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ADVERSE ENOUGH TO BE A NON-GRANTOR TRUST

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EXECUTIVE SUMMARY

If a grantor[4] creates a non-grantor trust under Internal Revenue Code sections 671-679, subpart E of subchapter J (commonly referred to as the "grantor trust rules"), the grantor will not be subject to federal income taxes on the trust's income and the trust will be a separate taxpayer for federal tax purposes, regardless of whether the transfer is a completed gift for estate and gift tax purposes.[5] If the non-grantor trust is formed under the laws of a state such as Delaware or Nevada, the trust may receive better asset protection from creditors and may avoid being subject to state income taxes in the grantor's home state. In addition, the non-grantor trust could receive the benefit of its own 20 percent deduction for qualified business income under section 199A, $10,000 deduction for state and local income taxes under section 164(b)(6), and $10,000,000 exclusion from capital gains for qualified small business stock under section 1202.[6]

However, the grantor trust rules are not clear about what happens when a grantor sets up a trust to take advantage of all the non-grantor trust benefits, but still is able to get trust assets back at a later date. If the trust instrument requires trust assets to be distributed to the grantor, then the trust most likely would be a grantor trust under sections 673(a) and 677(a). On the other hand, a grantor may be able to avoid grantor trust status and still get trust assets back in the future if the right to distribute assets back to the grantor is controlled by an "adverse party" as defined in section 672(a)—that is, a person who has a substantial beneficial interest in the trust that would be adversely affected by the distribution—even if that adverse party is "related or subordinate" to the grantor within the meaning of section 672(c). Additional guidance is needed from the Internal Revenue Service ("IRS") and Treasury Department to determine whether a trust will qualify as a non-grantor trust if an adverse party who is a close relative or subordinate employee of the grantor has the power to distribute trust assets to the grantor, and the grantor retains the right to determine whether that party ever gets any assets from the trust or the grantor.

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[4] A grantor is the individual taxpayer who creates a trust by transferring property to a trustee to hold for the benefit of beneficiaries. Other common terms for grantor include settlor, trustor, transferor and donor.

[5] All tax code section references are to the Internal Revenue Code of 1986, as amended (the "Code"), unless otherwise noted.

[6] But see section 643(f) (2010) and Treas. Reg. sections 1.199A-6(d)(3)(vii) (2019) and 1.643(f)-1 (2019) (anti-abuse rules to prevent taxpayers from establishing a non-grantor trust or contributing additional capital to an existing non-grantor trust with the principal purpose of avoiding federal income tax). See also Sections I.A. and I.B., and footnote 13 infra.

DISCUSSION

I. BACKGROUND.

There are numerous tax and non-tax reasons for creating a trust, and a variety of trust planning strategies that are permitted under the Code and Treasury Regulations to achieve both tax and non-tax objectives, such as grantor retained annuity trusts ("GRATs"), charitable remainder unitrusts and annuity trusts ("CRUTs" and "CRATs"), charitable lead annuity trusts ("CLATs"), qualified personal residence trusts ("QPRTs"), and intentionally defective grantor trusts ("IDGTs"). As a result of recent tax reform, commonly referred to as the Tax Cuts and Jobs Act of 2017 ("TCJA"), the federal income tax benefits for non-grantor trusts—especially incomplete gift non-grantor trusts ("INGs"), as discussed below—have substantially increased. Consequently, the TCJA has led to an exponential growth in the popularity of utilizing INGs and other non-grantor trusts as a planning strategy.[7] However, it is not clear under the Code and Treasury Regulations whether a trust will be entitled to non-grantor trust treatment under the grantor trust rules if it is possible for trust assets to be distributed back to the grantor.

A. Principal Purpose for Trust.

A grantor may have a desire to transfer assets during life—*inter vivos*—to an irrevocable trust for a number of different reasons that are unrelated to federal income tax. The grantor may want to create a vehicle that will provide financial assistance to relatives or other loved ones over a period of time. Ongoing professional asset management may be desired to protect one or more beneficiaries, who might otherwise make poor investment decisions or receive bad investment advice from an unscrupulous financial advisor. The grantor may want to protect assets for loved ones and future descendants from creditors and potential ex-spouses. In addition to greater asset protection and better financial management by professional trust companies, another consideration for establishing a trust unrelated to federal income tax may be more favorable state laws for the administration of trusts,

[7] The official name of the bill was changed prior to the final vote, but is commonly known as the "Tax Cuts and Jobs Act." The official title of the bill is, "H.R. 1 – An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018," Pub.L. 115–97. Source: https://www.congress.gov/115/bills/hr1/BILLS-115hr1eas2.pdf.

such as so-called silent trust or quiet trust statutes.[8] The grantor also may have certain estate planning objectives, including the potential for estate, gift and generation skipping transfer tax savings.

B. Benefits of Non-Grantor Trusts.

There are a multitude of situations where it would be in the grantor's best interest for an irrevocable trust to be treated as a non-grantor trust under the grantor trust rules, which would mean that the grantor would not be subject to income taxes on the trust's income and the trust would be a separate taxpayer for tax purposes.[9] The grantor may not want to pay taxes on the income of the trust, or may not have sufficient financial liquidity to pay the income taxes. The grantor also may desire greater asset protection from future creditors by taking advantage of a state with stronger asset protection laws—such as Delaware or Nevada.[10] In addition, the grantor may be

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[8] See, e.g., Alaska Stat. section 13.36.080; Ariz. Rev. Stat. section 14-10813; Del. Code Ann. tit. 12 section 3534; S.D. Codified Laws section 55-2-13; Tenn. Code Ann. section 35-15-813; N.H. Rev. Stat. Ann. section 564-B:1-105; D.C. Code section 19-1301.05; Maine Rev. Stat. Ann. tit. 18-B section 105; Mo. Rev. Stat. section 456.1-105; N.C. Gen. Stat. section 36C-1-105; Ohio Rev. Code Ann. section 5801.04; 20 Pa. Cons. Stat. Ann. section 7780.3; Va. Code Ann. section 64.2-703; and Wyo. Stat. Ann. section 4-10-813.

[9] With a grantor trust, the grantor would be subject to tax on the grantor trust's taxable income under the grantor trust rules, regardless of whether the grantor trust distributed any income to the grantor—in other words, the grantor would be treated as the owner of a grantor trust's assets for income tax purposes. Section 671 (1954). Instead of a non-grantor trust, a more tax efficient strategy for estate planning purposes may be to have the grantor intentionally retain certain rights that will cause the irrevocable trust to be treated as a grantor trust for income tax purposes under the grantor trust rules, but not cause the trust to be included in the grantor's estate for estate tax purposes—commonly referred to as an intentionally defective grantor trust ("IDGT"). In other words, the IDGT can continue to grow, free of taxes, outside of the grantor's estate for the benefit of children and future descendants. Moreover, because the grantor is required to pay those taxes, those payments are not treated as a gift for gift tax purposes and will further reduce the value of the grantor's estate for estate tax purposes. See section 675 (1988); Rev. Rul. 2011-28, 2011-49 I.R.B. 830; 2008-22, 2008-16 I.R.B. 796; 2004-64, 2004-29 I.R.B. 6; 85-13, 1985-1 C.B. 184; PLR 200606006 (Feb. 10, 2006) and 200603040 (Jan. 20, 2006). For a more detailed discussion of grantor trusts, see Akers, Stephen R., Blattmachr, Jonathan G. and Boyle, F. Ladson, "Creating Intentional Grantor Trusts," *44 Real Prop. Tr. & Est L.J.* 207 (2009); Blattmachr, Jonathan G., Gans, Mitchell M. and Lo, Alvina H., "A Beneficiary as Trust Owner: Decoding Section 678," 35 *ACTEC J.* 106 (2009); and Blattmachr, Jonathan and Crawford, Bridget, "Grantor Trusts and Income Tax Reporting: A Primer," 13 *Prob. Prac. Rep.* 1 (May 2001).

[10] Certain states may provide better asset protection for trust assets, especially those states that have adopted domestic asset protection trust legislation. See¸ e.g., Del. Code Ann. tit. 12, sections 3570-3576 for Delaware and Nev. Rev. Stat. sections 166.010-166.170 for Nevada. There is a question of whether a grantor in a state without domestic asset protection trust legislation can take advantage of another state's domestic asset protection statutes, especially if the grantor resides in a state that has adopted the Uniform Voidable Transactions Act, Uniform Law Commission, National Conference of Commissioners on Uniform State Laws (July 2014) accessed at https://www.uniformlaws.org/viewdocument/final-act-with-comments-112?CommunityKey=4226ae7c-91c0-4ce9-b488-8520dbc39ea3&tab=librarydocuments (as of Feb. 17, 2019). See Miller, Justin T. and Behn, Martin, "California Could Say No to NINGs and Don't to DINGs," *California Trusts & Estates Quarterly*, Vol. 22, Iss. 4 (2016). See also comments 2 and 8 to section 4 and section 10 of the Uniform Voidable Transactions Act. While the comments are not actually

interested in minimizing or avoiding state income taxation in the state where the grantor resides or is domiciled by setting up a non-grantor trust in a state without a state income tax.[11] The grantor also may want the non-grantor trust to receive the benefit of its own 20 percent deduction for qualified business income under section 199A and $10,000 deduction for state and local income taxes under section 164(b)(6), which may be possible as long as the principal purpose of creating the non-grantor trust is not avoiding federal income tax.[12]

To the extent the grantor has qualified small business stock ("QSBS") under section 1202, the grantor may be able to transfer the QSBS to a non-grantor trust in order to exclude an additional portion or all of the capital gain in the event of a future sale or exchange of the QSBS.[13] In general, section 1202 provides that a portion or all of the gain from the sale or exchange of QSBS will be excluded from gross income, provided that the QSBS has been held for more than 5 years.[14] The QSBS exclusion allows investors to exclude up to 100 percent of their gain on the sale of QSBS acquired after September 27, 2010, capped at the greater of $10,000,000 and 10 times the investor's tax basis in the stock.[15] The requirement that the QSBS be received directly from the issuing company does not apply to QSBS

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part of the model statute, courts may analyze the comments in a manner similar to legislative history: instructive, but not necessarily binding.

[11] For example, trust income is not taxable in Delaware provided there are no resident beneficiaries. 30 Del. Code sections 1102, subds. (a)(12) & (13), 1601, subd. (8). See Miller, Justin T. and Kinyon, Richard S., "When Should a Trust Be Subject to State Income Tax in California?" *California Tax Lawyer*, Vol. 23, No. 3 (Fall 2014) and Miller, Justin T. and Kinyon, Richard S., "When Should a Trust Be Subject to California Income Tax?" *State Tax Notes*, Vol. 72, No. 7 (May 2014).

[12] If multiple trusts have substantially the same grantors and beneficiaries, and a principal purpose for establishing such trusts or contributing additional cash or other property to such trusts is the avoidance of federal income tax, then the various trusts would be generally considered one trust. See section 643(f) (2010) and Treas. Reg. section 1.643(f)-1 (2019). See also Treas. Reg. section 1.199A-6(d)(3)(vii) (2019) (anti-abuse rules to prevent taxpayers from establishing a non-grantor trust or contributing additional capital to an existing non-grantor trust with the principal purpose of avoiding federal income tax). As discussed in Section I.A. supra, considerations for establishing trusts that are unrelated to federal income tax may include asset protection, competent financial management by professional trust companies, estate planning and favorable state law statutes related to trust administration.

[13] QSBS is stock of a C corporation that is a qualified small business ("QSB"), issued after August 10, 1993, and that satisfies the original issuance requirement. Section 1202(c) (2018). In order to be considered a QSB, it must be an active business and the aggregate gross assets of the corporation must not have exceeded $50,000,000 after August 10, 1993, before the issuance of the stock, and immediately after the issuance of the stock. Section 1202(d) and 1202(e) (2018). Only U.S. corporations can qualify as a QSB. Section 1202(d)(1) (2018).

[14] Section 1202(a)(1) (2018).

[15] QSB acquired between August 11, 1993, and February 17, 2009, is eligible for a 50 percent gain exclusion, but subject to a seven percent AMT addback; QSB acquired between February 18, 2009, and September 27, 2010, is eligible for a 75 percent gain exclusion, but subject to a seven percent AMT addback; and QSB acquired after September 27, 2010, is eligible for a 100 percent gain exclusion without any AMT addback.

received as a result of a gift or by death.[16] In other words, the recipient of a gift of QSBS—such as a non-grantor trust—is treated as having received and held the QSBS in the same manner as the grantor, and for the same time period as the grantor.[17] Therefore, if a grantor transfers QSBS to a non-grantor trust, the non-grantor trust should be able to separately qualify for the QSBS exclusion and have a separate cap—the greater of $10,000,000 and 10 times tax basis—on the maximum gain excluded.

To the extent a grantor is interested in the benefits of a non-grantor trust for income tax purposes, but does not want to pay any gift taxes, the grantor could reserve a special limited power to appoint the trust principal to beneficiaries other than the grantor, so that the transfer is treated as an incomplete gift for gift tax purposes—meaning that there would be no gift tax consequences or utilization of the grantor's lifetime exemption and no requirement to file an IRS Form 709 "United States Gift (and Generation-Skipping Transfer) Tax Return."[18] As an incomplete gift, the trust assets would continue to be included in the grantor's gross estate at death, which means the assets would receive the additional benefit of a step-up in basis at death under section 1041(a). Such a trust is commonly referred to as an incomplete gift non-grantor trust or ING trust. If the ING trust is created in a state such as Delaware, Nevada or Wyoming, it may be referred to as a DING, NING or WING, respectively.

There are a significant number of IRS private letter rulings ("PLRs") acknowledging that a grantor's transfer of assets to an ING trust is an incomplete gift for gift tax purposes, but a completed transfer for income tax purposes—making it a non-grantor trust.[19] In several of the more recent PLRs, the grantor was provided with an *inter vivos* special power of appointment for health, education, maintenance and support of the beneficiaries in a non-fiduciary capacity, and the powers of the distribution committee members, which included the beneficiaries, were only exercisable

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[16] Sections 1202(h)(1), (2)(A) and (B) (2018).
[17] Ibid.
[18] See Treas. Reg. sections 25.2511-2(b) and 25.2511-2(c) (1999). Treas. Reg. section 25.2511-2(c) states that a gift is incomplete if the donor reserves the power to name new beneficiaries or change the interests of the beneficiaries unless the power is exercisable in a fiduciary capacity and is limited by a fixed or ascertainable standard. Note that exemption amount is $11,400,000 per person for 2019. Rev. Proc. 2018-57, 2018-49 I.R.B. 827.
[19] See, e.g., PLRs 201410001- 201410010 (Mar. 7, 2014) and 201310002-201310006 (Mar. 8, 2013). Note that PLRs may not be relied upon as precedent by other taxpayers or IRS personnel, but they may serve as a persuasive tool for taxpayers and the IRS in similarly applicable circumstances.

in conjunction with the grantor.[20] Thus, a non-grantor trust may be able to eliminate state income tax liability attributable to the sale of an asset—which could be up to a 13.3 percent tax savings for a state such as California[21]—while avoiding or deferring a gift for federal gift tax purposes, even if the grantor is able to get all of the trust property back at a later date.[22]

> *Hypothetical #1*. Gary is a resident of California who owns 50 percent of the outstanding shares of a C corporation he acquired directly from the company six years ago, with a zero basis in the shares for tax purposes.[23] The shares qualify as QSBS for purposes of section 1202. The company may be purchased by a strategic or tactical buyer in the near future for $40,000,000—that is, $20,000,000 for Gary's shares—and there is no currently pending transaction that would trigger the "anticipatory assignment of income doctrine."[24] Gary transfers 50 percent of his shares to an ING trust in a state without state income taxes—such as Delaware or Nevada—in order to avoid any California income tax on the sale of those shares, to provide additional asset protection, and to take advantage of an additional $10,000,000 QSBS exclusion from federal income tax. Gary names Independent Institutional Bank in Nevada as the trustee of the ING, and his two adult children, Amy and Bob, as members of the trust distribution committee. Amy and Bob, who both live

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[20] Ibid.

[21] 13.3 percent is California's highest marginal income tax rate for trusts or estates—applicable to capital gains as well as ordinary income—with income greater than $1,000,000 (that is, 12.3 percent for income greater than $572,980, and an additional one percent for income greater than $1,000,000). "2018 California Tax Rates and Exemptions," FTB (2018).

[22] See, e.g., Miller, Justin T. and Behn, Martin, "California Could Say No to NINGs and Don't to DINGs," *California Trusts & Estates Quarterly*, Vol. 22, Iss. 4 (2016); Brown, Matthew G., Keligian, David L. and Lambourne, Gregory E., "California Income Tax Issues for Non-California Trusts – Part 1," *California Trusts and Estates Quarterly*, Vol. 19, Iss. 4 (2014) and Brown, Matthew G., Keligian, David L. and Lambourne, Gregory E., "California Income Tax Issues for Non-California Trusts – Part 2," *California Trusts and Estates Quarterly*, Vol. 20, Iss. 2 (2014). Note that in New York, under legislation enacted in 2014, if a trust is a non-grantor trust for federal income tax purposes and the grantor's transfer of assets to the trust is treated as an incomplete gift for federal tax purposes—that is, an ING—then the trust's income will be taxed as the grantor's income by New York City and State, regardless of whether such trusts are characterized as non-grantor trusts for federal tax purposes. NY Tax Law section 612(b)(41).

[23] Unless otherwise provided, the names, characters, businesses, places, and events discussed in the hypothetical examples in this paper are fictitious. Any resemblance to actual persons, living or dead, or actual events is purely coincidental.

[24] See *Lucas v. Earl*, 281 U.S. 111 (1930) (fruits cannot be attributed to a different tree from that on which they grew).

outside of California, are also named as beneficiaries, while Gary names himself as a contingent beneficiary. In addition, Gary reserves a limited power to appoint the trust principal to Amy or Bob. Amy and Bob have the power to make distributions back to Gary—in other words, Gary cannot get any trust property back without approval from his children. Based on the grantor trust rules, Treasury Regulations and multiple PLRs issued by the IRS, the transfer to the ING should be treated as an incomplete gift for federal gift tax purposes and a non-grantor trust for federal income tax purposes. Six months after the transfer of the QSBS to the ING, a strategic buyer purchases all of the outstanding shares of Gary's company for $40,000,000, which includes $10,000,000 for Gary's shares and $10,000,000 for the shares owned by the non-grantor trust created by Gary. Gary pays California's top marginal state income tax rate of 13.3 percent on the shares that he retained and $0 of federal income taxes on $10,000,000 of gain under the QSBS rules.[25] The ING, as a non-grantor trust, may avoid California income taxes,[26]and also would pay no federal income tax on the trust's separate $10,000,000 of gain under the QSBS rules. Three years later, Gary retires in Florida—a state without state income tax—and Amy and Bob, as members of the trust distribution committee, can agree to distribute all of the remaining trust assets back to Gary.

II. GRANTOR TRUST RULES IF ASSETS GO TO GRANTOR.

A. Reversionary Interests.

The grantor trust rules are not clear about what happens when a grantor sets up a trust to take advantage of all the non-grantor trust benefits, but still is able to get all of the trust assets back at a later date. If a grantor sets up a trust and automatically has the right to receive trust assets back at a

[25] Subject to graduated rates. See "2018 California Tax Rates and Exemptions," FTB (2018).
[26] It is unclear under California law whether an ING trust will be respected as a non-grantor trust for state income tax purposes, and the California Franchise Tax Board has not issued guidance on the matter. See footnote 23 supra.

certain point in the future—that is, a reversion—then the trust most likely would be a grantor trust under section 673(a).

In general, section 673(a) provides that the grantor shall be treated as the owner of any portion of a trust in which he or she has a reversionary interest in either the corpus or the income therefrom, if, as of the inception of that portion of the trust, the value of such interest exceeds five percent of the value of such portion. Under section 673(c), the value of the reversion must be calculated assuming the maximum exercise of discretion in the grantor. For instance, the IRS in PLR 201642019 revoked a ruling in PLR 201426014 with respect to an ING trust that would automatically revert back to the grantor if the grantor's two children no longer served on the distribution committee or if there were not at least two other members on the distribution committee. The IRS in PLR 201642019 found that such a trust would be a grantor trust under section 673 due to the reversion provision, which under the facts would represent the immediate resignation of all the distribution committee members immediately after trust funding, causing the reversionary interest to be worth 100 percent and causing the grantor to be treated as the owner of the entire trust for purposes of section 671.[27]

Provided the trust's assets do not automatically revert back to the grantor upon the occurrence of a specific event—such as under the facts of PLR 201642019 triggering section 673(c)—the grantor should not be treated as retaining a reversionary interest under section 673(a). Although section 673 was originally adopted in 1954, the current version of section 673(c)—which assumes the maximum exercise of discretion in favor of the grantor in valuing a reversion—was not adopted until 1988. No case law or administrative guidance clarifies the meaning of "assuming the maximum exercise of discretion in favor of the grantor" when valuing a reversionary interest.[28] The legislative history of section 673(c) simply provides that "in determining whether a reversionary interest has a value in excess of five percent of the trust, it will be assumed that any discretionary powers are exercised in such a way as to maximize the value of the reversionary interest."[29] There is no other explanation of how this provision affects the reversionary interest rule.

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[27] PLRs 201410001 - 201410010 (March 7, 2014) and 201310002 - 201310006 (March 8, 2013) did not involve such a reversion provision.
[28] Section 673(c) (1988).
[29] S. REP. NO. 100-445 at 362 (1988) reprinted in 1988 U.S.C.C.A.N. 4515, 4872.

Under traditional property law principles, a reversion under section 673 likely exists only if a portion of the transferred assets will return to the grantor upon the death of a person, after a term of years, or upon the grantor's demand.[30] On the other hand, if a grantor transfers all of his or her interest in property to a trust, then the grantor arguably has not retained a reversion, even if the grantor retains a beneficial interest, such as the right to receive distributions at the discretion of a trustee or distribution committee.[31] Moreover, there currently is no authority or guidance in which a trustee's or distribution committee's power to make distributions to the grantor would create a "reversionary interest" within the meaning of section 673 and prevent a trust from being treated as a non-grantor trust under the grantor trust rules.[32]

B. Income Accumulated for or Distributed to Grantor.

If a grantor sets up a trust and the grantor, the grantor's spouse or any nonadverse party (as defined and discussed in the section below) has the discretion to accumulate income[33] for the benefit of the grantor or make distributions back to the grantor, then the trust will be treated as a grantor trust under the grantor trust rules.[34] Pursuant to section 677, the grantor of a trust is deemed to own—and is taxable on—any trust or portion of the trust whose income is or may be, in the discretion of the grantor, the grantor's spouse[35]

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[30] See Simes, Lewis M. and Smith, Allan F., "The Law of Future Interests," section 82 (2d ed., 1956) and Schwartz, William, "Future Interests and Estate Planning," section 2.24 (1965).

[31] Ibid.

[32] Section 672 (1998) provides definitions for the grantor trust provisions of the Code, although it does not provide a definition of a "reversion" for purposes of the grantor trust rules.

[33] For purposes of the grantor trust rules, "income" means "income determined for tax purposes," which would include capital gains. Treas. Reg. section 1.671-2(b) (2000). For purposes of subchapter J of the Code, other than the grantor trust rules, "income" means "fiduciary accounting income," which is determined under the trust instrument and local law and typically would not include capital gains. Section 643(b) (2010).

[34] The trust could be a grantor trust as to income, as to principal, or as to both. Section 677 (1986). In other words, the grantor could be subject to tax on items of taxable income that are included in fiduciary accounting income, as determined under state law and the applicable trust instrument, that could benefit the grantor or the grantor's spouse, which typically would include dividends, interest and rents, but not capital gains. Alternatively, or in addition, the grantor could be subject to tax on items of taxable income that are allocated to principal, as determined under state law and the applicable trust instrument, that could benefit the grantor or the grantor's spouse, which typically would include capital gains. Moreover, if taxable income on only a portion of the trust—such as a percentage of the trust—may be accumulated for, or distributed to, the grantor or the grantor's spouses, then the trust would be a grantor trust as to that portion.

[35] For transfers in trusts prior to October 10, 1969, section 677 (1986) causes the grantor to be taxed on income which is or may be distributed or accumulated for the grantor only. Section 677 (1986) was revised by the 1969 Tax Reform Act to provide that for trusts created after October 9, 1969, the grantor will be taxed as the owner of income that is or may be distributed or accumulated for the grantor or the grantor's spouse. Treas. Reg. sections 1.677(a)-1(b)(1) and (2) (1996).

and/or any nonadverse person without the consent or approval of an adverse party, either:

(1) distributed, actually or constructively, to the grantor or grantor's spouse;[36]
(2) accumulated for future distribution to the grantor or grantor's spouse;[37]
(3) applied, actually or constructively, to pay premiums on policies of insurance on the life of the grantor or grantor's spouse, other than certain charitable policies;[38] or
(4) actually applied or distributed for the support or maintenance of a beneficiary whom the grantor or the grantor's spouse is legally obligated to support and maintain.[39]

In other words, a grantor can avoid the application of section 677—which triggers grantor trust status—by only allowing a distribution or accumulation of trust income for the benefit of the grantor with the consent or approval of an adverse party. Simply put, an adverse party can distribute assets back to the grantor, and the trust could still qualify as a non-grantor trust.

C. Adverse Parties.

A grantor may be able to avoid grantor trust status under both sections 673(a) and 677(a) and still get all of the trust assets back in the future, provided there is no automatic reversion of assets to the grantor and the power to distribute assets back to the grantor is controlled by an adverse party. Pursuant to section 672(a), an adverse party is:

> [A]ny person having a substantial beneficial interest in the trust which would be adversely affected by the exercise or nonexercise of the power which he possesses respecting the trust.[40]

In other words, an adverse party is a beneficiary of the trust—other than the grantor or the grantor's spouse[41]—who has:

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[36] Section 677(a)(1) (1986).
[37] Section 677(a)(2) (1986).
[38] Section 677(a)(3) (1986).
[39] Section 677(b) (1986).
[40] Section 672(a) (1998). In general, the term "adverse party" is a replacement for references in the Internal Revenue Code of 1939, and the regulations thereunder, to persons having a "substantial adverse interest."
[41] Section 672(e) (1992).

(1) A power with respect to the trust; and
(2) A substantial beneficial interest in the trust that would be adversely affected by the exercise or nonexercise of such power the individual possesses with respect to the trust.[42]

If any one of the foregoing two requirements is not satisfied, the individual will not be an adverse party, but instead will be a nonadverse party.[43] Section 672(b) simply provides that a nonadverse party is any person who is not an adverse party.

The reasoning behind the adverse party rule is that adverse parties would be acting against their self-interest as trust beneficiaries by distributing assets to the grantor that they otherwise potentially could receive.[44] In other words, since the grantor arguably does not really control the ability to get assets out of the trust without other beneficiaries acting against their self-interest, the Code does not treat the grantor as the owner of the trust and instead treats the trust as a non-grantor trust.[45]

Naming an independent trustee—that is, someone other than the grantor or a related or subordinate party—with a power to distribute trust assets to the grantor is not enough to prevent the trust from being treated as a grantor trust under section 677. It does not matter whether an independent trustee has a broad discretionary power or a power subject to an ascertainable standard, like health, education, maintenance and support. While appointing an independent trustee does prevent the trust from being treated as grantor trust under section 674(c), only an adverse party with a substantial beneficial interest in the trust under section 672(a) can prevent grantor trust status under section 677(a) if trust assets can be accumulated for, or distributed to, the grantor or the grantor's spouse.

Thus, in order for the grantor to be able to get his or her assets back from a trust and still achieve non-grantor trust status under the grantor trust rules, distributions back to the grantor must be made with the consent or

[42] Treas. Reg. section 1.672(a)-1(a).
[43] Section 672(a) (1998) specifically provides that a person with a general power of appointment over a trust has a beneficial interest in a trust.
[44] See, e.g., *Paxton v. Comm'r*, 44 T.C.M. 771 (1982) (trustee's interest was adverse where he had discretion to distribute trust income to himself and/or the grantors—if he were to exercise his income distribution power in favor of the grantors, he would be deprived of what he otherwise could distribute to himself).
[45] Section 674 (1997).

approval of individuals—other than the grantor or the grantor's spouse[46]—who qualify as adverse parties.[47] Accordingly, a trust will be treated as a non-grantor trust for federal income tax purposes under the grantor trust rules if the grantor only may receive a distribution with approval or consent from an adverse party.[48]

D. Substantial Interest.

Whether or not an individual has a substantial enough interest to qualify as an adverse party requires an analysis of all the facts.[49] The Treasury Regulations provide that an adverse party's interest is substantial "if its value in relation to the total value of the property subject to the power is not insignificant."[50] In other words, if an interest in a trust is so small, contingent, or remote that it is insignificant, the interest holder may be considered to be nonadverse.

For instance, in *Water Resource Control v. Commissioner*, the Tax Court ruled that a trust's income beneficiary did not have a substantial interest in the trust and was therefore a nonadverse party because the trustees had no obligation to make any payments to her and her right to income could be unilaterally terminated by the trustees.[51] Similarly, in *Chase National Bank v. Commissioner*, the 8th Circuit Court of Appeals found that a former spouse's interest was not substantial enough to be an adverse interest when the former spouse had merely a remote contingent remainder interest that would vest only upon the spouses' two children and their issue all dying before reaching age 35.[52] The Court in *Chase National Bank* noted that when the trust was created,

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[46] Section 672(e) (1998).
[47] Section 674 (1997).
[48] *Ibid.*
[49] See, e.g., IR-2007-127 (Jul. 9, 2007) and CCA 201208026 (Feb. 24, 2012). See also *D.G. McDonald Trust v. Comm'r*, 19 T.C. 672, 690 (1953).
[50] Treas. Reg. section 1.672(a)-1(a). See *Paxton v. Comm'r*, 57 T.C. 627 (1972), *aff'd*, 520 F.2d 923 (9th Cir. 1975), *cert. denied*, 423 U.S. 1016 (1976) (a trustee-son may come to have a substantial adverse interest, so the grantor is not taxed); and *Estate of Paxton v. Comm'r*, T.C. Memo 1982-464, *appeal dismissed* (9th Cir. 1983) (some amendments were nullities as there was no reservation of power to make them). Gift and estate tax cases are also relevant to the meaning of what is not a substantial enough interest to create an adverse interest. See also *Paxton v. Comm'r*, 57 T.C. 627 (1972), *aff'd*, 520 F.2d 923 (9th Cir. 1975) (3.8 percent is interest not substantial); *Paxton v. Comm'r*, T.C. Memo. 1982-464 (1982) (9.9 percent interest is not substantial); *Comm'r v. Prouty*, 115 F.2d 331 (1st Cir. 1940) (discretion to distribute or accumulate income for beneficiary for life with remainder passing to the beneficiary's issue as appointed by beneficiary's will is not a substantial adverse interest).
[51] 61 T.C. 2102, 2117-2118 (1991), *aff'd memo sub nom. Whitehouse v. Comm'r*, 972 F.2d 1328 (2d Cir. 1992), *cert. denied*, 507 U.S. 960 (1993).
[52] *D.G. McDonald Trust v. Comm'r*, 19 T.C. 672 (1953), aff'd sub nom., *Chase Nat'l Bank v. Comm'r*, 225 F.2d 621, 627 (8th Cir. 1955), cert. denied, 350 U.S. 965 (1956).

the remainder beneficiary was 54 years old, and the grantor's children were 29 and 18, each married, and each having a child either at the time the trust was created or soon thereafter.[53] The Court stated, "Where the possibility that contingent remaindermen will ever get anything is as remote as it is here, it cannot be considered a benefit amounting to a substantial adverse interest."[54]

What case law, the Code and Treasury Regulations fail to address is whether a beneficiary's interest will be considered to be substantial enough to qualify as an adverse party under section 672(a) if the grantor retains a limited testamentary power via will to re-distribute remaining trust assets among the beneficiaries (other than the grantor, the grantor's spouse, or their estates or creditors) or a lifetime special power to appoint trust assets in a non-fiduciary capacity to the beneficiaries for their health, education, maintenance and support.[55] In other words, without additional guidance from the IRS or Treasury Department, a beneficiary could still be considered an adverse party, even if the grantor retains the right to determine whether that beneficiary will ever get a distribution during the grantor's lifetime or after the grantor's death.

> *Hypothetical #2.* Gina transfers property to an irrevocable trust. She names ten individuals as contingent beneficiaries of the trust, each of whom is eligible to receive distributions from the trust only upon the unanimous consent of the distribution committee, which consists of the ten named individuals and Gina. A distribution may be made to Gina with the approval of any one member of the distribution committee other than Gina. It may be up to a court to determine whether the one distribution committee member authorizing the distribution back to Gina should be treated as having a substantial adverse interest based on the facts and circumstances. Consequently, it is unclear whether such trust would qualify as a non-grantor trust under the grantor trust rules.

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[53] Ibid.

[54] Ibid. See also *Cushman v. Comm'r*, 153 F.2d 510, 513-514 (2nd Cir. 1946), and *Joseloff v. Comm'r*, 8 T.C. 213 (1947).

[55] See, e.g., PLRs 201410001- 201410010 (Mar. 7, 2014) and 201310002-201310006 (Mar. 8, 2013); *Holt v. United States*, 699 F. Supp. 751, 752 (W.D. Va. 1987), *aff'd mem.*, 842 F.2d 1291 (4th Cir. 1988) (grantor's parents' contingent remainder in the trust principal was determined to be too remote and thus insignificant where it would vest only if all of the grantor's descendants died prior to the termination of the trust at the death of the grantor's last child).

E. Related or Subordinate Parties as Adverse Parties.

If a grantor really wants to get the trust assets back at a certain point, the grantor can exponentially increase the likelihood of the assets being returned by naming related or subordinate parties under section 672(c) as contingent beneficiaries of the trust with the power to distribute assets to the grantor. There is nothing in the Code or the Treasury Regulations that would disqualify an individual from being an adverse party based on a personal or business relationship to the grantor. For instance, section 1.672(a)-1 of the Treasury Regulations provides several examples to help determine whether an individual is an adverse party, and none of the examples would prohibit or limit a related or subordinate party from qualifying as an adverse party.[56]

In recent PLRs[57] the IRS found that even though a distribution committee that included the grantor's relatives as members could make distributions of income and principal back to the grantor, the trust was still a non-grantor trust. The IRS stated in PLR 201310002,

> [A]n examination of Trust reveals none of the circumstances that would cause Grantor to be treated as the owner of any portion of Trust under §§ 673, 674, 676, or 677.[58]

While the recent IRS PLRs approving ING trusts do not specifically address the issue of adverse parties, the fact that the grantor's relatives on the distribution committee had contingent beneficial interests in the ING trust would appear to be sufficient to make them adverse parties under section 672(a).[59]

Despite the lack of guidance from the IRS and Treasury Department, case law does reflect a tendency for courts to presume that trust beneficiaries who are members of the grantor's family are likely under the grantor's dominion and control, which means that they are not truly adverse. For instance, in *Fulham v. Commissioner*, a trust agreement provided that the trust could be revoked by a special committee with the consent of the grantor's spouse.[60] The committee had no interest in the trust, and there was a question

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[56] Treas. Reg. section 1.672(a)-1.
[57] See, e.g., PLRs 201410001- 201410010 (Mar. 7, 2014) and 201310002-201310006 (Mar. 8, 2013).
[58] *Ibid.*
[59] *Ibid.*
[60] *Fulham v. Comm'r*, 110 F.2d 916 (1st Cir. 1940).

of whether the spouse should be treated as an adverse party, since the spouse's only interest as a contingent trust beneficiary was limited to the trustees' discretion to pay her any part of the principal or accumulated income. The First Circuit Court of Appeals held that the spouse's interest was not substantially adverse because the trustees were not required to pay her anything, and even that right could have been destroyed by an exercise of the power to amend, given to the committee by the trust instrument.[61] It should be noted that *Fulham* was decided prior to the implementation of the current grantor trust rules, which now treat the grantor as holding any power or interest that is held by his or her spouse.[62]

Similarly, *Cox v. Commissioner* involved a trust agreement in which the grantor reserved the right to revoke the trust only with the consent of any beneficiary having "a substantial adverse interest."[63] Despite that provision, the Tenth Circuit Court of Appeals held that the trust's income was taxable to the grantor on the grounds that, "[i]n view of the broad powers of the donor, as trustee, and the family relation, we think it may be reasonably assumed that such a consent would be freely given."[64]

> *Hypothetical #3.* Grant transfers a rental property to an ING trust, naming himself, his secretary Andrew, his daughter Barbara, and his son Carl as beneficiaries. Grant retains a special lifetime power to appoint trust assets in a non-fiduciary capacity among the other beneficiaries for their health, education, maintenance and support, and a limited testamentary power to appoint the remaining trust assets in a non-fiduciary capacity among the other beneficiaries at his death. Distributions to Grant only can be made with a majority approval and consent of the distribution committee, consisting of Andrew, Barbara and Carl. Arguably, Andrew, Barbara and Carl would be acting adversely to their interests as trust beneficiaries by distributing any assets back to Grant, because they would be giving up their potential right to those assets. However, there could be a question as to whether Grant really has

[61] *Id.* at p. 918.

[62] Section 672(e) (1998). See *Vercio v. Comm'r*, 73 T.C. 1246, 1258 (1980) ("Congress effectively ruled out the possibility of a spouse being treated as an adverse party when a provision in the trust allows for the income to be used for that spouse's benefit.").

[63] *Cox v. Comm'r*, 110 F.2d 934, 936 (10th Cir.), *cert. denied*, 311 U.S. 667 (1940).

[64] *Id.* At 936.

given up his ability to control distributions back to himself, which otherwise would make the trust a grantor trust.[65] Since Andrew is Grant's employee and Barbara and Carl are Grant's children, it is possible that they simply have always done, and will always do, what Grant says. Andrew, Barbara and Carl could have implicitly agreed that they are required to distribute the assets in the trust back to Grant whenever he wants, or they may feel obligated to distribute the assets back to Grant rather than risk never getting another penny from him in the future.[66]

F. Comparison with Other Sections of the Code Addressing Familial Relationships.

The Code and the Treasury Regulations have other sections that specifically deal with familial relationships, specifically provisions that address partnership interests held by family members and provisions addressing family members in the context of private foundations.

Section 704(e) and the Treasury Regulations thereunder place restrictions on parents shifting income to partnership interests gifted to spouses, ancestors and lineal descendants, and any trusts for the primary benefit of those persons. In a similar vein, under the provisions relating to excise taxes on private foundations, family members (i.e., spouses, ancestors, children, grandchildren and great-grandchildren, as well as such persons' spouses) are attributed the same restrictions as the substantial contributor, the foundation manager, or the owner of more than 20 percent of the voting power of the private foundation.[67]

In isolation each of these provisions and related Treasury Regulations appear to fix individual points. Looked at collectively with other provisions of the Code, there is a pattern of increasingly complex provisions and regulations to cope with the reality that family members should not always

[65] Section 674 (1997).

[66] See *In re Wyly*, 2016 WL 3639176, pp. 13-14, and *In re Wyly*, 552 B.R. 338 (2016) (Bankruptcy Court found that grantor retained full control of the assets when there appeared to be an implicit agreement among the trust protector committee, the trustee, and the grantor that he would receive distributions). The consent of a person who would otherwise have a substantial adverse interest will not be sufficient to preclude completed gift treatment if there is an agreement in advance regarding the person's consent to exercise of the power by the donor. *Camp v. Comm'r*, 195 F.2d 999 (1st Cir. 1952); *Schwarzenbach v. Comm'r*, 4 T.C. 179 (1945).

[67] Section 4946(a)(1)(D) (2000).

be considered separate taxpayers. In recognition of this reality, the IRS has relied on actuarial standards,[68] as well as attribution rules.[69] With regard to a trust, an actuarial standard would be inadequate to resolve the family affinity problem if income and principal need not be distributed or a grantor retains the right through a limited power of appointment to direct assets away from any one of the beneficiaries. A hard-line attribution standard similar to other provisions of the Code also may not be appropriate because of the inflexible nature of having all related or subordinate parties barred from serving on trust distribution committees.

III. CONCLUSION.

While a non-grantor trust, such as an ING trust, potentially could allow taxpayers to have their cake and eat it, too, additional guidance is needed from the IRS and Treasury Department to determine whether a trust will still qualify as a non-grantor trust even if a grantor names related or subordinate parties as beneficiaries of a trust, retains the right to determine whether those beneficiaries ever get any assets from the trust or from the grantor's other assets, and has the ability get all the trust assets back in the discretion of those beneficiaries. Such clarification would help taxpayers determine when a trust beneficiary's interest is adverse enough under section 672(a) and Treasury Regulation section 1.672(a)-1 to allow the trust to be treated as a non-grantor trust for income tax purposes. Without adequate guidance regarding whether beneficiaries who are close relatives and/or subordinate employees of the grantor have a substantial enough interest to qualify as adverse parties while the grantor retains a limited lifetime power or limited testamentary power of appointment over those beneficiaries, a grantor could be faced with significant back taxes, interest and penalties if the IRS and the courts later determine that a trust should not qualify as a non-grantor trust under the grantor trust rules for federal income tax purposes.

Two alternatives are proposed in trying to reconcile the guidance needed. The alternatives acknowledge the mechanical nature of both the family attribution rules by virtue of incorporating the concept of section 672(c) "related or subordinate parties," as well as the reversionary interest rules of section 673(c). The first alternative provides additional guidance beyond the mechanical nature of the attribution rules, by acknowledging the

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[68] See section 673(a) (1988), which treats a grantor as the owner of a trust in which the grantor has an actuarially calculated revisionary interest that exceeds five percent of the value of the trust at inception.
[69] See section 4946(a)(1)(D) (2000).

reality of powers of appointment and their ability to impact the beneficial use and enjoyment of trust property:

> *Alternative #1*. If a beneficiary of a trust is a related or subordinate party under section 672(c), then it will be assumed that any discretionary powers held by such beneficiary will be exercised in such a way as to maximize the value of the grantor's reversionary interest in determining whether a reversionary interest has a value in excess of five percent of the trust pursuant to section 673(c).

The second alternative provides guidance in situations where discretionary powers of appointment are retained by the grantor, the grantor's spouse, or related or subordinate parties:

> *Alternative #2*. If a grantor, the grantor's spouse, or a related or subordinate party under section 672(c) retains an *inter vivos* or testamentary power of appointment or discretionary power in either a fiduciary or a non-fiduciary capacity over distributions from a trust to a beneficiary of the trust, then such beneficiary does not have a substantial beneficial interest in the trust for purposes of section 672(a) and is a nonadverse party under section 672(b).