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PROPOSED REVISION OF THE INCOME TAX "GRANTOR TRUST RULES"AND CORRESPONDING PROVISIONS OF THE ESTATE AND GIFT TAX RULES (IRC Sections 671 – 679, 2035 – 2038, and 2511)[1]

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[1] This proposal is based on a section of a Report of the American College of Trust and Estate Counsel ("ACTEC") Tax Policy Study Committee Grantor Trust Project, of which Mr. Kinyon is the principal author.

EXECUTIVE SUMMARY

The purpose of this paper is to examine the way in which the net income (including capital gains) of a domestic trust is taxed for federal income tax purposes during the lifetime of the U.S. resident settlor or grantor of the trust, and to recommend a revision of the so-called "grantor trust rules" in Subpart E of Subchapter J of the Federal Income Tax Law (IRC Sections 671 through 679) and the corresponding provisions of the estate and gift tax rules relating to irrevocable transfers in trust (IRC Sections 2035 – 2038 and 2511). Primarily as a result of the compression of the income tax rate brackets applicable to estates and trusts and the so-called "kiddie tax" in IRC Sections 1(e) and 1(g), respectively, enacted about 30 years ago, it is submitted that the bulk of those grantor trust rules are no longer needed to prevent the avoidance of income taxes, and ironically they are now utilized by taxpayers to avoid gift and save estate taxes.

The income tax grantor trust rules are substantially different from the estate, gift, and generation-skipping transfer ("GST") tax rules in IRC Sections 2035 through 2038, 2511, and 2642(f), relating to gratuitous transfers of property in trust. Consequently, an irrevocable transfer of property in trust that is complete for gift tax purposes may be treated as being incomplete for income tax purposes, and a transfer that is complete for income tax purposes may be treated as incomplete for gift tax purposes; and a transfer in trust that is complete for gift tax purposes may not prevent the trust property from being included in the grantor's gross estate for estate purposes or allow the grantor's GST exemption to be allocated to the trust for GST tax purposes. The compression of the income tax rate brackets without eliminating most of the income tax grantor trust rules referred to above, and Revenue Ruling 85-13, 1985-7 I.R.B. 28,[2] have led to the widespread establishment of so-called (1) Intentionally Defective Grantor Trusts ("IDGTs") that are irrevocable trusts resulting in a completed transfer for gift and estate tax purposes but an incomplete transfer for income tax purposes, enabling the grantor to (a) make a tax-free gift to the IDGT by paying the income tax attributable to the trust's taxable income and (b) avoid the recognition of gain or loss on a sale or exchange of property between the grantor and the trust, and (2) Incomplete Non-grantor Gift ("ING") trusts in states with no or low income tax rates applicable to undistributed trust income, enabling a grantor residing in relatively high income tax rate states to avoid paying state income taxes on the trust's income even though the grantor is treated as still owning the trust property for gift and estate tax

[2] That ruling declined to follow *Rothstein v. United States*, 735 F.2d 704 (2d. Cir. 1984), and held that a sale or exchange of assets between a grantor and his or her grantor trust was not a sale or exchange for federal income tax purposes.

purposes. Both the income tax grantor trust rules and the estate and gift tax rules relating to transfers in trust have been in the law for many decades without substantial revisions. This paper describes a proposal to revise those provisions by correlating the income tax grantor trust rules with revised estate and gift tax relating to transfers in trust.

The federal income tax law generally taxes net income with respect to property to the person to whom the property belongs. In the estate planning context, income with respect to property owned by an individual is taxed to the individual; and if that individual (a donor) makes a completed gift of property to another individual (a donee), outright and free of trust and any other restrictions, the net income with respect to that property thereafter is taxable to the donee. However, if a completed gift of property is made to an irrevocable trust, the person to whom the net income with respect to the trust property is taxable is either the grantor, the trust, one or more beneficiaries of the trust, and/or a person other than the grantor who is treated as the owner of the property because of powers exercisable or previously exercised by that other person.

In order to determine who should be taxable on the net income with respect to property given to an irrevocable trust, it seems logical and appropriate to (i) generally correlate the income tax grantor trust rules with the gratuitous transfer tax grantor trust rules, in furtherance of the principal referred to above, i.e., that the net income with respect to property is generally taxable to the person to whom the property belongs, and (ii) revise and simplify the way in which property ownership is determined for both income and gratuitous transfer tax purposes.

> "For example, under current law, if the grantor of an IDGT transfers $1,000,000 to the trust and the money is invested in property that produces net income (including capital gains) totaling $2,000,000 during the period that the trust is a grantor trust, the grantor rather than the trust would be liable for the amount of the tax attributable to the trust's $2,000,000 of net income because of the grantor-trust provisions of the code. Because the grantor would have no right of reimbursement from the trust for paying the tax attributable to its net income, this would result in a reduction in the value of the grantor's gross estate for estate tax purposes equal to the amount of the tax paid. In effect, the grantor would be enhancing the value of the trust (effectively making a gift tax-free gift)

as the trust is able to grow tax-free because the grantor, not the trust, is liable for the tax attributable to the trust's net income. However, the value of this enhancement would not be subject to gift tax because the grantor-trust provisions require the grantor to pay the tax attributable to the trust's net income. Because current law also treats the grantor as owning the trust property for income tax purposes, the grantor and the trust would be able to sell or exchange appreciated assets with each other without any recognition of gain. Under this proposal, (1) no such tax-free gift would be possible because by definition a grantor trust would be an incomplete gift for gift and estate tax purposes, and (2) no such tax-free exchange would be possible because the grantor would not be treated as owning the trust property."

DISCUSSION

I. DETERMINATION OF PROPERTY OWNERSHIP FOR INCOME AND GRATUITOUS TRANSFER TAX PURPOSES.

A. Complete Gifts for Income and Gratuitous Transfer Tax Purposes.

Under current law, the rules for determining whether a gift of property in trust is complete for income tax purposes are very complicated. Those rules incorporate definitions and other provisions relating to adverse parties and specified nonadverse related or subordinate parties (including corporations or employees of corporations in which the stock holdings of the grantor and the trust are significant from the viewpoint of voting control, subordinate employees of corporations in which the grantor is an executive, and in certain situations, presumptions of subservience unless a party is shown not to be subservient by a preponderance of the evidence).

By comparison, under current law (i) a gift of property in trust generally is incomplete for gift tax purposes so long as the grantor has a significant beneficial interest in the trust and/or a significant power to affect the beneficial enjoyment of the trust property, and (ii) trust property generally is included in the grantor's gross estate for estate tax purposes if the grantor has a significant beneficial interest in the trust at the time of his or her death and/or a significant power to affect the beneficial enjoyment of the trust property at that time. Determining whether the grantor has such a significant beneficial interest or power also can be complicated.

In an effort to correlate and simplify income and gratuitous transfer tax laws, it is submitted that the power of the grantor of a trust to affect the beneficial enjoyment of the trust property generally should be irrelevant with respect to the completion of the gift by the grantor for income and gift tax purposes and the inclusion of the trust property in the grantor's gross estate for estate tax purposes. Therefore, a lifetime gift of property to an irrevocable trust of which neither the grantor nor his or her spouse has a significant beneficial interest as of the date of the transfer generally should be treated as a completed gift for both income and gift tax purposes, and the value of the trust property generally should not be included in the grantor's gross estate on his or her later death for estate tax purposes.

(1) ***Grantor's Power to Affect the Beneficial Enjoyment of Trust Property.***

In support of the proposition that the power of the grantor to affect the beneficial enjoyment of the trust property generally should be irrelevant for income and gratuitous transfer tax purposes, in the November 1984 Treasury Department Report to the President, entitled "Tax Reform for Fairness, Simplicity, and Economic Growth," Volume 2, Chapter 19, Section 19.01 (the Proposal for the Unification of Gift and Estate Taxes), on p. 379, the Treasury Department proposed the following:

> Retained powers. In determining whether a gift is complete for transfer tax purposes, the proposal would treat a retained power to control the beneficial enjoyment of the transferred property as irrelevant where the power could not be used to distribute income

> or principal to the donor. Thus, the fact that the transferor as trustee or custodian can exercise control over the identity of the distributee of the property or over the amount or timing of a distribution would be irrelevant in determining whether a gift is complete (although such factors may be relevant in determining whether the transfer qualifies for the annual gift tax exclusion). Under this rule, a transfer would be complete for gift tax purposes where the grantor creates an irrevocable trust but retains the absolute right to determine who (other than himself) will receive the trust income or principal.

The power of the grantor of a trust to affect the beneficial enjoyment of the trust property by determining which beneficiaries will receive trust income and/or principal, and how much, should be irrelevant for purposes of determining whether a transfer in trust is complete for tax purposes, for the following reason: The grantor of a trust will often name as trustee a friendly individual or trust company, neither being a "related or subordinate party" as defined in IRC Section 672(c), but who, because of a close personal or business relationship with the grantor, will administer the trust in accordance with his or her wishes. In light of that reality, it seems appropriate to acknowledge that reality and simply let the grantor of a trust, acting in a fiduciary capacity, exercise the power to affect the beneficial enjoyment of the trust property without treating the transfer as incomplete for tax purposes, as long as that power cannot be exercised in favor of the grantor or his or her spouse, directly or indirectly, alone or in conjunction with any other person.[3]

(2) Grantor and/or Grantor's Spouse's Beneficial Interest

One way to determine whether the grantor and/or his or her spouse has a significant beneficial interest in the trust, as of the date of the gift, would be to determine whether (i) the value of their interest exceeds 5% of the fair market value of the property transferred, and (ii) either of them currently is, or in the future may be, able to deal with the trust on other than an arms-length basis, e.g., to (A) purchase, exchange, or otherwise deal with any trust property for less than full and adequate consideration in money or money's worth, or (B) borrow any trust property without adequate interest and security. However, a transfer of property to a trust qualifying for the gift tax marital deduction should be treated as a completed gift for gratuitous transfer tax purposes.

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[3] At a minimum, if property is transferred to an UTMA custodianship or an IRC Section 2503(c) or 2642(c)(2) trust, or is otherwise vested in another individual, it should be treated as a completed gift by the grantor for both income and gift tax purposes, and the property should not be included in the grantor's gross estate for estate tax purposes, even if the grantor is acting as the custodian or trustee and can control the timing of the beneficiary's enjoyment of the property, whether limited by an ascertainable standard of not. Furthermore, property transferred (i) to a "family-pot trust" in which the only beneficiaries are the issue of the grantor or another individual, and maybe also the grantor's ancestors and/or qualified charitable organizations, or (ii) to a "dynasty trust" for the primary benefit of a child of the grantor or another individual, of which the child's issue may be secondary beneficiaries, also should be treated as a completed gift by the grantor for both income and gift tax purposes, and not be included in his or her gross estate for estate tax purposes, even if the grantor is acting as the trustee and has the power to determine which beneficiaries will receive the income and/or principal of the trust and how much, whether limited by an ascertainable standard or not.

The value of the beneficial interest of the grantor and/or his or her spouse, as of the date of the gift, might be determined by assuming the maximum exercise of discretion in favor of the grantor and/or his or her spouse, as is currently provided by IRC Section 673(c) (Special Rule for Determining Value of Reversionary Interest). This 5% threshold is similar to the 5% threshold with respect to reversionary interests under IRC Section 2037. Under Section 2037 the trust property is included in the grantor's gross estate if the value of the reversionary interest exceeds 5% of the value of the trust property immediately before the date of the grantor's death rather than the date of the gift.[4]

(3) *Incomplete Gifts for Income and Gratuitous Transfer Tax Purposes.*

On the other hand, it would seem appropriate to provide that property transferred to a revocable trust, or to an irrevocable trust of which the grantor and/or his or her spouse has a significant beneficial interest generally (a) should not be a completed gift for income and gift tax purposes, and (b) any remaining portion of the trust property at the grantor's death should be included in his or her gross estate for estate tax purposes. However, any distribution from the trust to a beneficiary other than the grantor or another trust that also is an incomplete gift for gift tax purposes, and any portion of the trust property that otherwise ceases to be an incomplete gift for gift tax purposes during the grantor's lifetime, should be treated as a completed gift by the grantor at that time for gift tax purposes.

(4) *Alternative Methods for Determining Whether a Gift in Trust is Complete for Income and Gratuitous Transfer Tax Purposes.*

(a) A Completed Gift Only If Neither the Grantor Nor the Grantor's Spouse Has Any Beneficial Interests in or Certain Powers With Respect to the Trust.

Because of the difficulty in many cases of determining whether the value of the beneficial interest of the grantor and his or her spouse exceeds 5% of the fair market value of the property or is otherwise significant as of the date of the gift, a better way to determine whether a gift in trust is complete for tax purposes (resulting in a "Completed Gift Trust") might be to provide that such a gift would only be treated as complete if neither the grantor nor his or her spouse can ever, directly or indirectly, have (1) a beneficial interest in the trust, mandatory or in the discretion of the trustee, a protector or any other person, pursuant to the exercise of a non-

[4] Retaining the rule under IRC Section 2037 would be an exception to the general rule referred to above that property transferred in trust resulting in a completed gift for gift tax purposes generally should not result in the trust property later being included in the grantor's gross estate for estate tax purposes. However, an appropriate exception to that principle might be where a transfer in trust is treated as a completed gift for gift tax purposes because neither the grantor nor his or her spouse has a significant beneficial interest in the trust at the time, but on the date of the grantor's death the grantor and/or his or spouse does have a significant beneficial interest in the trust. For example, if an existing reversionary interest of a "*Clifford*" trust has increased in value, or a trust protector or other person, or the holder of a special power of appointment, has added (or has the power to add) the grantor and/or his or her spouse as a beneficiary or beneficiaries of the trust, or to a class of beneficiaries designated to receive trust income or corpus (*cf.* the last sentence of IRC Section 674(b)(5)), making his, her, or their beneficial interest(s) in the trust significant or giving him, her, or them the ability to deal with the trust on other than an arms-length basis, the trust property probably should be included in the grantor's gross estate, with an appropriate credit allowed for any gift tax paid and/or unified credit used with respect to property remaining in the trust at that time.

general power of appointment, or otherwise pursuant to a non-taxable gratuitous transfer; or (2) the power to deal with the trust on other than an arms-length basis (e.g., purchase, exchange, or otherwise deal with any trust property for less than full and adequate consideration in money or money's worth, or borrow any trust property without adequate interest and security) or exercise any power with respect to the trust, individually, as a trustee, or otherwise, in other than in a fiduciary capacity.

The trust instrument of a Completed Gift Trust probably should be required to so provide, and any later violation of these prohibitions probably should result in the trust property thereafter being treated as belonging to the grantor for tax purposes. A trust failing to meet these requirements, as well as a Completed Gift Trust with respect to which any of those prohibitions is violated, would be an "Uncompleted Gift Trust"); provided, however, that a trust qualifying for a marital deduction should be treated as a Completed Gift Trust.

(b) A Completed Gift Only for Beneficial Interests Vested in Beneficiaries Other Than the Grantor and the Grantor's Spouse.

Another way to determine whether a gift in trust is complete for tax purposes (resulting in a "Completed Gift Trust") might be to simply provide that in general, a trust established during the grantor's lifetime would be an Uncompleted Gift Trust for tax purposes regardless of whether the grantor or his or her spouse has a beneficial interest in, or a power to affect the beneficial enjoyment of, the trust property. However, a trust in which the interest of a beneficiary or beneficiaries other than the grantor or the grantor's spouse is vested would be treated as a Completed Gift Trust. This alternative would enable the state of residency of the grantor of an Uncompleted Gift Trust, or the vested beneficiary of a Completed Gift Trust, to tax the trust income and/or property because that grantor or vested beneficiary would be treated as the owner of the trust property for tax purposes. This alternative also would make a wealth tax more effective because the grantor of an Uncompleted Gift Trust, or the vested beneficiary of a Completed Gift Trust, would be treated as the owner of the trust property for purposes of imposing the wealth tax.

(1) During the grantor's lifetime –

(A) the DNI mechanism would be inapplicable, and payments and distributions of money or other property to the beneficiaries would not carry out trust income,

(B) the income, deductions, and credits against tax attributable to an Uncompleted Gift Trust would be included in the grantor's income tax return, but the additional tax attributable to the trust would be charged to it,

(C) the income, deductions, and credits against tax attributable to a Completed Gift Trust would be included in the vested beneficiary's income tax return, but the additional tax attributable to the trust would be charged to it,

(D) distributions of money or other property to beneficiaries other than the grantor of an Uncompleted Gift Trust would be completed gifts to them by the grantor,

(E) because the grantor would be treated as the owner of the property in an Uncompleted Gift Trust, and the vested beneficiary would be treated as the owner of the property in a Completed Gift Trust, transactions between the grantor and the Uncompleted Gift Trust, and between the vested beneficiary and the Completed Gift Trust, would be disregarded for income and gratuitous transfer tax purposes, and

(F) the Uncompleted Gift Trust property would be included, and the Completed Gift Trust property would not be included, in the grantor's gross estate upon his or her death.

(2) Following the grantor's death the DNI mechanism would be applicable to a trust other than a Completed Gift Trust, whether established during the grantor's lifetime or after his or her death.

B. Income Taxation of Trusts.

The grantor's income tax liability should be determined as though he or she owned the property of an Uncompleted Gift Trust, and the trust should be disregarded for income tax purposes. The income tax liability of a Completed Gift Trust generally should be determined in the usual manner, in accordance with its applicable (compressed) rate brackets, including any deduction for DNI distributed to beneficiaries.[5]

C. Income Taxation of Trusts Over Which a Beneficiary Has a General Power of Appointment or Withdrawal.

If a beneficiary has a general power of appointment or withdrawal over all or a portion of a trust, the beneficiary should be treated as though he or she were the grantor with respect to the trust or that portion. If such a beneficiary releases the power or allows it to lapse but the beneficiary and/or his or her spouse has a significant beneficial interest in the trust or that portion as of the date of the release or lapse, the release or lapse should be treated as an incomplete gift by the beneficiary; and the income of the trust or that portion generally should be taxed as though the beneficiary were the grantor with respect to the trust or that portion, as provided in Subpart B of this paper, above. However, if a beneficiary has the power to withdraw $5,000 or 5 percent of the value of the trust property annually, whichever is greater, as provided in IRC Section 2514(e), or the grantor and/or his or her spouse does not have a significant (or any) beneficial interest in the trust or that portion as of the date of the release or lapse of the power, the release or lapse should be disregarded for both income and gratuitous transfer tax purposes.

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[5] Because of the harsh income tax liability with respect to Completed Gift Trusts, the beneficiary and the trustee of certain trusts, such as (1) an IRC Section 2503(c), a 2642(c)(2) trust, a terminating trust following the terminating event, or any other trust of which one or more beneficiaries have vested interests, might be allowed to elect to have the trust's undistributed taxable income taxed at the vested beneficiary's marginal income tax rates; and (2) a "family-pot trust" or "dynasty trust," described in footnote 2, above, also might be allowed to elect to have the trust's undistributed taxable income taxed at the marginal income tax rates of (a) the issue of the grantor or other individual, determined on a per stirpes basis, or (b) the child of the grantor or other individual who is the primary beneficiary, respectively, similar to the "kiddie tax" under IRC Section 1(g).

D. Income Taxation of *Clifford* Trusts.

The income of a *Clifford* trust with respect to which the grantor has retained a reversionary interest having an actuarial value in excess of 5% of the value of the property as of the date of the transfer of the property to the trust, should be taxed as provided in Subpart B of this paper, above, regardless of whether the initial term interest in the trust is a completed gift for gift tax purposes. However, if that term interest is treated as a completed gift for gift tax purposes, distributions with respect to that term interest should not be treated as further gifts by the grantor.

E. Income Taxation of Grantor Retained Interest Trusts.

The establishment of a grantor retained annuity trust (GRAT), a grantor retained unitrust (GRUT), or qualified personal residence trust (QPRT) generally should be treated as provided in Subparts A(3) and B of this Part 0, above, until the first to occur of the end of the fixed term or the grantor's death. However, if the remainder beneficiary(s) has (have) a vested remainder interest in the trust as of the date of the transfer, the actuarial value of that interest (a) should be treated as a completed gift for gift tax purposes, (b) if the grantor dies during the fixed term, only the actuarial value of the remaining fixed term at the date of the grantor's death should be included in the grantor's gross estate for estate tax purposes, and (c) if the grantor does not die during the fixed term, the trust thereafter should be treated as a Completed Gift Trust in the same manner as provided in Subpart B of this Part 0, above.

F. Proceeds of Life Insurance Policies Owned by Trusts.

If the power of the grantor of a trust to affect the beneficial enjoyment of the trust property is going to be disregarded and the determination of whether a gift, in trust, is complete for gratuitous transfer tax purposes will only depend on whether the grantor and his or her spouse have a significant beneficial interest in the trust property, or no beneficial interest at all, any incidents of ownership other than the power to name oneself as the beneficiary, directly or indirectly, alone or in conjunction with any other person, of any insurance policies on the life of the powerholder owned by a Completed Gift Trust also should be disregarded.

G. Income Taxation of Charitable Lead Trusts.

The income with respect to a charitable lead annuity trust (CLAT) or charitable lead unitrust (CLUT) generally should be taxed as a Completed Gift Trust in the same manner as provided in Subpart B of this Part 0, above. However, an exception might be made to obtain grantor-trust treatment where the grantor elects to take an upfront income tax deduction for the present actuarial value of the charitable lead interest.

H. Income Taxation of Charitable Remainder Trusts.

The income with respect to a charitable remainder annuity trust (CRAT) or charitable remainder unitrust (CRUT) probably should be taxed in the same manner as under present law.

II. TRANSITION RULE

All new trusts established after the effective date of the new law and additions to existing trusts after the effective date should be treated as provided under the new law.

An existing trust that was treated as a completed gift for gift tax purposes under the old law should continue to be treated as a completed gift for gift tax purposes. With regard to the taxable year of the effective date and subsequent taxable years, an existing trust that was treated as a grantor trust for income tax purposes should continue to be treated as a grantor trust unless that status is discontinued; however, the trust should be liable for the tax attributable to the trust's net income for the entire year, and sales or exchanges of appreciated property between the grantor and the trust following the effective date generally should be taxable.