequate interest, adequate security, and is made by a trustee other than the grantor and other than a related or subordinate trustee subservient to the grantor. Section 675(3); Reg. 1.675-1(b)(3).

a. Borrowing and Repaying Trust Funds in the Same Year: The IRS view is that Section 675(3) may trigger grantor trust status for the entirety of any year in which the grantor borrows trust assets, even if the loan is repaid in the same year. Rev. Rul. 86-82; *Mau v. U.S.*, 355 F. Supp. 909 (D. Haw. 1973).

b. Indirect Borrowing: As with Section 675(2), indirect borrowing can trigger grantor trust status under Section 675(3). Additional examples of indirect borrowing include a trust's purchase of notes issued by the grantor, a grantor's assignment of a note he issued to a trust, and a trust's loan to a partnership of which the grantor was a general partner. *Holdeen v. C.I.R.*, T.C. Memo. 1975-29; TAM 88020041 (Sept. 28, 1987); *Bennett v. C.I.R.*, 79 T.C. 470 (1982).

c. Portion of Trust Property Owned: Where a grantor has borrowed all of the trust income (but not principal) for a given year, courts and the IRS have treated the grantor as the owner of the entire trust for income tax purposes. *Benson v. C.I.R.*, 76 T.C. 1040 (1981). Where a grantor borrows less than all of the trust income, he is treated as the

income tax owner of a fractional share of the trust income. *Bennett v. C.I.R.*, 79 T.C. 470 (1982) (not ruling on whether the grantor was also the owner of a portion of the trust principal). Put more simply, the portion of the trust as to which the grantor is treated as the income tax owner is the greater of (i) the portion which the current year's borrowings bear to the current year's income, and (ii) the portion which total borrowings bear to total income from the trust's inception through the end of the taxable year.

4. Power to Vote Certain Stock or Securities: A trust is a grantor trust as to any portion in respect of which any person, acting in a nonfiduciary capacity without the approval or consent of any person in a fiduciary capacity, may exercise 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. What constitutes "significant" holdings in this context is not defined. Section 675(4)(A); Reg. 1.675-1(b)(4)(i).

5. Power to Control Investment of Trust Funds: A trust is a grantor trust as to any portion in respect of which any person, acting in a nonfiduciary capacity without the approval or consent of any person in a fiduciary capacity, may exercise 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. What constitutes "significant" holdings in this context is again not defined. Section 675(4)(B); Reg. 1.675-1(b)(4)(ii).

6. Power to Reacquire Trust Corpus (Substitution or Swap Power): A trust is a grantor trust as to any portion in respect of which any person, acting in a nonfiduciary capacity without the approval or consent of any person in a fiduciary capacity, may exercise a power to reacquire the trust corpus by substituting other property of equivalent value. Section 675(4)(C); Reg. 1.675-1(b)(4)(iii).

a. Power Must Be Exercised in a Nonfiduciary Capacity: If a swap power is exercisable by a person as trustee, it is presumed that the power is exercisable in a fiduciary capacity primarily in the interests of the beneficiaries. This presumption may be rebutted only by clear and convincing proof that the power is not exercisable primarily in the interests of the beneficiaries. If a power is not exercisable by a person as trustee, the determination of whether the power is exercisable in a fiduciary or a nonfiduciary capacity depends on all the terms of the trust and the circumstances surrounding its creation and administration. Reg. 1.675-1(b)(4)(iii).

b. Swap Power Alone Should Not Cause Estate Tax Inclusion: A swap power will not, by itself, cause trust property to be includible in the grantor's gross estate, provided the trustee has a fiduciary obligation under local law to ensure that properties acquired and substituted by grantor are of equivalent value, and that the swap power cannot be exercised in a manner that can shift benefits among trust beneficiaries. Rev. Rul. 2008-22.

7. Power to Amend Administrative Trust Provisions: If a grantor retains a power to amend the administrative provisions of a trust that is broad enough to permit an

amendment causing the grantor to be treated as the owner of a portion of the trust under Section 675, the grantor will be treated as the owner of that portion from its inception. Reg. 1.675-1(a).

D. Grantor Cannot Hold Power to Revoke: A trust is a grantor trust as to any portion thereof where at any time the power to revest in the grantor title to such portion is exercisable by the grantor or a nonadverse party, or both, regardless of whether the power is a power to revoke, terminate, alter, amend, or appoint. Section 676(a); Reg. 1.676(a)-1.

1. Irrevocable Trusts Are the Default Under Washington Law: RCW 11.103.030(1) provides that unless the terms of a trust expressly provide that the trust is revocable, the trustor may not revoke or amend the trust.

2. Examples of Power to Revoke or Revest: In addition to a straightforward revocation power, courts have found Section 676 applicable where a grantor retains the power to reacquire trust assets for less than FMV (which also triggers Section 675(1)), or to control trust distributions by paying principal to the grantor, or in some cases where the grantor has a right to receive distributions. *Chandler v. C.I.R.*, 119 F.2d 623 (3rd Cir. 1941), *aff'g* 41 B.T.A. 165 (1940); *Vnuk v. C.I.R.*, 621 F.2d 1318 (8th Cir. 1980), *aff'g* T.C. Memo. 1980-524; Rev. Rul. 66-161. A demand loan to a trust by the grantor can likewise trigger Section 676. *Kushner v. C.I.R.*, T.C. Memo. 1991-26, *aff'g without opinion*, 955 F.2d 41 (4th Cir. 1992).

3. Power to Revoke Held by Nonadverse Party Triggers Grantor Trust Status: If a trustee who is not an adverse party has the power to revoke the trust or revest trust assets in the grantor, the trust will be a grantor trust under Section 676. *See* Grantor Trust TMP at ¶ VIII. Similarly, a power to revoke the trust held jointly by the grantor and another person will trigger Section 676 unless the other power holder is an adverse party. Rev. Rul. 75-257.

4. Exception for Power Affecting Beneficial Enjoyment Only After Occurrence of an Event: A trust is not a grantor trust under Section 676(a) solely because of 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. The grantor may be treated as the owner after the occurrence of the event unless the power is relinquished. This exception is perhaps less important since the 1986 amendment to Section 673 described above. Section 676(b); Reg. 1.676(b)-1.

E. Trust Income Cannot Be Distributed or Held for Distribution to Grantor or Spouse: The grantor is treated as the owner of any portion of a trust, whether or not he or she is treated as 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, or (2) held or accumulated for future distribution to the grantor or the grantor's spouse, even if such distributions are never made. This extends to payments of income satisfying the obligations of the grantor or grantor's spouse. Section 677(a)(1)-(2); Reg. 1.677(a)-1(b)(2).

1. Constructive Distributions Trigger Grantor Trust Status: Section 677 is triggered where the grantor or grantor's spouse can receive trust income actually or constructively. Examples of a constructive distribution include payment of their legal obligations, or a payment at their direction. Reg. 1.677(a)-1(c)-(d). An exception exists where there is the mere possibility that the trust could make a distribution to a person whom the grantor or spouse is legally obligated to support (see below).

2. Transactions Between Grantor and Trust Can Trigger Grantor Trust Status: A sale of property by a grantor to a trust for less than the property's FMV, or with respect to which the trust's payment obligation is tied to the trust's income, may be viewed as a gift by the grantor with a retained income interest, triggering grantor trust status and inclusion in the grantor's estate. A bona fide sale of property for full and adequate consideration should not trigger Section 677. *See* Grantor Trust TMP at ¶ IX.A.

3. Exception for Power Affecting Beneficial Enjoyment Only After Occurrence of an Event: A trust is not a grantor trust under Section 677(a) solely because of 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. The grantor may be treated as the owner after the occurrence of the event unless the power is relinquished. This exception is perhaps less important since the 1986 amendment to Section 673 described above, and does not apply merely because the grantor or spouse must await the expiration of a period of time before he or she can receive or exercise discretion over previously accumulated income of the trust. Section 677(a), flush language; Reg. 1.677(a)-1(e)-(f).

4. Exception Where Trust Income Is Taxable to Ex-Spouse: Section 677 does not apply when the income of a trust is taxable to a grantor's spouse under Section 71 (relating to alimony and separate maintenance payments) or Section 682 (relating to income of an estate or trust in case of divorce, etc.). Reg. 1.677(1)-1(a)(1). But see the discussion below regarding divorce settlement trusts.

5. Mere Possibility of Payments to Grantor's Dependents Not Sufficient: Income of a trust is not taxable to the grantor under Sections 671-679 merely because such income in the discretion of another person, the trustee, or the grantor acting as trustee, may be 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. Section 677(b); Reg. 1.677(b)-1.

F. Trust Income Cannot Be Used to Pay Insurance Premiums on Life of Grantor or Spouse: The grantor is treated as the owner of any portion of a trust, whether or not he is treated as 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 applied to the payment of premiums on policies of insurance on the life of the grantor or the grantor's spouse (except insurance policies irrevocably payable for a purpose specified in Section 170(c), relating to the definition of charitable contributions). Section 677(a)(3).

1. Exception for Power Affecting Beneficial Enjoyment Only After Occurrence of an Event: See above. Section 677(a), flush language; Reg. 1.677(a)-1(e)-(f).

G. Beneficiary Treated as Owner of Trust Property: A beneficiary of a trust is treated as the owner for income tax purposes of any portion of a trust with respect to which: (1) the beneficiary has a power exercisable solely by himself or herself to vest the corpus or income in the beneficiary, or (2) the beneficiary has previously partially released or otherwise modified such a power, and after the release or modification retains a power or interest that would trigger grantor trust status for a grantor under Sections 671 through 677. Section 678(a).

1. Exception Where Grantor Is Treated as Owner: A beneficiary is not treated as the owner of trust property for income tax purposes if the trust's actual grantor is already treated as the owner under Sections 671 through 677. Section 678(b).

2. Mere Possibility of Payments to Grantor's Dependents Not Sufficient: A beneficiary is not treated as the owner of trust property for income tax purposes merely due to a power enabling him or her, as trustee, to apply the income of the trust to the support or maintenance of a person whom he or she is obligated to support or maintain, except to the extent that such income is so applied. Section 678(c).

3. Renunciation of Power: A beneficiary is not treated as the owner of trust property for income tax purposes if he or she renounces a power giving rise to such treatment within a reasonable time after becoming aware of its existence. Section 678(d).

4. Qualified Subchapter S Trust: A beneficiary is generally treated as the owner of that portion of a trust that consists of S corporation stock for income tax purposes if the trust is a qualified subchapter S trust. Section 678(e); Section 1361(d); Reg. 1.1361-1(j)(8).

VI. Tax Planning Strategies with Nongrantor Trusts: A nongrantor trust may be a useful planning tool beyond a situation in which a grantor does not wish to pay the trust's income tax.

A. Incomplete Gift Nongrantor Trusts (INGs): These trusts, often created under Delaware (DINGs) or Nevada (NINGs) law, can be used as a state income tax planning strategy where a grantor residing in an income tax state creates an ING and transfers property to the trust. If properly structured and depending on the state of the grantor's residency, the trust may not be subject to state income tax on disposition of the property. ING's are often structured so that the grantor is a beneficiary and retains limited access to the trust property. Planners drafting an ING walk a tightrope: the grantor must give up enough control over the trust property that the trust is not a grantor trust, but not so much that the grantor is deemed to have made a completed gift. Some states have declared their intention not to respect an ING as a state income tax avoidance device. *See, e.g.,* Schoenblum & Schoenblum, *Avoid State Income Tax with the Right Kinds of Trusts*, 41 Est. Planning J. 5 (May 2014); Ronald D. Aucutt, ed., *Recent Developments 2015*, 50 U. MIAMI HECKERLING INST. ON EST. PLAN. (2016) at VI.B; Ed Morrow, *Federal and Oregon Income Tax Planning for Trusts*, 18 OR. STATE BAR TAX'N SECTION 2 (2015); Miller & Behn, *California Could Say No to NINGs and Don't to DINGs*, 22 CAL. TRUSTS & EST. QUARTERLY 4 (2016); Priv. Ltr. Ruls. 201628010, 201652002, 201718004, 201742006, 201832005.

B. Qualified Small Business Stock (QSBS): Stock that meets the requirements of Section 1202 provides significant tax benefits, including up to 100% exclusion of gain on sale and the option to defer gain by reinvesting in other QSBS companies. While generally limited to a maximum of \$10M of gain exclusion per taxpayer, per issuer, because a nongrantor trust is a separate taxpayer, a trust that receives a gift of QSBS may be eligible for its own \$10M of gain exclusion on sale of the stock, apart from any gain excluded by the grantor on sale of his or her own stock. Commentators have suggested that this strategy could be further enhanced by structuring the trust such that a beneficiary is part-owner of the trust for income tax purposes under Section 678, or by using multiple nongrantor trusts (subject, perhaps, to the IRS' authority to disregard "mirror trusts" under Section 643(f) and in particular proposed regulations issued in 2018 in the context of Section 199A). *See* Section 1202; Paul S. Lee, *Qualified Small Business Stock: The Next Big Bang?*, 53 U. MIAMI HECKERLING INST. ON EST. PLAN. c. 2 (2019); Gordon P. Stone III, *Tax Planning Techniques for Client Selling a Business*, 43 EST. PLANNING J. 10 (Oct. 2016); MacDonough, Wehrheim & Ross, *Investing in Qualified Small Business Stock May Result in Significant Tax Benefits*, 18 J. TAX'N OF INVESTMENTS 2 (Winter 2001).

C. Charitable Giving Structure: Under current law, many individuals receive no tax benefit from charitable contributions since the (now increased) standard deduction is more favorable than itemizing deductions. Clients might consider a relatively modest gift to a nongrantor trust for the benefit of children and one or more charities. The trust will receive a charitable deduction under Section 642(c) for amounts distributed to charity, and since DNI is calculated taking into account this deduction, any additional distributions to children may carry out little or no DNI. Hat tip to Steve R. Akers, *Estate Planning Current Developments and Hot Topics* (July 2019) at 121, available at https://www.bessemertrust.com/sites/default/files/2019-09/Hot_Topics_Current_Developments_09_04_19.pdf (last visited Sept. 29, 2019).

D. State and Local Tax (SALT) Deduction: Under current law, the deduction permitted to an individual for SALT paid is limited to \$10,000, or \$5,000 for a married individual filing separately. As a separate taxpayer, a nongrantor trust would be eligible for its own \$10,000 SALT deduction separate from that of the grantor. *See* Section 164(b)(6).

E. Qualified Business Income (QBI) Deduction: New Section 199A permits a deduction of up to 20% of the qualified business income of a domestic business operated as a sole proprietorship or through a partnership or S corporation. The Section 199A deduction may be taken by individuals, estates, and nongrantor trusts. For taxpayers whose taxable income exceeds a statutorily-defined amount or "threshold amount," the deduction may be limited, or even lost, based on the type of business, the amount of wages paid by the business, or the unadjusted basis of assets used in the business. Transfers to nongrantor trusts can be structured in such a way as to maximize this deduction; however, the rules are extremely complicated and estate planners and CPAs should conduct a thorough analysis before recommending such transfers. In addition, the IRS has issued new regulations under Section 643(f) to prevent taxpayers from using so-called "mirror trusts" to abuse the QBI deduction. Furthermore, Reg. 1.199A-6(d)(3)(vii) provides that a trust formed or funded with a principal purpose of abusing Section 199A will not be respected. *See generally* Section 199A and the accompanying, recently finalized, regulations; Reg. 1.643(f)-1; Melissa J. Willms, *Getting the 411 on IRC 199A: Just the Facts, Ma'am*, 53 U. MIAMI HECKERLING INST. ON EST. PLAN. c. 1 (2019).

F. Qualified Opportunity Zone Investments: Opportunity Zones are designed to spur economic development by providing tax benefits to investors. The rules provide two potential benefits; first, investors can defer tax on prior gains invested in a Qualified Opportunity Fund (QOF) until the earlier of the date on which the QOF investment is sold or exchanged, or December 31, 2026. If the QOF investment is held for longer than 5 years, there is a 10% exclusion of the deferred gain. If held for more than 7 years, the 10% becomes 15%. Second, if the investor holds the investment in the Opportunity Fund for at least 10 years, the investor is eligible for an increase in basis of the QOF investment equal to its fair market value on the date that the QOF investment is sold or exchanged. Although the proposed regulations treat a gift of an interest in a QOF to a nongrantor trust as an inclusion event subjecting deferred capital gains to immediate tax, a nongrantor trust with its own capital gains may invest those gains in a QOF and take advantage of deferral and a possible basis step-up. *See* Sections 1400Z-1 and -2; 84 Fed. Reg. 98 at 22,987; Bittker & Lokken, *Fed. Tax'n of Income, Estates & Gifts* at ¶ 45.4 (2019).

VII. Other Issues

A. Toggling Grantor Trust Status: Grantor trust status can be “turned off” or “turned on” in any number of ways, for example by giving the trustee or a trust protector the right to modify the trust or to grant or remove certain powers, by naming an independent or an adverse trustee, or by having the grantor, the grantor’s spouse, or a nonadverse party, as applicable, relinquish certain powers that cause grantor trust status. *See, e.g.*, Reg. 1.677(a)-1(c); PLR 9304017; Steve R. Akers, *ACTEC 2016 Summer Meeting Musings* c. 21 (Bessemer Trust, Sept. 2016), available at https://www.bessemertrust.com/sites/default/files/2018-06/ACTEC%202016%20Summer%20Meeting%20Musings_FINAL%20WEB.pdf (last visited Sept. 7, 2019). The timing of the change to or from grantor trust status may depend on the method used to toggle. Where a grantor borrows from the trust at any time during the year, for instance, he or she will be treated as the income tax owner of trust property for the entire year under Rev. Rul. 86-82.

1. Income Tax Treatment of Conversion from Nongrantor to Grantor Trust: The conversion of a nongrantor trust to a grantor trust is not a transfer for income tax purposes that requires gain recognition. CCA 200923024 (June 5, 2009). However, it is not clear whether gain recognition should apply where the trust holds assets subject to debt, and that debt exceeds the trust’s basis in the assets immediately prior to the conversion. *See* the discussion immediately below.

2. Income Tax Treatment of Conversion from Grantor to Nongrantor Trust During Grantor’s Lifetime: The conversion of a trust from a grantor to a nongrantor trust during the grantor’s lifetime is treated as a transfer from the grantor to the trust (now a separate taxpayer) and can trigger gain in certain circumstances. For example, if the trust holds assets subject to debt, and that debt exceeds the grantor’s basis in the assets immediately prior to the conversion, the grantor will recognize gain to that extent (though some commentators have argued that this rule should only apply where the debt is owed to third parties, not the grantor). *See* Reg. 1.1001-2, Example 5; Rev. Rul. 77-402. In addition, if the trust owns an interest in a QOF the conversion to a nongrantor trust may be treated as an inclusion event that subjects

deferred capital gains to immediate tax. *See* the proposed regulations at 84 Fed. Reg. 98 at 22,987.

3. Toggling Grantor Trust Status as a Reportable Transaction: Notice 2007-73 identifies certain transactions that “toggle” grantor trust status as reportable transactions. The transactions described in the Notice were aimed at creating an artificial tax loss and may not be relevant in the more vanilla estate planning context, and the Notice makes clear that merely terminating grantor trust status without a subsequent “turning on” of that status does not constitute a reportable transaction. Planners should be cautious, however, in toggling grantor trust status more than once.

4. Treating Beneficiary as Income Tax Owner of Trust to Permit a Sale Without Triggering Income Tax: Query whether it would be possible to cause a beneficiary of an existing nongrantor trust (Trust 1) to be treated as income tax owner of that trust under Section 678 prior to a sale between that trust and a second dynasty trust (Trust 2) of which the beneficiary of Trust 1 is grantor. Presumably Trust 2 would have more favorable terms, be situated in a more favorable tax jurisdiction, be exempt from GST tax, or have a longer term under the rule against perpetuities. Section 678 could be satisfied by modifying Trust 1 to provide for a withdrawal right over the trust’s capital gains. While limiting the beneficiary’s estate tax exposure (the withdrawal right would not apply to trust corpus), this should cause Trust 1’s capital gains to be taxed to the beneficiary. If Trust 2 is also a grantor trust as to the beneficiary, the sale should be disregarded for income tax purposes. If Trust 1 cannot be modified, it might instead create and fund a new trust that provides the beneficiary with this withdrawal right, being careful not to retain any powers that cause Trust 1 to be deemed the owner of the new trust for income tax purposes under Sections 671-677. *See* Edwin P. Morrow III, *IRC § 678 and the Beneficiary Deemed Owner Trust*, IDAHO STATE BAR 2017 ESTATE PLANNING CONFERENCE 393 (2017); *Campbell v. Comm’r*, T.C. Memo. 1979-495; Priv. Ltr. Ruls. 201927003 and 201633021. *But see* Priv. Ltr. Rul. 9211026; *Benson v. C.I.R.*, 79 T.C. 1040 (1981).

B. Trusts Created by Other Trusts: As discussed above, a trust can be treated as the grantor of a second trust to which the first trust makes a gratuitous transfer of property. Structured properly, the first trust may be treated as the owner of the second trust’s property for income tax purposes. Reg. 1.671-2(e)(5), -(e)(6), Example (8). The IRS has approved a structure in which a trust created and funded a charitable remainder unitrust. Priv. Ltr. Rul. 9821029. Presumably a trust could also create a grantor retained annuity trust or charitable lead trust as well, though this would only provide estate tax benefits to the extent that the original trust was an incomplete gift trust.

C. Trusts with Foreign Grantors: Where the grantor is a nonresident alien, Sections 671-679 will cause grantor trust status only as to that portion of the trust with respect to which (1) the grantor holds the power to revest property trust in himself or herself exercisable 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 (2) 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 grantor’s spouse. Section 672(f); Reg. 1.672(f)-1-5. There is considerable nuance to this rule not addressed here.

D. Foreign Trusts with U.S. Grantors and Beneficiaries: A U.S. person who directly or indirectly transfers property to a foreign trust is generally treated as the income tax owner of such property if there is a U.S. beneficiary of any portion of such trust. Section 679; Reg. 1.672(f)-1, -2, -3, -4, -5, -6, -7. Again, there is considerable nuance to this rule.

E. Divorce Settlement Trusts: Trusts created in connection with a divorce or separation are likely to be grantor trusts as they often contain powers that trigger Sections 671-679 (reversionary interests, powers held by the grantor over distributions, etc.). If the transferor and transferee spouses are still married to each other when the trust is created, Section 677 may apply even if the marriage is terminated immediately afterward. *See* Section 672(e)(1). *See generally* Carlyn S. McCaffrey, *Marriage and Divorce After the 2017 Tax Act*, 53 U. MIAMI HECKERLING INST. ON EST. PLAN. c. 5 (2019). Prior to January 1, 2019, Section 682 provided that if spouses were divorced from each other or separated under a decree of separate maintenance or under a written separation agreement, the amount of any income one of them received or was entitled to receive from a trust was included in his or her gross income regardless of Sections 671-679. However, Section 682 was repealed effective January 1, 2019.

VIII. Checklist for Nongrantor Trust Status

Section 671	<ul style="list-style-type: none">• Know your grantor. Be alert where the trust is created or funded by a trust, entity, or individual intermediary.
Section 672	<ul style="list-style-type: none">• Potential grantor trust powers effective only after a notice requirement or the expiration of a period of time may still trigger grantor trust status.• A power of the grantor to remove, substitute, or add a fiduciary (e.g., to remove a trustee and replace him or her) in such a way as to trigger grantor trust status will cause the trust to be a grantor trust.• Remember that an independent trustee is not necessarily an adverse party. Appointing an independent trustee, though it may be helpful, does not guarantee that the trust will be a nongrantor trust.• Remember that powers granted to a grantor's spouse if the two were married at the time the power was created, or if not, during any period after the creation when the pair are married, are treated as held by the grantor.
Section 673	<ul style="list-style-type: none">• Does the grantor (or the grantor's estate) have a 5% or greater reversionary interest in the trust, assuming maximum exercise of discretion in favor of the grantor?
Section 674	<ul style="list-style-type: none">• Does the grantor or a nonadverse party have the power to control the beneficial enjoyment of the trust property, including a power to:<ul style="list-style-type: none">○ Add or eliminate beneficiaries;○ Distribute or withhold corpus or income; or○ Appoint trust property?• If so, does the power to control beneficial enjoyment fit within one of the exceptions to grantor trust status? This may include a power (subject to certain exceptions):<ul style="list-style-type: none">○ To apply income to support a dependent;○ To affect beneficial enjoyment only after the occurrence of an event;○ Exercisable only by will;○ To allocate trust property among charitable beneficiaries;

	<ul style="list-style-type: none"> ○ To distribute corpus subject to a reasonably definite standard; ○ To distribute corpus to or for a current income beneficiary, if that distribution is chargeable against the beneficiary's share of corpus; ○ To withhold income temporarily, provided that the withheld income must ultimately be payable to certain designees; ○ To withhold income during a beneficiary's disability or minority; ○ To allocate between corpus and income; ○ To distribute, apportion, or accumulate income to or for a beneficiary, or to pay corpus to or for a beneficiary, if the trustee is an independent trustee; and ○ To allocate income if that power is limited by a reasonably definite external standard. ● Does anyone hold a power to add beneficiaries (e.g., a lifetime power of appointment or trust protector's power to modify the trust)? If so, the above exceptions may not apply. ● Can the grantor remove and replace the trustee or amend the trust in such a way that a trust that initially qualifies for the above exception then fails to qualify? If so, the above exceptions may not apply.
Section 675	<ul style="list-style-type: none"> ● Does the grantor or a nonadverse party have the power to enable any person to deal with the trust for less than adequate and full consideration? ● Does the grantor or a nonadverse party have the power to enable the grantor to borrow from the trust without adequate interest or security (including an indirect borrowing such as an installment sale to the trust)? ● Has the grantor actually borrowed (directly or indirectly) from the trust under a loan that does not provide for adequate interest or security or that was made by a trustee related or subordinate to the grantor? ● Does any person acting in a nonfiduciary capacity have the right to vote or control the investment of trust shares of a corporation in which the grantor has a significant voting interest? ● Does any person acting in a nonfiduciary capacity have the power to acquire trust corpus by substituting other property of equivalent value? ● Has the grantor retained the power to amend the administrative provisions of the trust such that the trust would be a grantor trust under Section 675?

Section 676	<ul style="list-style-type: none"> • Does the grantor or a nonadverse party hold the power to revest trust property in the grantor, including a power to reacquire trust property for less than FMV or to make distributions to the grantor?
Section 677	<ul style="list-style-type: none"> • Can trust income be actually or constructively distributed or held for distribution to the grantor or the grantor's spouse, including the payment of their legal obligations? • Can trust income be actually or constructively used to pay premiums on insurance on the life of the grantor or the grantor's spouse?
Section 678	<ul style="list-style-type: none"> • If the trust is otherwise a nongrantor trust, a beneficiary will be treated as the owner of part or all of the trust for income tax purposes if he or she: <ul style="list-style-type: none"> ○ Has a power to vest trust property in himself or herself; or ○ Previously had such a power, partially released or modified it, and after the release or modification retained a power that would cause a grantor to be treated as the trust's income tax owner under Sections 671-677.
During the Trust Administration	<ul style="list-style-type: none"> • Any transaction between a grantor and the trust should be carefully considered to avoid inadvertently triggering grantor trust status, e.g. direct or indirect loans or sales of property, whether to or from the trust. • Actual or constructive distributions to a dependent of the grantor can trigger grantor trust status.