CONTEMPORARY ISSUES IN THE FEDERAL INCOME TAXATION OF TRUSTS

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From a federal income tax standpoint, it generally stinks to be a trust. The income tax brackets for trusts taxed as separate taxable entities are anemically thin. Trusts have greater exposure to the alternative minimum tax. Trusts suffer more from the two-percent haircut on miscellaneous itemized deductions, and trusts are especially affected by the new 3.8-percent surcharge on net investment income. Trusts have to be specially structured if they are to hold S corporation stock. Yes, the income tax life of a complex trust is challenging.

But darned if trusts taxed as separate taxable entities aren't important tools in estate planning. We still see them all the time, and for whatever reasons some of us tend to like them better than those trusts where the grantor or the beneficiary is the deemed owner. Accordingly, these materials offer a guidepost for some of the more current income tax issues related to trusts.

I. A SHORT PRIMER ON THE INCOME TAX TREATMENT OF TRUSTS

Subchapter J of the Code (IRC §§641 – 692) implements a simple principle: the income of a trust will be taxed at its final destination. Trust income distributed to a beneficiary will be taxed to the beneficiary. Trust income that is accumulated will be taxed to the trust. Whether the trust will distribute income to a beneficiary depends on the terms of the governing instrument, applicable state law, and, in some cases, the exercise of a trustee's discretion.

To implement this simple principle, subchapter J permits trusts to claim a deduction for the amount distributed to a beneficiary. The amount of the deduction is determined with reference to the trust's "distributable net income" (or more commonly, "DNI"). The trust's distribution deduction may not exceed DNI, and the amount of a distribution included in a beneficiary's gross income likewise may not exceed the beneficiary's share of DNI. DNI,

generally, is the trust's taxable income, with some modifications. First, we add back the distribution deduction and the personal exemption deduction. Second, we subtract capital gains that were included in taxable income. Third, we add back capital losses allocable to principal. Fourth, we subtract extraordinary dividends and, sometimes, taxable stock dividends allocable to principal. Finally, we add back the trust's net tax-exempt income (tax-exempt income less deductions allocable to tax-exempt interest). By subtracting capital gains from taxable income in the computation of DNI, we effectively make it so that capital gains will generally be taxed to the trust and not to the beneficiaries.

In addition to DNI, another term that practitioners must know to make any headway into understanding the income taxation of trusts is "fiduciary accounting income," or "FAI." It is the first step in the computation of trust taxable income. To compute FAI, a trustee must classify receipts and expenses as allocable either to income or principal. The classification used by the trustee is usually determined under the governing instrument and by applicable state law. Amounts allocated to income are part of FAI; amount allocated to principal are not.

A. Simple and Complex Trusts. There are two types of trusts treated as separate taxable entities. A **simple trust** is one in which: (1) all FAI is to be distributed currently; (2) no distributions of principal are made during the taxable year; and (3) no distributions to charity are made during the taxable year. A **complex trust** is one that is not a simple trust. So if the trustee accumulates income, makes discretionary distributions of income, makes any distribution of principal, or makes distributions to charity, the trust is a complex trust.

A simple trust deducts the amount distributed or deemed distributed to its beneficiary (but not in excess of the trust's DNI). That means the simple trust is taxed on capital gain and any phantom income (i.e., income allocated to the trust but not distributed to it, like the flow-through income from S corporations and partnerships). The beneficiary, though, is taxed on the amount of the distribution (but again, not in excess of DNI). The character of income received by the beneficiary is determined at the entity level. Thus a trust's dividend income will be dividend income in the hands of the beneficiary.

Complex trusts also get deductions for distributions to beneficiaries, though the amount of the deduction is not limited to FAI. Like simple trusts, however, the amount of the deduction is limited by the trust's DNI. Because distributions from complex trusts are inherently more complicated, subchapter J uses a "tier system" for categorizing distributions. *First-tier distributions* consist of income required to be distributed pursuant to the governing instrument. All other distributions are *second-tier distributions*. DNI is assigned first to first-tier distributions, and any leftover DNI is allocated to second-tier distributions.[1] Beneficiaries

[1] If the amount of first-tier distributions exceeds DNI, then each first-tier beneficiary includes in gross income only that beneficiary's proportionate share of DNI. If second-tier distributions total more than the amount by which DNI exceeds first-tier distributions, recipients of second-tier distributions include in gross income a proportionate share of such excess.

include in gross income their allocated shares of the DNI. Likewise, the trust deducts the sum of all first- and second-tier distributions, or, if less, the amount of DNI.

B. Separate Share Rule. Absent a special rule, disproportionate distributions from a trust could create unfairly different tax consequences for the beneficiaries. Suppose, for example, that a trust with two beneficiaries (A and B) and $100,000 of DNI in Year 1 distributes $100,000 to A and nothing to B. Early in Year 2, the trust distributes $100,000 to B but the trust's Year 2 DNI is only $60,000. A will have $100,000 of gross income in Year 1 but B will have gross income of only $60,000 in Year 2. Because of the DNI ceiling rule, the beneficiaries have different tax consequences even though they received equal distributions.

The separate share rule solves this problem. Under IRC §663(c), substantially separate and independent shares of different beneficiaries of a trust are treated as separate trusts, solely for purposes of computing DNI. This effectively treats multiple beneficiaries of a single trust as if each was the sole beneficiary of a single trust with a proportionate share of DNI. To illustrate, consider again the above example with beneficiaries A and B. Under the separate share rule, A will include only $50,000 in gross income in Year 1 even though A received $100,000, because A's share of the DNI is only $50,000. B's share of the DNI (also $50,000) was not distributed to B, so it would be taxed instead to the trust. In Year 2, B would be taxed on B's share of the DNI ($30,000) and the DNI allocable to A (also $30,000) would be taxed to the trust. The separate share rule, then, is not a perfect solution for situations like that posed in the example; still, it provides a fairer result.

Note that the separate share rule applies only for purposes of determining the proper allocation of DNI. It does not affect the tax treatment of the trust otherwise. So separate shares are not separate trusts that file separate returns, claim multiple exemptions, and take multiple runs up the progressive income tax rates.

C. The 65-Day Rule. The distribution deduction for a trust looks generally to distributions actually made during the taxable year. But often a trustee of a complex trust, seeking to distribute out all of the trust's DNI for any given year, will not know the trust's DNI until after the close of the taxable year. IRC §663(b) thus permits a trustee of a complex trust to elect to treat any distribution made to a beneficiary within the first 65 days of the trust's subsequent taxable year as if it had been made on the last day of the preceding taxable year. The election must be made on an annual basis, and once it has been made for any particular year it becomes irrevocable for that year after the end of the 65th day. The amount that can be treated as distributed on the last day of the prior taxable year cannot exceed the trust's undistributed DNI or undistributed FAI for that prior year, whichever is greater.

D. Computing Trust Taxable Income. IRC §641(b) states that the taxable income of a trust is computed in the same manner as an individual. Similarly, a trust's adjusted gross income just like an individual, except that the trust gets three more above-the-line deductions: (1) costs incurred in the administration of the trust that would not have been incurred if the property were held outside the trust; (2) the distribution deduction; and (3) the personal

exemption. In lieu of the personal exemption, trusts get a specific exemption under IRC §642(b). Simple trusts get a $300 exemption, and complex trusts get a $100 exemption.

Just like people, trusts get charitable contribution deductions. But unlike people, there is no percentage limitation on the amount of the deduction. A trust can reduce its taxable income to zero through charitable contributions. And also unlike people, trusts can make deductible contributions to foreign charities.

Where a trust has both taxable and tax-exempt income, expenses must be allocated between both forms of income. Expenses allocable to tax-exempt income are not deductible under IRC §265, so this apportionment is crucial. Generally, expenses allocable to both forms of income may be allocated on a proportionate basis—the percentage of any given expense allocable to tax-exempt income is equal to the percentage of total trust income that consists of tax-exempt income. A common example of an expense allocable to both taxable and tax-exempt income is trustee commissions.

II. TRUSTS AND THE NET INVESTMENT INCOME SURCHARGE

A. Mechanics and Definitions. The 3.8-percent surcharge under IRC §1411 applies to trusts as well as individuals. In the case of a trust, the surcharge applies to the lesser of two figures: (1) the trust's "undistributed net investment income;" or (2) the excess of the trust's adjusted gross income over the amount at which the highest income tax bracket begins. Let's focus first on the latter of these two figures. For 2015, trusts hit the highest (39.6-percent) tax bracket once taxable income exceeds $12,300.[2] So the surcharge will not apply if the trust's adjusted gross income is below this threshold. Remember that a trust's adjusted gross income is computed in the same manner as it is for an individual except that trusts also get deductions for charitable contributions, the personal exemption, distributions to beneficiaries, and costs "which are paid or incurred in connection with the administration of the estate or trust and which would not have been incurred if property were not held in such trust or estate." More than ever, then, the distinction between expenses that are unique to trust administration (good because they reduce a trust's adjusted gross income) and those that would normally be incurred by individuals (bad because they are miscellaneous itemized deductions) is crucial. Charitable contributions and distributions are also important in reducing a trust's adjusted gross income.

Now let's consider the concept of "undistributed net investment income." Net investment income for a trust is calculated just as it is for an individual: we take the trust's passive investment income (dividends, interest, rents, royalties, and annuities), its income from all passive activities, and its gains from the sale or exchange of investment property and

[2] Note that because the threshold for the highest income tax bracket is adjusted annually for inflation, the amount of adjusted gross income required to trigger application of the surcharge changes every year. This is not the case for individuals, where the $200,000 threshold for single taxpayers and the $250,000 for married couples filing jointly are fixed and not subject to inflation adjustments.

subtract the deductions properly allocable to such income.[3] As a practical matter, then, most of a trust's income will be net investment income. A trust's "undistributed" net investment income is its net investment income minus two amounts: (1) the distributions of net investment income made to beneficiaries; and (2) the amount of the trust's charitable deduction under IRC §642(h).

How do you know that a distribution contains net investment income? The regulations make it easy, providing that the deduction for distributed net investment income is either the total amount of distributions or the total net investment income of the trust, whichever is less.[4] Functionally, then, for this purpose, distributions consist first of net investment income and then of other forms of income.

B. To Distribute or Not to Distribute. When a trust distributes net investment income to beneficiaries, the net investment income taint travels with the distributed income. Thus, trustees will often seek to distribute net investment income to beneficiaries that are below the $200,000/$250,000 adjusted gross income thresholds. But that's not always practical. Beneficiaries may have creditor problems. Some beneficiaries are spendthrifts. In some cases, moreover, trustees may determine that accumulating the income for future events is either required under the trust instrument or simply a more prudent course of action. Regardless, trustees should expect added pressure to make distributions where doing so will reduce the amount of the surcharge. The surcharge may even motivate trustees to redirect the trust's investments into municipal bonds so as to reduce the amount of net investment income.

There are other ways to reduce a trust's exposure to the surcharge. For instance, the trust instrument can give a beneficiary a power each year to withdraw an amount equal to the amount of trust income that would otherwise be taxed at the 39.6-percent rate. Possession of the power makes the beneficiary the deemed owner of the trust under IRC §678, and if the beneficiary is well under the surcharge threshold, the surcharge will not apply and the income will be taxed at a lower regular rate as well. Alternatively, the beneficiary may have a power to withdraw an amount equal to the trust's net investment income.[5]

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[3] IRC §1411(c); Reg. §1.1411-4(a). Expenses are first allocated directly to the income item that gave rise to the expense. Indirect expenses, on the other hand, are allocated under IRC §652 however the trustee decides. That means the trustee can allocate these expenses first against ordinary income that would be subject to a potential tax rate of 43.4 percent (39.6 percent regular tax plus 3.8 percent surcharge) before allocating any against capital gains and dividends that will be taxed at a maximum rate of 23.8 percent. Steve Akers notes that "Tax preparation software will typically not do this. The preparer will need to override the software output to make such special allocations of indirect expenses." Akers, Aucutt, Donaldson, Fox, Pennell & Zaritsky, Recent Developments – 2013, in 48 HECKERLING INST. ON EST. PLANNING 139 (2014).

[4] Reg. §1.1411-3(e)(3).

[5] For sample form language conferring these withdrawal powers, see Blase, "Drafting Tips That Minimize the Income Tax on Trusts, Part I and II," EST. PLAN. (July & August 2013).

C. Special Rules for Capital Gains. As with individuals, the net capital gain of a trust is treated as net investment income. Trustees might prefer to distribute capital gain to a beneficiary not subject to the surcharge in order to save total tax, but a trustee must have authority to distribute capital gain under the governing instrument or under state law. To deal with the potential problem, planners can consider giving the trustee discretion to allocate capital gain to income instead of principal. That opens the door for distributing such gain to the beneficiaries. Of course, treating capital gain as income means that the capital gain will likewise increase the trust's DNI.

Trusts that have interests in closely-held businesses may be affected by two special rules related to capital gain. First, capital gain distributed to a trust in the ordinary course of partnership operations and allocated to the trust on the partnership's Schedule K-1 may pass through to the beneficiaries.[6] Second, under the Uniform Principal and Income Act, cash distributions from an entity are usually allocated to FAI. (Distributions in liquidation of the company are excepted out from this rule, as are several other, less common distributions.) So any capital gain coming out in the form of a cash distribution are treated as income and not principal.

D. The Material Participation Problem. Passive income is considered net investment income, and the statute defines passive income with reference to the passive loss allowance rules of IRC §469. Recall that under IRC §469, passive income is the income from a passive activity, and a passive activity is one in which the taxpayer does not "materially participate." Regulations under IRC §469 explain in detail how an individual can "materially participate" in an activity. Those regulations are silent when it comes to trusts. The Service's position has long been that a trust materially participates only if the trustee personally does so. If a trust will hold an interest in a closely-held pass-through business, then, consideration should be given to naming an individual who materially participates in the business as a co-trustee. In *Technical Advice Memorandum 201317010*, however, the strategy did not work. But the co-trustee in this ruling was a "special trustee" whose fiduciary power was limited to voting and selling the closely-held business's stock. Moreover, while the co-trustee was president of the company and actively involved in its operation, those activities could not be imputed to the trust. Just as a sole proprietor cannot count the activities of his or her employees to satisfy the material participation requirement, the work of someone serving as co-trustee and president "was as an employee of [the company] and not in [his] role as a fiduciary" and thus "does not count for purposes of determining whether [the trust] materially participated in the trade of business activities" of the company. Note that the Service treats individuals differently. A shareholder who works for the corporation can count those hours as employee toward the material participation threshold, but a trustee who works for the corporation cannot do so. There seems to be little basis for treating individuals and trusts differently on this point, but it's the position of the Service.

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[6] See, e.g., *Crisp v. United States,* 34 Fed. Cl. 112 (1995).

In issuing final regulations under IRC §1411 in November of 2013, Treasury had this to say about the material participation issue in the Preamble:

> Several commentators noted that the enactment of section 1411 has created an additional and compelling reason for the need to determine how an estate or a trust materially participates in an activity. An estate's or a trust's income or gain from a trade or business activity in which the entity materially participates does not constitute income from a passive activity under section 469 or section 1411. One commentator noted that, in the case of estates or trusts that have not incurred losses from a passive activity, those estates and trusts previously have not had to characterize either losses or income under section 469.
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> Commentators stated that the legislative history of section 469 suggests that only a fiduciary's participation should control in determining whether an estate or a trust materially participates in a trade or business activity. In certain situations, case law has concluded that the participation of beneficiaries and employees also should be considered. One commentator noted that case law and IRS guidance conflict, leaving taxpayers with uncertainty in determining the material participation of a trust.
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> A number of commentators requested that the Treasury Department and the IRS provide guidance on material participation of estates and trusts. However, the commentators acknowledged that guidance on material participation would apply under both sections 469 and 1411, and consequently suggested the initiation of a guidance project to propose the rules for which §1.469-5T(g) has been reserved.
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> The Treasury Department and the IRS believe that the commentators have raised valid concerns. The Treasury Department and the IRS considered whether the scope of these regulations should be broadened to include guidance on material participation of estates and trusts. The Treasury Department and the IRS, however, believe that this guidance would be addressed more appropriately in the section 469 regulations. Further, because the issues inherent in drafting administrable rules under section 469 regarding the material participation of estates and trusts are very complex, the Treasury Department and the IRS believe that addressing material participation of trusts and estates at this time would significantly delay the finalization of these regulations. However, the issue of material participation of estates and trusts is currently under study by the Treasury Department and the IRS and may be addressed in a separate guidance project issued under section 469 at a later date. The Treasury Department and the IRS welcome any comments concerning this issue, including recommendations on the scope of any such guidance and on specific approaches to the issue.

So for now, it seems, all we can do is wait for further guidance under IRC §469.

In the meantime, however, practitioners may find comfort with the Tax Court's decision in *Frank Aragona Trust v. Commissioner*.[7] In that case, the Tax Court held that services performed by individual trustees on behalf of a trust may be treated as personal services performed by the trust, allowing the trust to qualify for the rental exception in IRC §469(c)(7). The case involved a trust with six trustees, three of whom were full-time employees of a limited liability company wholly owned by the trust. The LLC managed rental real estate. The trust had net losses for 2005 and 2006, which the Service disallowed in part on the grounds that the real estate activities of the trust were passive activities. IRC §469(c)(2) treats any rental activity as a passive activity, but IRC§469(c)(7) offers an exception from that rule where more than half of the "personal services" performed in trades or businesses during the year is performed in real-property trades or businesses in which the taxpayer materially participates and where the taxpayer performs more than 750 hours of services during the year in real-property trades or businesses in which the taxpayer materially participates.

The Service argued that a trust cannot perform "personal services," citing the regulation defining personal services as "work performed by an individual in connection with a trade or business."[8] But the Tax Court rejected this contention, holding that "If the trustees are individuals, and they work on a trade or business as part of their trustee duties, their work can be considered" as personal services. If the IRC §469(c)(7) exception was supposed to be available only to individuals, reasoned the court, it would be limited to "any natural person," like other exceptions within IRC §469 that are so limited.

The court further held that the trust in the case bar materially participated in the rental real estate activities. It observed that because the regulations do not yet explain how a trust materially participates in an activity, "we must make the determination … in the absence of regulatory guidance." It went on to conclude that "the activities of the trustees--including their activities as employees of [the] LLC--should be considered in determining whether the trust materially participated in its real-estate operations." Just as trustees who also serve as directors of a corporation owned by the trust cannot divorce their actions as directors from their actions as trustees, said the court, trustees who are employees of an LLC owned by the trust cannot separate their services performed as employees from their work as trustees. Thus the services performed by the employee-trustees count toward determining whether the trust materially participated. Under that rationale, the trust easily qualified for the IRC §469(c)(7) exception. Pending promulgation of regulations explaining how trusts materially participate, then, practitioners can rely on *Frank Aragona Trust* in imputing the services of a trustee-employee to the trust.

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[7] 142 T.C. No. 9 (March 27, 2014).

[8] Treas. Reg. §1.469-9(b)(4).

III. GRANTOR TRUSTS, THE BETTER SOLUTION IN MANY CASES

A trust that qualifies as a grantor trust is not a separate taxable entity. Instead, all of the trust's tax items are considered to be received and paid by the trust's deemed owner (usually the grantor, but sometimes a trust beneficiary). Since individuals do not reach the 39.6-percent bracket until taxable income exceeds more than $400,000 (more than $450,000 in the case of joint filers), very often the trust's taxable income will be taxed at a lower rate if the trust is a grantor trust. Even where the grantor is in the highest tax bracket already, though, there are many other tax advantages to grantor trust status.

A. Grantor Trust Status. IRC §§ 671 – 677 list several powers, any one of which is usually sufficient to make the grantor the deemed owner of the trust for income tax purposes. Until recently, practitioners always yearned for those powers that avoided gross estate inclusion. That may still be the right approach, even in a world with a very high applicable exclusion amount. So one might well expect that planners will continue to use one or more of the following three powers to create a grantor trust.

1. *Loans to the Grantor*. The grantor is treated as the deemed owner of at least a portion of the trust where the grantor or a "nonadverse party" (or both) may exercise a power that enables the grantor to borrow principal or income without having to pay adequate interest or without having to give adequate security for the loan. This rule will not apply, however, where a trustee (other than the grantor) has a general power under the trust instrument to make loans to anyone without regard to the payment of adequate interest or the giving of adequate security. Furthermore, if the grantor-trustee has a general power under the trust instrument "to determine interest rates and the adequacy of security," it does not necessarily follow that the grantor holds a power to borrow principal or income without adequate interest or security.

A grantor's power to borrow from the trust without having to pay adequate interest or without having to give adequate security should not cause gross estate inclusion of the trust property. Such a power does not affect beneficial enjoyment of the trust property and does not constitute a power to alter or amend the terms of the trust. This power is thus a good candidate for "defective grantor trust" status.

Borrowing on a below-market interest basis, however, is fraught with income and gift tax consequences. Accordingly, most planners seeking to create a defective grantor trust through the borrowing power should provide that any such loans must require the grantor to pay adequate interest. As long as the grantor (or the nonadverse party or both) has an express power to borrow from the trust on an unsecured basis, grantor trust status exists.

Even where the instrument does not contain an express power enabling the grantor to borrow on an unsecured basis, grantor trust treatment can arise in operation. Specifically, the grantor is treated as the deemed owner of at least a portion of the trust to the extent the

grantor or the grantor's spouse has actually borrowed principal or income from the trust and has not completely repaid the amount borrowed (including interest) before the start of the taxable year. Deemed ownership will not occur, however, if the loan provides for both adequate interest and adequate security, assuming the loan was made by a trustee other than the grantor, the grantor's spouse, or a "related or subordinate party" that is subservient to the grantor.

Merely borrowing from the trust would not necessarily indicate that the grantor has retained ownership of the trust property sufficient to warrant inclusion in the gross estate. For instance, where the grantor borrows trust principal from an independent trustee on an unsecured basis but has agreed to pay adequate interest to the trust, it is difficult to see how IRC §2036 or IRC §2038 (or any other gross estate inclusion provision) would be invoked. Thus, this power is also a good candidate for planners seeking to create a defective grantor trust. In fact, because of its flexibility this may be a better power than the power to borrow without adequate interest or security.

2. *Power to Add Charitable Beneficiary*. Generally, any power exercisable by the grantor or a nonadverse party to control beneficial enjoyment of trust property without the consent of an adverse party will render the grantor the deemed owner of the trust. But most powers to affect beneficial enjoyment of trust property will also trigger inclusion in the grantor's gross estate under either or both of IRC §2036 and IRC §2038. One important exception is a power to add one or more charitable beneficiaries held by a nonadverse party. For example, suppose Grantor creates an irrevocable trust for the benefit of Sibling and names a nonadverse party as trustee. If the trustee has the power to add one or more IRC §501(c)(3) organizations as beneficiaries to the trust, Grantor is treated as the owner of the trust for federal income tax purposes. And assuming Grantor has no retained interest in the trust and no direct power to alter or amend the terms of the trust, no portion of the trust will be included in Grantor's gross estate.

3. *Power to Substitute Assets*. A power held by anyone in a nonfiduciary capacity to "reacquire the trust corpus by substituting other property of an equivalent value" will cause the grantor to be the deemed owner of the trust property. For this purpose there is a presumption that a trustee holding such a power would exercise it in a fiduciary capacity, so the power needs to be held by the grantor or a nonadverse party that has no fiduciary ties to the trust. A nonfiduciary power to substitute assets (a "swap power," as some like to call it) should not cause inclusion of the trust assets in the grantor's gross estate because the right to swap assets does not allow the grantor to make additional wealth transfers or to diminish the value of the trust's holdings. In order for the grantor to take $2 million in assets out of the trust, for example, the grantor must transfer $2 million in assets to the trustee in exchange.

B. Estate Tax Inclusion Caused by Swap Powers. For a long time, we worried about whether a swap power caused inclusion of the trust assets in the grantor's gross estate. In

Estate of Jordahl v. Commissioner,[9] the Tax Court held that a swap power was not a power to alter beneficial enjoyment under IRC § 2036(a) or IRC § 2038(a) in that there could be no economic benefit to the grantor. Furthermore, the court held that there was no incident of ownership of life insurance by virtue of the swap power, thus negating inclusion under IRC § 2042 where the trust owned a policy of insurance on the grantor's life. But some practitioners think the *Jordahl* case was not very helpful because the grantor in that case arguably held the swap power in a fiduciary capacity. If that's the case, then the trust is not a grantor trust for income tax purposes.

Fearful that *Jordahl* would not give the green light to swap powers held in a fiduciary capacity, some planners used to give the swap power to an independent third party instead of the grantor. The thinking here is that if the grantor holds no power, there is no argument for re-inclusion in the grantor's gross estate under IRC §2036 or IRC §2038. The strategy makes sense, but there is an argument that only the grantor can hold the swap power if the intent is to create a grantor trust. Section 675(4)(C) refers to the swap power as a power to "reacquire trust property." If the grantor contributes the property but an independent third party has the swap power, the third party would not "reacquire" the property through exercise of the power. To some practitioners, therefore, a swap power in the hands of someone other than the grantor does not confer grantor trust status.

In *Revenue Ruling 2008-22*,[10] the Service concluded that a swap power:

> will not, by itself, cause the value of the trust corpus to be includible in the grantor's gross estate under § 2036 or 2038, provided the trustee has a fiduciary obligation (under local law or the trust instrument) to ensure the grantor's compliance with the terms of this power by satisfying itself that the properties acquired and substituted by the grantor are in fact of equivalent value, and further provided that the substitution power cannot be exercised in a manner that can shift benefits among the trust beneficiaries.

This language imposes two conditions on those seeking certainty from gross estate inclusion under IRC §2036 or IRC §2038. The first condition requires that the trustee have a fiduciary obligation to ensure that the assets being swapped have equal values. This duty must be imposed under local law or the trust instrument. Most local laws would probably impose this duty to the trustee, albeit generally as part of the trustee's general duty to act in the interests of the beneficiaries. Some practitioners have decided to add specific language to their grantor trust instruments that impose the required duty on the trustee. But that can be dangerous because if the trust is supposed to be a grantor trust, the swap power must be exercisable "without the approval or consent of any person in a fiduciary capacity." If the trust instrument

[9] 65 T.C. 92 (1975), acq. 1977-1 C.B. 1.

[10] 2008-16 I.R.B. 796.

makes the exercise of the swap power specifically contingent on the trustee's approval, there is great risk that the grantor will not be the deemed owner of the trust's assets. If the practitioner wants to add specific language to the trustee's powers to meet this first condition, therefore, it should be expressed as a duty to ensure that the grantor properly exercises the swap power by exchanging property of equivalent values. For example, the trust could provide that if the trustee suspects that the property to be received in exchange for the property to be returned to the grantor is not of equivalent value, the trustee must obtain a court determination that the properties have equivalent value.

It's the second condition—that the power cannot be exercised so as to shift the relative benefits of the beneficiaries—that is key to the Service's conclusion. It is apparent that the Service is concerned with situations where the grantor could, for instance, reacquire income-producing property by substituting nonincome-producing property of equal value. This would give the grantor the power to control an income beneficiary's stake, and that would normally trigger gross estate inclusion. But if the grantor cannot exercise a swap power in this manner, the swap power should not trigger gross estate inclusion.

The ruling gives two examples that meet this second condition. In the first example, "the trustee has both the power (under local law or the trust instrument) to reinvest the trust corpus and a duty of impartiality with respect to the trust beneficiaries." So if the grantor reacquires income-producing property by substituting non-income-producing property, no gross estate inclusion is required if the trustee converts the new property into income-producing property so as to protect an income beneficiary's interest.

In the second example, "the nature of the trust's investments or the level of income produced by any or all of the trust's investments does not impact the respective interests of the beneficiaries, such as when the trust is administered as a unitrust (under local law or the trust instrument) or when distributions from the trust are limited to discretionary distributions of principal and income." This is a very helpful example, for most irrevocable trusts are either structured as unitrusts or as trusts with only discretionary distributions. So in most cases, compliance with this second condition will not be problematic.

C. Exercising Swap Powers. To be clear, the grantor never has to exercise a swap power in order to achieve grantor trust status. Still, there are situations in which we might advise a grantor to exercise the swap power.[11] Here are five situations where the exercise of a swap power could be advisable (and there may be more):

1. *Near-Death Swaps to Leverage the § 1014 Step-up*. Assets held in a properly structured "defective grantor trust" will not be included in the grantor's gross estate at death. But that means the assets will not be eligible for the § 1014(a) step-up in basis. Instead, the bases of the trust assets will be unchanged as a result of the grantor's death. In most cases, the trust assets will have the same basis that the grantor had in the assets at the

[11] Kuno S. Bell, *Use Defective Grantor Trusts for an Effective Triple Play*, PRACTICAL TAX STRATEGIES 12 (July 2005).

time of contribution to the trust. Since the grantor will normally fund a grantor trust with rapidly appreciating assets in order to maximize the benefit of the estate planning strategies utilizing grantor trusts (most notably GRATs and installment sale transactions), it is not uncommon for the trust to hold low-basis assets shortly before the grantor's death or the scheduled termination of the trust.

If the grantor's death is anticipated in the short-term, the grantor might exercise the swap power by exchanging high-basis assets for the trust's low-basis assets. This way, the grantor dies holding low-basis assets that will be eligible for the IRC §1014(a) step-up. The high-basis assets swapped into the trust will not be included in the grantor's gross estate, and the exchange of assets is not a taxable event. Since those high-basis assets have the same value as the low-basis assets, the grantor has preserved the asset appreciation inside the trust while maximizing use of the basis step-up at death for assets included in the gross estate.

For example, suppose Grantor transferred $1 million in non-depreciable assets (with an aggregate basis of $100,000) to an irrevocable trust in Year One. The trust instrument gave the grantor a swap power. By the end of Year Seven, the assets had grown in value to $3 million. Grantor owned $3 million in cash outside of the trust. Grantor expected to die early in Year Eight, so at the end of Year Seven, Grantor transferred the $3 million in cash to the trust in exchange for the trust's assets. At Grantor's death in Year Eight, the $3 million in low-basis assets is included in Grantor's gross estate, but the $3 million in cash, now held by the trust, is not included. The basis in the assets included in Grantor's gross estate is stepped up to $3 million. By making the swap shortly before death, Grantor maintains the same size of gross estate ($3 million), but is able to get a $2.9 million increase in income tax basis.

In other contexts, attempts to get a last-minute step-up in basis are often thwarted through IRC §1014(e). This provision states that if a donor makes a gift to a donee who dies within a year of the gift, the gifted property will not receive a step-up in basis to fair market value if the property is bequeathed or devised back to the donor. This rule does not apply to the exercise of a swap power because there is no "gift" of the low-basis assets to the grantor. Put another way, since the grantor and the trust are the same person for federal income tax purposes, there cannot be the gift required to invoke IRC §1014(e).

2. *Near-Death Swaps to Preserve Loss*. While we often refer to IRC §1014(a) as the "step-up" in basis, planners should never forget that there can be a step-down in basis too. If the grantor owns a loss asset (one with a basis in excess of value) outright, he or she should consider reacquiring one or more low-basis assets from the grantor trust by substituting the loss asset. This way, the loss is preserved in the trust.

3. *Swaps to Elude the Three-Year Rule*. Suppose the grantor owns an insurance policy outright but has other assets sitting in a defective grantor trust. The current fair market value of the policy might be substantially less than the promised death benefit but the grantor might not want to create an irrevocable life insurance trust because there is concern that the grantor may not survive for the requisite three years following the transfer of

the policy.[12] The grantor could swap the policy into the trust to avoid inclusion of the death benefit in the grantor's gross estate. The three-year rule does not apply because, for transfer tax purposes, the exchange between the grantor and the trust is a sale for full and adequate consideration. Moreover, as explained elsewhere in these materials, the exchange will not trigger the "transfer for value" rule, meaning the death benefit will still be excluded from gross income for federal income tax purposes.

4. *Swaps to Control Cash Flow*. Asset swaps can be helpful in situations outside the defective grantor trust context. For example, a GRAT is not a defective grantor trust because the trust's assets will be included in the grantor's gross estate if the grantor dies before the end of the annuity term. But the GRAT regulations do not prohibit giving the grantor a swap power, and doing so could prove useful if the assets inside the GRAT do not appreciate as expected or do not generate the cash flow required to make the GRAT successful. An asset swap might also be desirable near the end of a GRAT's term or just after the conclusion of an installment sale to a defective grantor trust. If the grantor wants to keep the asset(s) transferred to the trust at the start of the strategy for whatever reason, the grantor could swap in other assets at such time and reacquire the desired property.

5. *Swaps of a Residence*. Conventional wisdom says that a client's personal residence should be placed into a qualified personal residence trust, assuming the client has a taxable estate. That's fine, of course, but there are limits on what a qualified personal residence trust can do: the client has to survive the trust term in order for the arrangement to work and it is impossible to make a zeroed-out gift of the residence to the trust. But a swap of the client's residence into an existing defective grantor trust eliminates these hurdles while preserving the income and transfer tax benefits of the qualified personal residence trust strategy. Swapping the home into the defective grantor trust is not a gift (remember, it's a sale for full and adequate consideration for transfer tax purposes) and is not an income recognition event (it's still a transfer between the grantor and the grantor trust).

In order for the swap to be meaningful, the client will have to pay rent to the trust if the client continues to reside in the home following the swap. This is perhaps a wonderful accident, since other cash payments to the trust would probably be considered gifts. Rent payments are not gifts yet they increase the amount of cash held in the trust.

One can achieve great results through exercise of a swap power. That said, there is one significant caveat to the exercise of a swap power: the values of the exchanged assets need to be identical. Swaps involving easily valued assets (cash, marketable securities) present no problems, but swaps involving real property, closely-held business interests, or other assets often appraised by professionals invites dispute. If the values of the exchanged assets are off by even a little bit, adverse tax consequences can follow. For instance, if the value of the reacquired property (the asset(s) reclaimed from the grantor trust) turns out to be less than the

[12] IRC §2035(a).

value of the substituted property (the asset(s) transferred to the grantor trust), the grantor has made a gift of the difference in value to the trust. Likewise, if the value of the reacquired property is greater than the value of the substituted property, there is very likely a gift from the beneficiaries of the trust to the grantor, and that's usually a wealth transfer in the wrong direction.

The moral here is that appraisals of the reacquired property and the substituted property are absolutely vital. Planners may also consider written agreements between the grantor and the trustee providing that if the finally-determined values of the swapped assets do not match, the over-compensated party shall pay cash or transfer other assets to the under-compensated party in an amount necessary to equalize the transfers.

D. *Crummey* Powers in Grantor Trusts. Some commentators express concern about inserting *Crummey* powers into grantor trust instruments so that gifts to the trust can qualify for the federal gift tax annual exclusion. The concern stems from IRC §678(a). It says that the *beneficiary* (not the grantor) will be treated as the owner of the trust if the beneficiary has a "power exercisable solely by himself to vest the corpus or the income therefrom in himself." In the eyes of many commentators, a *Crummey* power is a power of the beneficiary to vest corpus in himself (or herself), meaning IRC §678(a) would apply. In public pronouncements, the Service has supported this view. In *Revenue Ruling 81-6*, the Service concluded that a beneficiary was taxable under IRC §678(a) because the beneficiary held a *Crummey* power, even though the beneficiary was a minor and thus unable to exercise the power without the appointment of a legal guardian.

If the ruling is correct, this has profound consequences. For one thing, it means the beneficiary (not the grantor) is to be taxed on at least some portion of the trust's income. Unfortunately, *Revenue Ruling 81-6* did not indicate how the beneficiary was to be taxed. Regulations suggest that we apply the trust income to a fraction, the numerator being the amount subject to the *Crummey* power and the denominator being the fair market value of the principal as of the date the *Crummey* power arose. In essence, therefore, the beneficiary will be taxed on a proportionate amount of trust income.

For example, assume Grantor creates a grantor trust and, in 2015, transfers $140,000 worth of income-producing property to the trust. There is one beneficiary of the trust, Child. So that the first $14,000 of Grantor's gift qualifies for the federal gift tax annual exclusion, Child is given a *Crummey* power. Specifically, for 30 days following Grantor's contribution, Child has the power to withdraw up to $14,000 from the trust. Child's withdrawal right lapses in 2015. For the 2015 year, the trust had income of $15,000, $1,000 of which was earned during the 30-day period that Child's withdrawal right existed. Because Child had the right to withdraw $14,000 from the trust but allowed the right to lapse, *Revenue Ruling 81-6* and Regulation §1.671-3(a)(3) suggest that Child will be taxed on a proportionate share of the trust's income. Child's share is determined by the following fraction:

Amount subject to withdrawal
-- x trust income = A's income share
FMV of trust at contribution

Thus Child is taxed on ten percent of the trust income, but what we do not know for sure is whether Child is taxed on ten percent of $15,000 (trust income for the year) or ten percent of $1,000 (trust income during the period that the withdrawal right existed).

From a technical standpoint, the beneficiary should only be taxed on income that accrued while his or her withdrawal right was open. After all, under IRC §678(a)(1), the beneficiary only has the requisite "power…to vest the corpus or the income therefrom" during the period that the *Crummey* power is effective. At all other times, the beneficiary has no such power, so IRC §678(a)(1) should not apply. Under IRC §678(a)(2), the beneficiary will be treated as the owner for income tax purposes even if he or she has released the power to access trust funds, but only if the beneficiary "retains such control as would…subject a grantor of a trust to treatment as the owner thereof." When the right to withdraw lapses, a beneficiary retains no ongoing control over the trust corpus or income; thus, IRC §678(a)(2) should not apply to cause the beneficiary to be taxed. Even if the beneficiary had a "hanging power" with respect to the trust property, the beneficiary should be taxed only on his or her proportionate share of trust income that accrues during the period in which the "hanging power" can be exercised.

Another profound consequence of concluding that IRC §678(a) applies to *Crummey* powers in grantor trusts relates to installment sale transactions involving grantor trusts. If the grantor is no longer the deemed owner of the entire trust that purchased property from the grantor, the grantor likely must recognize at least a portion of the realized gain from the sale to the trust. But the exact amount of gain that the grantor would have to recognize is uncertain. Assume that Grantor from the previous example sold $1 million worth of assets (with a basis of $200,000) to the trust for a promissory note. Grantor did not recognize gain from the sale because the trust was a grantor trust. Must Grantor now recognize any portion of the $800,000 gain because Child is treated as a part-owner of the trust under IRC §678(a), though perhaps for only one month of each year? Certainly if Child were treated as a ten-percent owner at all times during the trust's existence, the answer would be easy: Grantor should recognize ten percent of the gain (or $80,000). But since Child is only the owner for one month (and in this case, for a period that ended prior to the sale), would we say that Grantor should recognize 1/12 of ten percent of the gain? Maybe it would be cleaner and simpler answer to say that Grantor should not recognize the gain if Child's withdrawal right is not in existence at the date of the sale.

The foregoing suggests that one should leave *Crummey* powers out of grantor trust instruments, But some practitioners find solace in IRC §678(b). It says that the general rule of IRC §678(a) does not apply "with respect to a power over income … if the grantor of the trust … is otherwise treated as the owner under the provisions of this subpart other than this section." In other words, IRC §678(a) does not apply "with respect to a power over income" if the trust is a grantor trust with respect to income. This *may* mean that a beneficiary will not be taxed on

the trust's income if the *Crummey* power relates to income and the grantor has a power over trust income described in Subpart E. But most *Crummey* powers relate to principal: the beneficiary is typically given a power to withdraw and aliquot share of the principal contributed to the trust. The *Crummey* power is typically, therefore, a power over principal and not a power over income. So not everyone is convinced that IRC §678(b) makes for the safe use of *Crummey* powers in grantor trusts.

The Service, however, appears to have a relaxed and favorable interpretation of IRC §678(b). In *Private Letter Ruling 200606006*, the grantor contributed cash and stocks to an unrelated party as trustee of an irrevocable trust. The trustee had discretion to distribute income and principal to the grantor's spouse both during the grantor's life and following the grantor's death. The spouse held a testamentary power of appointment over the trust; to the extent the power is not exercised, trust assets are to pass to the grantor's issue. The spouse also held a *Crummey* power with respect to trust contributions. The Service ruled that although the spouse's *Crummey* power would normally cause the trust income to be taxed to her to some extent under IRC §678(a), the trust will still be a wholly grantor trust under IRC §677, thanks to the exception in IRC §678(b). Although the spouse's *Crummey* power, by definition, is not simply a power over income, the Service is apparently willing to read the IRC §678(b) exception broadly enough such that the addition of *Crummey* powers in a defective grantor trust will not prevent the trust from being a wholly grantor trust for income tax purposes.

The Service reached similar results in a series of 12 related private letter rulings issued on the same day. In each of *Private Letter Rulings 200729005 – 200729016*, one or more grantors created a trust that provided for discretionary distributions to other beneficiaries. The grantor(s) in each ruling retained a swap power. Each trust instrument required the trustee to divide the trust assets into sub-trusts, one for each beneficiary. Each beneficiary was also given a *Crummey* power. Each of the grantors sought a ruling that they were the deemed owners of the trust for federal income tax purposes, including the 100-shareholder limitation applicable to S corporations, even though the beneficiaries had withdrawal powers that would appear to be governed by IRC §678(a). The Service, citing IRC §678(b), gave them each the ruling they sought. Accordingly, the beneficiaries were not the deemed owners of the trusts.

Similarly, in *Private Letter Ruling 200840025*, a trust created by the grantor gave a nonadverse trustee the power to make unsecured loans to the taxpayer. That made the trust a grantor trust under IRC §675(2), but the trust also stated that when a beneficiary attains a certain age, the beneficiary may withdraw all or any portion of the trust assets allocated to that beneficiary's separate share. The Service ruled that because the trust is otherwise a grantor trust under IRC §675(2), grantor trust status will not be lost when a beneficiary reaches the designated age for withdrawal. It also concluded that the trust could hold S corporation stock as long as a nonadverse trustee had the power to make unsecured loans to the grantor.

If the Service has read IRC §678(b) favorably in 14 rulings, one could fairly conclude that there is no problem with adding *Crummey* powers to the form grantor trust instrument. Again, however, caution is warranted. Sure, the rulings may indicate the Service's current position on

the application of IRC §678(b) to *Crummey* powers, but these rulings are not binding authority and generally cannot be cited as precedent. The only public, binding interpretation of the issue is *Revenue Ruling 81-6* and, as discussed above, it only applies the general rule of IRC §678(a). Until the Service takes an official position on the matter, practitioners should not feel wholly confident about inserting *Crummey* powers into grantor trusts. *More* confident, perhaps—but not wholly confident.

E. Payment of Tax and Tax Reimbursement Clauses. In general, it's better that the trust's income be taxed to the grantor instead of the trust. First and foremost, to the extent the income from a grantor trust is taxed to the grantor or some other individual, it is likely that less total federal income tax is paid. Second, the grantor's payment of the income tax attributable to the trust's assets allows all of such income to remain in the trust without making any additional gift. Where the trust is a separate taxable entity, the grantor would have to make an additional wealth transfer to the trust to restore the amount lost to taxes. By paying the taxes directly, the grantor effectively makes a tax-free wealth transfer to the trust.

To be clear, when the grantor pays the federal income tax liability attributable to the grantor trust's income, there is no income to the trust and it is not a gift by the grantor to the beneficiaries. The tax liability belongs to the grantor, so payment of the liability is not a legal benefit to the trust or the beneficiaries. Treasury made this clear in *Revenue Ruling 2004-64*, stating: "When the grantor of a trust, who is treated as the owner of the trust under subpart E, pays the income tax attributable to the inclusion of the trust's income in the grantor's taxable income, the grantor is not treated as making a gift of the amount of the tax to the trust beneficiaries."

Some trust instruments permit the trustee to reimburse the grantor for the extra income taxes attributable to the trust. These are fine, but in practice the trustee should rarely, if ever, exercise the discretion to reimburse the grantor. Tax reimbursement clauses became all the rage when Treasury issued *Revenue Ruling 2004-64*. The ruling indicates that the reimbursement of the grantor's additional tax expense may cause inclusion of the trust assets in the grantor's gross income. The ruling holds that if the trust instrument requires the trustee to reimburse the grantor, the grantor has effectively retained the right to use trust property to discharge the grantor's obligation to pay federal income tax, meaning the full value of the trust assets must be included in the grantor's gross estate under IRC §2036(a)(1). (The ruling offers one piece of good news here: the distribution from the trust is not an indirect gift *to* the grantor from the trust beneficiaries, since the distribution is required by the trust instrument.)

If, however, the trust instrument gives the trustee the discretion to make reimburse the grantor from trust funds, then—assuming there is no express or implied understanding between the grantor and the trustee that the trustee will exercise its discretion in favor of the grantor—there is no inclusion of the trust's assets in the grantor's gross estate at death under IRC §2036(a)(1), no matter whether the discretion is exercised and no matter whether the discretion is granted by the trust instrument or by virtue of state law. (Here, too, by the way, the Service said there is no indirect gift by the trust beneficiaries to the grantor if the trustee

exercises its discretion to reimburse the grantor—this time because the transfer was made "pursuant to the exercise of the trustee's discretionary authority granted under the terms of the trust instrument.")

These results are correct and hardly surprising. To the extent the trust is required to reimburse the grantor for income taxes paid, the grantor clearly has a retained interest in the trust property that warrants inclusion in the gross estate under § 2036(a) unless the grantor's right to reimbursement expires prior to the grantor's death. Discretionary tax reimbursements, however, should not be included in the gross estate because the grantor's interest in the trust property must go through a trustee. Unless the trustee has indicated that the trustee will always pay the reimbursement or will do so anytime the grantor makes a request, one cannot say that the grantor has formally retained any right to possess or enjoy the trust assets or the income therefrom.

But just because a discretionary tax reimbursement clause does not automatically cause inclusion in the grantor's gross estate, it does not follow that they should be used. Because the grantor's payment of the taxes attributable to the trust's income is not a gift, the grantor's payment is a good vehicle for effecting additional wealth transfers to the trust's beneficiaries at no transfer tax cost. Where the grantor has sufficient assets to pay the trust's tax liability, the use of a tax reimbursement clause might undermine the opportunity to effect the equivalent of a transfer-tax-free contribution to the trust. If the trustee reimburses the grantor for income taxes paid, one of two results will follow, and neither is pretty: either the trust will have less after-tax income available for the beneficiaries (whether distributed or accumulated), or the grantor will have to make a gift transfer to the trust in an amount equal to the reimbursement to keep the trust whole.

That said, a tax reimbursement clause is not a bad idea. If there is a chance that the tax burden associated with grantor trust status poses a cash-flow problem for the grantor, or if one fears unexpected events that may dramatically increase the tax burden associated with the trust (a surge in asset value or yield, a change in tax laws, or the like), a tax reimbursement clause makes sense, though the analysis above suggests that trustees should be careful to exercise the reimbursement power only as absolutely necessary.

Another issue to consider is creditor protection. If the trustee has the discretion to reimburse the grantor from trust assets, perhaps state law might subject the trust property to the claims of the grantor's creditors. Practitioners might want to avoid a tax reimbursement clause if applicable state law would cause the assets to be available to the grantor's creditors.

Those planning to add discretionary tax reimbursement clauses to form grantor trust instrument, should keep two important considerations in mind. First, if the planner seeks to avoid inclusion of the trust's assets in the grantor's gross estate, there should not be a mandatory tax reimbursement clause. This is not a significant sacrifice, since mandatory tax reimbursement undermines some of the effectiveness of the grantor trust strategy in contemporary estate planning.

Second, discretionary tax reimbursement clauses are acceptable provided the trust has an independent trustee and measures are taken to ensure that the trustee will not automatically accede to every reimbursement request from the grantor. For example, the discretionary tax reimbursement clause might limit the trustee's exercise of discretion to an ascertainable standard, providing that the trustee may reimburse the grantor only where the trustee determines that such reimbursement is necessary to allow the grantor to maintain the grantor's accustomed standard of living or for the grantor's maintenance, education, support or health. This limitation on the trustee's discretion is not required by *Revenue Ruling 2004-64*, but it should be an adequate safeguard against an assertion that that trustee and the grantor had an implied arrangement that the trustee would routinely exercise its discretion in favor of the grantor.

More aggressive (but still perfectly ethical and responsible) planners might simply insert a discretionary tax reimbursement clause and be willing to fight if the Service alleges an implied arrangement between the grantor and trustee. Even this more aggressive strategy should employ an independent trustee; neither the grantor nor a "related or subordinate party" should be the trustee if the trust will contain a naked discretionary tax reimbursement clause.

Planners contemplating a tax reimbursement clause in a GRAT might want to limit the ability of the trustee to pay a reimbursement to the grantor to those situations where the trust's income exceeds the amount of income required to pay the annuity amount to the grantor. Such payments from excess income to the grantor will not jeopardize the qualification of the grantor's annuity right as a qualified annuity interest. The tax reimbursement should not count against the amount required to the distributed to the grantor; any reimbursement must be in excess of the amount required to be paid under the qualified annuity interest. Of course, a tax reimbursement clause may not be required at all if the grantor intends to use all or a portion of the distributed annuity amount to satisfy the federal income tax obligation associated with including the trust's income as part of the grantor's income. If the maximum transfer benefit of a GRAT arises from leaving principal and excess income inside the trust, a tax reimbursement clause on top of the qualified annuity interest may be antithetical to the trust's purpose; on the other hand, the tax reimbursement clause can provide a means for effecting a larger-than-otherwise-allowed distribution to the grantor should the grantor have a sudden or unexpected need for a larger distribution.

F. Toggling. Yes, Virginia, it is possible to construct a "toggle switch" in the trust instrument to switch from grantor trust status to non-grantor trust status. In *Private Letter Ruling 9304017*, the Service ruled that the trusts at issue were grantor trusts where the trustee had the power to add or remove a beneficiary. The trust agreements also allowed the trustee to renounce this power irrevocably if done so in writing. Doing so would eliminate the power of control beneficial enjoyment of the trust property, so a waiver in compliance with the trust agreement would be effective in "turning off" grantor trust status.

And yes, one can properly draft the trust instrument so that grantor trust status starts at some point in the future and not upon formation of the trust. Structuring a "springing power"

(thus causing a non-grantor trust to convert to a grantor trust) may present a trickier drafting problem, but it should be possible. Presumably, the power would arise at a certain date or upon the occurrence of a stated event.

The trust could also be structured so that some person or persons hold the power to confer grantor trust status. Some have suggested the trustee could have the power to create grantor trust status (by giving the grantor a swap power, for example) that arises every two years. At such time, the trustee could decide whether to "turn on" grantor trust status. If the trustee decides against the power, he or she simply refuses the power and waits two years for the power to arise again. This is an untried technique and its validity is certainly open to speculation. Yet as long as the trustee may exercise this power to "turn on" grantor trust status only in a fiduciary capacity, the trustee should not face adverse income, estate, or gift tax consequences.

The concern is that a trustee acting in the best interests of the beneficiaries will almost always want grantor trust status. ("Gee," thinks the trustee, "why should the trust pay the tax on its income when I can make the grantor pay the tax?") If the trustee has the power to give the grantor a swap power but refuses to do so, there might be a legitimate question as to why the trustee would prefer to have the taxes paid at the expense of the beneficiaries. For this reason, it might be safer to have an independent committee of non-fiduciaries with the power to give the grantor a swap power. But one may wonder, if the committee members have no fiduciary duties, what standards would apply to guide them in deciding whether and when to confer the power to the grantor. Theoretically, therefore, a spring power is possible, but there is little firm guidance for how this is to be implemented in practice.

Planners, of course, want the best of both worlds. They want to be able to turn grantor trust status on or off each year as circumstances dictate. It looks like this too is possible, and no special drafting should be required. As long as the grantor borrows principal or income from the trust and has not repaid the amount borrowed before the start of the trust's taxable year, the trust will be a grantor trust for that taxable year.[13]

IV. TRUSTS AS S CORPORATION SHAREHOLDERS

Only certain domestic trusts qualify as S corporation shareholders. If S corporation falls into the hands of an "ineligible" shareholder, the S election is lost and the corporation becomes a C corporation unable to elect S corporation status for five years unless it successfully obtains

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[13] IRC § 675(3). Deemed ownership will not occur, however, if the loan provides for both adequate interest and adequate security, assuming the loan was made by a trustee other than the grantor, the grantor's spouse, or a related or subordinate party subservient to the grantor. To "turn off" grantor status, the grantor need only repay all amounts borrowed from the trust. If there are no loans outstanding, the grantor can "turn on" grantor trust status simply by borrowing from the trust in the year before the year in which the "turn on" is to occur. This ability to toggle back and forth from grantor trust status to non-grantor trust status is somewhat limited by the fact that grantor trust status is measured as of the *first* day of the taxable year. The grantor may not know at the beginning of the year whether grantor trust status would be desirable.

discretionary relief from an inadvertent termination of the S election. Although many trusts qualify as eligible shareholders of S corporation stock, some common trust arrangements do not qualify. For instance, a charitable remainder trust is not an eligible shareholder of S corporation stock. Planners should therefore not advise clients to fund charitable remainder trusts with S corporation stock because doing so would sacrifice the S election.

Generally there are five kinds of trusts that qualify as S corporation shareholders. The first is the **qualified subchapter S trust**, or QSST.[14] A QSST is a domestic trust[15] that has only one income beneficiary during that beneficiary's life (unless each beneficiary has a separate share of the trust) who is a United States citizen or resident. The trust instrument must require that all income be distributed currently (or such income must in fact be paid at least annually to the current income beneficiary). A QSST may permit distributions of principal only to the current income beneficiary during his or her life. No one else may be entitled to distributions of income or principal during the trust term, and no payments can be made from the trust that discharge someone else's obligation to support the current income beneficiary. The trust instrument must provide that the current income beneficiary's income interest terminates at his or her death or, if earlier, upon expiration of a fixed term. If a QSST terminates during the current income beneficiary's life, all assets must be distributed to him or her.

To become a QSST, the current income beneficiary must make a QSST election. In the case of a trust owning shares in a C corporation that becomes an S corporation, the QSST election is made on Part III of the Form 2553, Election by a Small Business Corporation. If the corporation's S election is already in effect when the trust receives the shares, the QSST election is made by signing and filing a statement with the service center where the corporation files its income tax return.

The current income beneficiary reports all S corporation items attributable to the stock held by the QSST on his or her personal tax return.[16] For purposes of the 100-shareholder limitation, the current income beneficiary is treated as the shareholder of the stock.[17]

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[14] IRC §1361(d).

[15] See IRC §§7701(a)(30)(E); 7701(a)(31)(B). Under these rules, a trust is a domestic trust only if: (a) a court within the United States has primary supervision over the administration of the trust, and (b) one or more United States fiduciaries control all substantial decisions of the trust. The regulations give some examples of the "substantial decisions" related to a trust that a fiduciary may have. Treas. Reg. §301.7701-7(d)(1)(ii). These include, among others: (1) whether and when to make distributions of income and principal; (2) the amount of distributions; (3) whether a receipt is allocated to income or principal; (4) the selection of a beneficiary; and (5) whether to appoint a successor trustee to succeed another trustee that is unable or willing to serve or continue to serve.

[16] If the trust sells the S corporation stock, gain or loss is recognized by the trust (although the sale is considered to have been made by the current income beneficiary for purposes of the at-risk rules in IRC §465 and the passive loss rules in IRC §469). See IRC §1361(d)(1)(C).

[17] 15 IRC §1361(c)(2)(B)(i).

Because the QSST pays all of its income each year to the beneficiary, the trust has no income to be taxed to the trust. Accordingly, a QSST will not be subject to the net investment income surcharge. Instead, any net investment income earned by the trust passes to the beneficiary, who may or may not face surcharge liability. Since the QSST beneficiary is treated as the owner of the trust for income tax purposes, material participation for purposes of the surcharge is likely tested with reference to the beneficiary's own participation in the activity.

The second is the **electing small business trust**, or ESBT.[18] A trust can qualify as an ESBT if it has only individuals, estates, and/or qualified exempt organizations as present, remainder, or reversionary beneficiaries.[19] A trust cannot qualify as an ESBT if any person has acquired an interest in the trust by purchase.[20] In addition, each "potential current beneficiary"[21] of the trust must be an eligible shareholder of S corporation stock if the trust is to qualify as an ESBT. The trust cannot be a charitable remainder trust or otherwise exempt from federal income tax.

An eligible trust becomes an ESBT when the trustee(s) with authority to legally bind the trust sign and file an election statement with the service center where the corporation files its income tax return.[22] While the requirements for an ESBT are easier to meet than the requirements for a QSST, the price for ease lies in the taxation of the trust's income. The trust itself must pay a flat tax of 39.6 percent on the trust's taxable income attributable to the S corporation items,[23] the exemption amount for alternative minimum tax purposes is reduced to zero, and no capital loss carryovers are permitted. For purposes of the 100-shareholder limitation, each potential current beneficiary is counted as a shareholder.[24]

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[18] See IRC §1361(e).

[19] A person who may take under the exercise of a power of appointment is not considered a beneficiary of the trust for this purpose unless such power is actually exercised in that person's favor.

[20] A purchase includes any transaction in which the basis of the acquired property is its cost. IRC §1361(e)(1)(C).

[21] A potential current beneficiary is one entitled to (or who may currently) receive distributions of income or principal from the trust. IRC §1361(e)(2).

[22] Treas. Reg. §1.1361-1(m)(2)(i). The statement must include: the name, address, and taxpayer identification number of the trust, the potential current beneficiaries, and the corporation; a statement that an ESBT election pursuant to IRC §1361(e)(3) is being made; the date when the trust first owned stock in the corporation; the date the election is to take effect (cannot be more than 2 months and 15 days before the date the election is filed); and requirements for a QSST, the price for ease lies in the taxation of the trust's income. The trust itself must pay a flat tax of 39.6 percent.

[23] Formally, the tax rate is equal to the highest rate applicable to trusts and estates under IRC §1(e). IRC §641(c)(2)(A).

[24] IRC §1361(c)(2)(B)(v). During any period that there is no potential current beneficiary of an ESBT, the trust itself is treated as the shareholder for purposes of applying the 100-shareholder limitation.

In computing an ESBT's income attributable to the S corporation, the only items taken into account are: (1) the trust's shares of the S corporation's item of income, gain, loss, deduction, and credit; (2) gain or loss from the trust's sale of the S corporation stock; (3) state or local income taxes and administrative expenses allocable to the S corporation stock; and (4) interest paid or accrued on debt used to acquire stock in the S corporation.[25]

An ESBT may face liability for the net investment income surcharge. Of course, if the ESBT's interest in an S corporation qualifies as an active trade or business of the trust, the income from the S corporation would not constitute net investment income. The regulations treat ESBTs as two separate trusts, one holding the assets allocable to the S corporation and the other all other trust assets. But the regulations then consolidate the two trusts in applying the adjusted gross income threshold for the net investment income surcharge. This may seem surprising, but Treasury explains that it's necessary "so as to not inequitably benefit ESBTs over other taxable trusts."

The third kind of trust eligible to be an S corporation shareholder is a good, old-fashioned **grantor trust**. As discussed above, a grantor trust is effectively disregarded for federal income tax purposes because all of the trust's tax items are reported by the deemed owner. Accordingly, if the deemed owner is an eligible shareholder of S corporation stock, transfers of S corporation stock to a grantor trust will not jeopardize the company's S election. For purposes of the 100-shareholder limitation, the deemed owner is counted as the shareholder.[26]

The net investment income surcharge does not apply to grantor trusts, but the net investment income from the trust is treated as owned by the grantor, and such income may be subject to the surcharge depending on the grantor's individual tax profile. Material participation is also tested at the grantor level, so the surcharge would not apply to pass-through income from a business entity in which the grantor materially participates.

The fourth kind of eligible trust is a **former grantor trust**. As its name implies, a former grantor trust is a trust that was a grantor trust (with a United States citizen or resident as the deemed owner) immediately before the deemed owner's death and that continues after such death. Although the trust is no longer a grantor trust because of the deemed owner's demise, the trust itself remains an eligible S corporation shareholder regardless of its dispositive scheme until the day before the second anniversary of the deemed owners death. After such time, the trust will need to qualify as a QSST, ESBT, or grantor trust if the S election is to continue. The estate of the deemed owner is counted as the shareholder for purposes of the 100-shareholder limitation.

[25] IRC §641(c)(2)(C).

[26] IRC §1361(c)(2)(B)(i).

The final kind of eligible trust is a **testamentary trust**. All testamentary trusts are permitted S corporation shareholders for a two-year period beginning on the date the stock is transferred to the trust. After such time, the trust will need to qualify as a QSST, ESBT, or grantor trust if the S election is to continue. During the two-year grace period, the trust itself pays the tax on the items of income, gain, loss, deduction, and credit attributable to its share of the S corporation's stock if no one is the deemed owner of the trust. The testator is treated as the shareholder for purposes of applying the 100-shareholder limitation.