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Grantor Trust Status Under Section 677:
Trust Income For the Benefit of the Grantor

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**Grantor Trust Status Under Section 677:
Trust Income For the Benefit of the Grantor or Grantor's Spouse**

I. Introduction to Section 677

When the grantor of a trust retains certain interests or powers with respect to the trust, the grantor is considered the owner of the property to which the retained interests or powers relate for purposes of income taxes, and the trust is deemed a "grantor trust." The rules setting forth the certain interests or powers that will trigger grantor trust status are set forth in Sections 673-679 of the Internal Revenue Code (the "Code"). There can be several benefits to grantor trust status, thus practitioners often intentionally trigger it by utilizing one or more of the grantor trust powers.¹ Some of the interests and powers lend themselves to creating an intentional grantor trust better than others because of the specific outcomes of their application and likelihood of negative estate tax consequences.

Section 677 of the Code provides that the grantor of a trust is deemed to own, and is therefore taxable on, any trust or portion thereof whose income is or may be, in the discretion of the grantor, the grantor's spouse² and/or any nonadverse person without the consent or approval of an adverse party, either:

- a. distributed, actually or constructively, to the grantor or grantor's spouse;³
- b. accumulated for future distribution to the grantor or grantor's spouse;⁴
- c. 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;⁵ or
- d. 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.⁶

¹ Such benefits include avoiding the use of trust assets to pay taxes thereby leaving them to grow tax free and allowing the grantor to remove additional assets from his or her estate without gift tax liability; enabling a tax free sale between the grantor and the trust since the sale is viewed as a sale from the grantor to himself or herself, etc.

² For transfers in trusts prior to October 10, 1969, § 677 causes the grantor to be taxed on income which is or may be distributed or accumulated for the grantor only; the 1969 Tax Reform Act revised § 677 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. §§ 1.677(a)-1(b)(1) and (2).

³ I.R.C. § 677(a)(1).

⁴ *Id.* § 677(a)(2).

⁵ *Id.* § 677(a)(3).

⁶ *Id.* § 677(b).

II. Definitions Relevant to Section 677

- a. **What is Income?** The regulations under Sections 671⁷ and 677 indicate that the reference to “income” in Section 677 means “taxable income.” Specifically, the two examples under Treasury Regulation Section 1.677(a)-1(g) provide that if a trust document states a grantor is entitled to mandatory or discretionary distributions of ordinary income, the grantor is taxable on items allocated to income under local trust law but not items allocable to trust principal;⁸ additionally, if a trust’s terms provide that a grantor retains a reversionary interest in the trust while a third party receives the trust’s ordinary income then the grantor is taxable on capital gains and other items of income allocable to principal under local law.⁹
- b. **Who is a Spouse?** Under Section 677(a), the grantor is treated as the owner of a portion of a trust when its income is, or may be, distributed or accumulated for future distribution to the grantor’s spouse or applied to the payment of premiums for insurance on the spouse’s life, *solely during the period of the marriage of the grantor to a beneficiary*.¹⁰ Thus, if the grantor and the spouse divorce, it would seem the grantor ceases to be taxable as the trust’s owner under Section 677(a) for income distributions or accumulations that benefit the former spouse.
 - i. But, Section 672(e) of the Code treats a grantor as holding any power or interest his or her spouse holds, based on the marital relationship when the power or interest is created (or for the period after the marriage if the marriage occurs after the power was created), *and without regard to any subsequent dissolution*. Thus, how does Section 672(e) affect the tax treatment of a grantor who creates a trust whose beneficiaries include his or her spouse, thereby invoking Section 677(a), and the grantor and spouse subsequently divorce? Under Section 672(e), it would seem the grantor would remain taxable.¹¹
 - ii. The IRS, however, seems to view Section 682 of Code as trumping Section 672(e). Section 682 governs the taxation of trusts that are established prior to a couple’s divorce and continue to make payments to the former spouse. It provides that the gross income of a spouse who is divorced or legally separated from the grantor spouse under a written separation agreement must include the

⁷ Treas. Reg. § 1.671-2(b) provides “[w]hen it is stated in the regulations under subpart E that “income” is attributed to the grantor or another person, the reference, unless specifically limited, is to income determined for tax purposes and not to income for trust accounting purposes. When it is intended to emphasize that income for trust accounting purposes (determined in accordance with the provisions set forth in §1.643(b)-1)) is meant, the phrase “ordinary income” is used.”

⁸ *Id.* § 1.677(a)-1(g), Ex. 1.

⁹ *Id.* § 1.677(a)-1(g), Ex. 2; *see also*, Amy E. Heller, *Grantor Trusts: Income Tax Rules of Subpart E*, outline provided for presentation at ABA Real Property, Probate & Trust Law Conference (April 27, 2007).

¹⁰ *Id.* § 1.677(a)-1(b)(2).

¹¹ The inclusion of grantor’s spouse under § 677 was added under the Tax Reform Act of 1969; § 672(e) spousal attribution rules were added to the Code by the Tax Reform Act of 1986.

amount of the income of any trust which he or she is entitled to receive and which, without the application of Section 682, would be taxable to the grantor spouse.

- iii. Treasury Regulation Section 1.677(a)-1(b)(2) specifically provides that Section 677 does not apply when the income of a trust is taxable to the grantor's spouse under Section 682 or Section 71 (relating to alimony and separate maintenance payments). Moreover, Treasury Regulation Section 1.1361-1(k)(1), Ex. 10(ii), states that where the grantor is the deemed owner of an inter vivos qualified terminable interest property (QTIP) trust, if the couple divorces, the grantor ceases to own the trust under Section 677 because of the application of Section 682.¹²

- c. **Who is an Adverse Party?** In the context of Section 677, the determination as to whether a person is an "adverse party" with respect to a trust is important for two reasons: first, if a "nonadverse party" may distribute or accumulate trust income for the benefit of the grantor or grantor's spouse without appropriate consent or approval, the trust or the portion thereof to which the nonadverse party's power relates will be considered as owned by the grantor; and second, if the power to distribute or accumulate trust income for the benefit of the grantor or grantor's spouse is conditioned upon the consent or approval of an "adverse party," then such power, regardless of who holds it, will not cause grantor trust status under Section 677.

- i. The Code and the accompanying regulations define and discuss "adverse party" and "nonadverse party."
- ii. Section 672(b) provides that a "nonadverse party" is simply any person who is not an adverse party.
- iii. Section 672(a) provides that an "adverse party" is an individual who has:
 - A. A power with respect to the trust;
 - B. A substantial beneficial interest in the trust; and
 - C. Such interest would be adversely affected by the exercise or nonexercise of such power the person possesses with respect to the trust.¹³

If any of these three prongs is not satisfied, the person will not be an adverse party, but rather will be a nonadverse party.¹⁴

¹² ROBERT T. DANFORTH & HOWARD M. ZARITSKY, 819 T.M., *Grantor Trusts: Income Taxation Under Subpart E*, at IX.A.4 (2010).

¹³ Treas. Reg. § 1.672(a)-1(a); see also M. CARR FERGUSON, JAMES J. FREELAND & MARK L. ASCHER, *FEDERAL INCOME TAXATION OF ESTATES, TRUSTS AND BENEFICIARIES* § 10.10 (3d ed. 1998).

1. *A Power With Respect to the Trust*: Whether a person has a power with respect to a trust should be relatively easy to determine from the terms of the trust document.
 - a. Note that a trustee will not be an adverse party solely due to his or her trustee powers over the trust.¹⁵ If, however, a trustee has a substantial interest in the trust (defined and discussed below), which would be adversely affected by the exercise or nonexercise of one of the trustee's powers, he or she could be an adverse party.¹⁶
2. *Substantial Beneficial Interest*: A party's interest in a trust is a "substantial interest" if the total value of the party's interest in the trust in relation to the total value of the property subject to the power is not insignificant.¹⁷ This is largely a factual question that must be determined on a case by case basis, as some interests in a trust may be so contingent or remote that they are insignificant and thereby cause the interest holder to be nonadverse.¹⁸
 - a. For example, in *Holt v. United States*, the 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. Consequently, the grantor's parents were nonadverse parties.¹⁹
 - b. In *Chase National Bank v. Commissioner*, the Eighth Circuit found that where a remainder beneficiary would take under a trust only if the grantor's two children and their issue died before reaching age 35 (at which age the trust was supposed to terminate and distribute outright to such child or issue), the remainder beneficiary did not have a substantial interest in the trust. The Court noted that when the trust was created, the remainder beneficiary was 54 years old, and the grantor's

¹⁴ A person with a general power of appointment over a trust undoubtedly has a beneficial interest in a trust, as § 672(a) specifically provides so.

¹⁵ Treas. Reg. § 1.672(a)-1(a).

¹⁶ See, e.g., *Paxton v. Comm'r*, 44 T.C.M. 771 (1982) (the trustee's interest was adverse where he had discretion to distribute any amount of the trust income to himself and/or the grantors; if he were to exercise his income distribution power in favor of the grantors, it would deprive him of what he could distribute to himself).

¹⁷ Treas. Reg. § 1.672(a)-1(a).

¹⁸ See *D.G. McDonald Trust v. Comm'r*, 19 T.C. 672, 690 (1953).

¹⁹ 699 F. Supp. 751, 752 (W.D. Va. 1987), *aff'd mem.*, 842 F.2d 1291 (4th Cir. 1988).

children were 29 and 18, each being married and having a child either at the time the trust was created or soon thereafter.²⁰ Thus, the remainder beneficiary was a nonadverse party.

- c. The Tax Court held in *Water Resource Control v. Commissioner*, that a trust's income beneficiary was a nonadverse party because she did not have a substantial interest in the trust where the trustees had no obligation to make any income payments to her and her right to income could be unilaterally terminated by the trustees.²¹

- 3. *Adverse Interest*: Whether a person's interest in trust is adverse to the exercise or non-exercise of a power held by such person depends upon the power and interest. Thus, like the determination of a substantial beneficial interest, whether a particular person's interest in a trust, regardless of size, is of an adverse nature must be determined under the facts of each case.²²

- a. Treasury Regulation Section 1.672(a)-1 provides several examples that help illustrate how to determine if a person has an interest that would be adversely affected by the exercise or nonexercise of the person's power.
- b. If a beneficiary has an interest in both a trust's income and principal, he or she could be adverse if he or she has a power that affects the entire trust.

For instance, in the context of Section 677(a), if a nonadverse trustee is granted the discretion to distribute trust income or accumulated income to the grantor's spouse, but only with the consent of the grantor's son, who is entitled to all trust income not distributed to the spouse as well as the trust's principal and accumulated income after a set term of years, then the grantor's son would be adverse with respect to the trust's income and principal. If the grantor's son consented to a distribution of income or accumulated income to the grantor's spouse, there would be less income or principal distributable to the grantor's son and thus he would be

²⁰ 225 F.2d 621, 627 (8th Cir. 1955), *cert. denied*, 350 U.S. 965 (1956).

²¹ 61 T.C. 2102, 2117-2118 (1991), *aff'd mem. sub nom. Whitehouse v. Comm'r*, 972 F.2d 1328 (2d Cir. 1992), *cert. denied*, 507 U.S. 960 (1993).

²² See *Paxton v. Comm'r*, 57 T.C. 627, 631 (1972), *aff'd* 520 F.2d 923 (9th Cir. 1975), *cert denied*, 423 U.S. 1016 (1976).

adversely affected (hence the grantor would not be taxed on any income or accumulated income under Section 677(a)).²³

- c. A remainderman's interest in a trust is adverse to the exercise of any power over the principal of the trust, but not to the exercise of a power over any income interest preceding his or her remainder.

For example, if the grantor creates a trust which provides for income to be distributed to grantor's son for 10 years and then for the corpus to go to grantor's daughter if she is then living, a power exercisable by grantor's daughter to revest corpus in the grantor is a power exercisable by an adverse party; however, a power exercisable by grantor's daughter to distribute part or all of the ordinary income to the grantor may be a power exercisable by a nonadverse party since grantor's daughter has no interest in the trust's income (this would cause the ordinary income to be taxed to the grantor).²⁴

- d. Similarly, the interest of an ordinary income beneficiary of a trust may or may not be adverse with respect to the exercise of a power over corpus.

If the income of a trust is payable to grantor's daughter for life and she has a limited power of appointment to appoint the principal to the grantor either *during her life* or by will, then her interest is adverse to the return of the principal to the grantor *during her life*, but is not adverse to a return of the principal after her death. In other words, grantor's daughter's interest is adverse as to ordinary income but is not adverse as to income allocable to principal (thus, the grantor would not be taxable on the ordinary income of the trust, but would be taxable under Section 677 on income allocable to principal, since it may in the discretion of a nonadverse party be accumulated for future distribution to the grantor).²⁵

²³ Treas. Reg. § 1.672(a)-1.

²⁴ *Id.* § 1.672(a)-1(d).

²⁵ *Id.* § 1.672(a)-1(c).

- e. Or, if a beneficiary has an interest in only a portion of a trust's income or principal, he or she may be adverse with respect to only that part.

Thus, if A, B, C, and D are equal income beneficiaries of a trust and the trustee can distribute income to the grantor with A's consent. A's interest is adverse only with respect to A's own interest – not B's, C's and D's interest – because only A's income interest would be adversely affected by allowing the trustee to distribute trust income to the grantor (the grantor would therefore be treated as the owner of a portion which represents three-fourths of the trust under Section 677(a)).²⁶

III. Section 677(a)(1): Income Distributed to or on behalf of the Grantor or Grantor's Spouse

a. Generally.

- i. Section 677(a)(1) provides that a grantor will be treated as owner of any portion of a trust whose income is, or may be in the discretion of the grantor, the grantor's spouse and/or a nonadverse party, currently distributed to or on behalf of the grantor or grantor's spouse without the consent of an adverse party.
- ii. This section obviously applies when the grantor or the grantor's spouse is entitled to, or can demand, trust income, but it also applies when a nonadverse trustee has the discretion to distribute trust income to either without the consent of an adverse party. Thus, the mere possibility that the grantor or the grantor's spouse will receive trust income is sufficient to trigger the application of Section 677(a)(1) such that the grantor will be taxed on all the income that could be so distributed, regardless of whether distributions are actually made. Consequently, the grantor can be taxed on trust income even though the distributions are made to another beneficiary.²⁷

b. Consequence of Contingent Right to Income Distributions?

- i. It would seem that Section 677(a)(1) even captures income payable to or for the benefit of the grantor or grantor's spouse upon the occurrence of potentially remote specified contingencies – such as a medical emergency, disability or bankruptcy – since such income “may be” distributed to the grantor or spouse if the contingency occurs.

²⁶ Treas. Reg. § 1.672(a)-1(b).

²⁷ See HOWARD M. ZARITSKY, NORMAN LANE & ROBERT T. DANFORTH, FEDERAL INCOME TAXATION OF ESTATES AND TRUSTS ¶ 10.03[2][a] (3d ed. 2001).

- ii. There are, however, no cases on point confirming or rejecting this notion. But, the Section 677 regulations do seem to support it, stating that a grantor is treated as owner of a portion of the trust property “if he has retained *any interest which might*, without the approval or consent of an adverse party, enable him to have the income from that portion, distributed to him *at some time*” (emphasis added).²⁸ While it is true that it would be difficult to determine what amount of trust income would be distributable for such a contingent purpose and thus the amount on which the grantor should be taxed, arguably, if there is no limitation on the amount of income that could be distributed upon the occurrence of such contingency, then the grantor should be taxed on the entire amount of the trust’s income.²⁹

c. Income Constructively Distributed on Behalf of Grantor or Grantor’s Spouse.

- i. In applying Section 677(a)(1), income is treated as distributed to a grantor or grantor’s spouse not only if it is paid or payable directly to one of them but also if it is paid to another person on the behalf of either of them pursuant to his or her instructions.³⁰
- ii. Thus, the use of trust income to discharge a legal obligation of the grantor or grantor’s spouse (other than the obligation of support, which falls under the provision of Section 677(b) discussed in Section VII, below), without the consent of an adverse party, is equivalent to the payment of that income to the grantor or the grantor’s spouse. Consequently, under Section 677(a), the grantor owns any portion of trust income that is or may be used to discharge such obligations.³¹

d. Trust Authorization for Income Distribution Not Required to Trigger Section 677.
Section 677 also applies to trusts that actually distribute income to the grantor, even if those distributions are not authorized by the terms of the trust instrument.³²

²⁸ ZARITSKY ET AL., *supra* note 27, at ¶ 10.03[3]; Treas. Reg. § 1.677(a)-1(c).

²⁹ See HOWARD M. ZARITSKY, *Open Issues and Close Calls – Using Grantor Trust in Modern Estate Planning*, ¶ II.D.3, outline provided for webcast (March 2009).

³⁰ Treas. Reg. § 1.677(a)-1(c) (fourth sentence).

³¹ *Id.* § 1.677(a)-1(d); see, e.g., Rev. Rul. 75-257, 1975-2 CB 251 (although the trust did not provide that the trustees had the power to distribute income to the grantor, under the authority inherent in the instrument, the trustees exercised the power to distribute income to the grantor by discharging certain of his obligations for housing and health care and therefore the grantor was the owner of the trust under § 677).

³² ZARITSKY ET AL., *supra* note 27, at ¶ 10.03, citing *United States v. Rosales*, 7 Fed. Appx. 766, 2001 WL 371920, 88 AFTR2d 2001-5370, 2001-1 USTC ¶ 50,397 (9th Cir. 2001), a not-officially-published opinion affirming a criminal tax fraud conviction based on the grantor’s failure to report income distributed to herself or her then spouse, even though the instrument required distribution of income to the grantor’s children; see also, Rev. Rul. 75-257, 1975-2 CB 251.

IV. Section 677(a)(2): Income Accumulated for Future Distribution to Grantor or Grantor's Spouse

- a. Section 677(a)(2) provides that a grantor will be treated as owner of any portion of a trust whose income is, or may be in the discretion of the grantor, grantor's spouse and/or a nonadverse party, currently accumulated for future distribution to the grantor or the grantor's spouse, without an adverse party's consent.
- b. In other words, if items of income are added to principal, either as accumulations made per the trust's terms, trustee's discretion or because of local law (e.g., capital gains allocable to principal), and if there is 1) a reversion to the grantor or a remainder to the grantor's spouse at any time or upon the occurrence of an event, 2) discretion in the trustee to distribute accumulated income to the grantor or grantor's spouse at any time, or 3) any power in the grantor or grantor's spouse to reach the accumulated income at any time, the grantor will be treated as the owner of the income that may be so accumulated.³³
 - i. For example, if trust income (including capital gains) is to be accumulated for 10 years and then will, or may in the discretion of the grantor, grantor's spouse and/or a nonadverse party, be distributed to the grantor or his spouse, the trust is a wholly owned grantor trust as of its inception, despite that the income is not distributable until years later.³⁴ If instead the trust distributes ordinary income to an income beneficiary for 10 years and then will, or may in the discretion of the grantor, grantor's spouse and/or a nonadverse party, distribute outright to the grantor or his spouse, then the grantor is taxable only on the items of income allocable to principal as of the trust's inception.
- c. This is the case despite that the grantor or the grantor's spouse has no current benefit from or access to the accumulated income. The grantor is taxed on the income in the year in which it is or could be accumulated for the benefit of the grantor or the grantor's spouse, even though it may never actually be distributed to either.³⁵

V. Exception to Section 677(a): Deferred Right to Distributions or Accumulations

- a. The final sentence of Section 677(a) provides that the general rule of Section 677(a) does not apply to cause a grantor to be taxable on trust income when a *discretionary* power to apply income for the benefit of the grantor or the grantor's spouse may occur only after a period of time which would not cause the grantor to be treated as an owner under Section 673³⁶ if the discretionary power were a reversionary interest.³⁷

³³ JEFFERY N. PENNELL & A. JAMES CASNER, ESTATE PLANNING § 5.11.4 (6th ed. 2003)

³⁴ Treas. Reg. § 1.677(a)-1(f) (third sentence).

³⁵ ZARITSKY ET AL., *supra* note 27, at ¶ 10.04[1].

³⁶ § 673 of the Code provides that the grantor of a trust will be treated as the owner of any portion of a trust in which he has a reversionary interest in either the principal or the income therefrom, if, as of the inception of that portion of

- i. For example, Grantor creates a trust for the benefit of his granddaughter. The trust's ordinary income is to be distributed to the granddaughter for 40 years, after which, in the *discretion* of the nonadverse trustee, ordinary income may be paid to grantor or his granddaughter. So long as the Section 7520 rate was at least 7.8% at the time the trust was created, a reversionary interest after 40 years would be less than 5% of the trust principal. Consequently, Section 677(a) is inapplicable and so Grantor will not be taxed as the owner of the ordinary income during the initial period. However, after the 40 years has run, Grantor will be treated as the owner of the trust's income.³⁸
- b. Note, however, that in any year in which income is accumulated for future distribution to the grantor or grantor's spouse, this exception to Section 677(a) will not apply just because the grantor or the grantor's spouse must wait for a certain period of time before he or she can receive the accumulated income, even if the deferral period is sufficient to avoid the application of Section 673.³⁹
 - i. Thus, if a trust requires that capital gains be accumulated for 15 years and then distributed to the grantor's spouse, the grantor will be taxed on the gains in the year earned, even if the spouse's reversionary interest in the gains is less than 5% of the trust's value at inception.⁴⁰

VI. Section 677(a)(3): Income Applied to Pay Premiums on Life Insurance Policies on the Life of the Grantor or Grantor's Spouse.

- a. **Generally.** Section 677(a)(3) provides that the grantor of a trust is treated as the owner of any portion thereof the income from which is, or may be in the discretion of the grantor, grantor's spouse or a nonadverse party, without the consent or approval of an adverse party, applied to pay premiums on life insurance policies on the grantor or grantor's spouse. This section does not apply, however, where the insurance proceeds are irrevocably payable for a charitable purpose specified in Section 170(c).⁴¹
- b. **On What Portion of Income is the Grantor Taxed?**
 - i. It is clear from the face of the statute that any income actually used to pay premiums on life insurance policies on the life of the grantor or grantor's spouse is taxable to the grantor.

the trust, the value of such interest exceeds 5% of the value of such portion. The value of a reversionary interest is determined with tables based on an interest rate equal to 120% of the federal midterm rate for the month in which the transfer is made.

³⁷ Treas. Reg. § 1.677(a)-1(e).

³⁸ DANFORTH ET AL., *supra* note 12, at IX.C.

³⁹ *Id.*

⁴⁰ *Id.*

⁴¹ See ZARITSKY ET AL., *supra* note 27, at ¶ 10.05[1], for a discussion regarding the definition of "life insurance."

- ii. It would also seem from the literal language of the statute that the mere ability to use any trust income to pay premiums on such life insurance policies would cause the grantor to be treated as the owner of any and all income which could be so used. If this were true, not prohibiting a trustee from making such payments would seem to trigger grantor trust status with respect to the trust's income (unless of course the trustee is adverse or could pay such premiums only with the consent of an adverse party). However, practitioners often rely on case law, much of which is based on the predecessor section to 677(a)(3) (Section 167(a)(3), whose language differs only slightly⁴²) to limit the consequences of this literal interpretation.
- A. For instance, in *Corning v. Commissioner*, the court held the grantor would not be taxed merely because the trust granted the trustee the power to purchase and pay life insurance premiums when the trust did not actually own any such policies.⁴³ Similarly, a series of cases from the late 30's - early 40's (to which the IRS acquiesced) held that the grantor was only taxable to the extent of the income actually used to pay premiums, not on all of the income that could have been so used.⁴⁴
- B. Additionally, a 1966 Revenue Ruling published after the enactment of Section 677(a)(3) essentially as it is written today held that "the grantor will be considered the owner under Section 677(a) of the Internal Revenue Code of 1954 of the amount of the trust income which is used to pay the premiums on these policies of insurance on [the grantor's] life."⁴⁵ This Revenue Ruling also cites two cases based on predecessor Section 167(a)(3), which both held that a grantor is taxable only on the amount of trust income used to pay premiums on life insurance policies, thereby buttressing reliance on the precedent of the early case law.
- C. The more recent IRS guidance on Section 677(a)(3), however, is inconsistent and thus unfortunately not very informative.

⁴² The predecessor section to § 677(a)(3) was § 167(a)(3), which was identical in both the 1939 and 1924 Codes; this section provided "[w]here any part of the income of a trust...is, or...may be, applied to the payment of premiums upon policies of insurance on the life of the grantor...then *such part of the income* of the trust shall be included in computing the net income of the grantor." The greatest change between § 167(a)(3) and § 677(a)(3) (made under the 1954 Code) is the replacement of "such part of the income" with language treating the grantor as the owner of "any portion of a trust" whose income may be applied to pay life insurance premiums on policies on the grantor's or the grantor's spouse's life. While this change in language seems to broaden the application of the provision, Howard Zaritsky proffers that more likely the change in language was consistent with the same change of terminology in every other section of the grantor trust rules made by Congress in 1954. See HOWARD M. ZARITSKY, TAX PLANNING FOR FAMILY WEALTH TRANSFERS: ANALYSIS WITH FORMS ¶ 12.07[3][a][v] (3d ed. 2002).

⁴³ 104 F.2d 329 (6th Cir. 1939).

⁴⁴ See, e.g., *Iversen v. Comm'r*, 3 T.C. 756 (1944); *Weil v. Comm'r*, 3 T.C. 579 (1944), *acq.*, 1944 C.B. 29; *Rand v. Comm'r*, 40 B.T.A. 233, (1939), *acq.*, 1939-2 C.B. 30, *aff'd*, 116 F.2d 929 (8th Cir. 1941), *cert. denied*, 313 U.S. 594 (1941); and *Moore v. Comm'r*, 39 B.T.A. 808, (1939), *acq.*, 1939-2 C.B. 25.

⁴⁵ Rev. Rul. 66-313, 1966-2 CB 245.

1. For instance, several Private Letter Rulings hold that the mere power of a nonadverse trustee to cause trust income to be used to purchase and/or service life insurance policies on the life of the grantor creates a wholly owned grantor trust, regardless of whether the trustee has exercised, or will exercise, such power.⁴⁶
2. Yet other Private Letter Rulings provide that a trust is a grantor trust with respect to the entire trust where the entire income was actually used to pay premiums⁴⁷ or only with respect to the portion of the trust income actually used to pay premiums.⁴⁸
3. Most recently, in Field Attorney Advice Memorandum 20062701F the IRS, in reviewing a trust which was part of a “tax avoidance arrangement ... designed to save taxes and transfer assets offshore”, stated that because the trustee was not limited in the amount of income which could be used to pay premiums on insurance on the life of the grantor, the entire trust was a grantor trust regardless of whether a policy was actually acquired by the trust.⁴⁹

D. Hence, most practitioners are more comfortable relying on Revenue Ruling 66-313 and the case law under the predecessor section to Section 677(a)(3) for purposes of determining what portion of a trust will be a grantor trust when trust income may be or is used to pay premiums on life insurance policies on the life of the grantor or grantor’s spouse.⁵⁰

⁴⁶ See, e.g., Priv. Ltr. Rul. 8852003 (Aug. 31, 1988) (trustee’s power to purchase life insurance policies for grantor is power which, under § 677(a)(3), would cause trusts to be treated as owned entirely by grantor); Priv. Ltr. Rul. 8126047 (Mar. 31, 1981) (since trustee could apply trust income or principal if necessary to pay premiums of policies initially funding trust, grantor is treated as owner of entire trust); Priv. Ltr. Rul. 8118051 (Feb. 9, 1981) (same); and Priv. Ltr. Rul. 8103074 (Oct. 23, 1980) (grantor treated as owner of trust for income tax purposes because the trust permitted the trustee to apply trust income to pay premiums on insurance policy on grantor’s life).

⁴⁷ See, e.g., Priv. Ltr. Rul. 8839008 (Sept. 30, 1988) (although trusts provided that trust income shall not be used to pay insurance premiums for policies on the life of any grantor, trustees paid premiums with a single payment thereby causing the trusts to be a grantor trust for that year to the extent of the income actually so used (which was all of it) despite the violation of the trust instrument); Priv. Ltr. Rul. 8014078 (Jan. 10, 1980) (trust agreement provided that the premiums on the life insurance policies on the life of the grantor shall be paid first from net income of the trust, then from accumulated income from the trust, and then from the principal of the trust; therefore, the grantor will be treated as owner of the entire trust); Priv. Ltr. Rul. 8007080 (Nov. 26, 1979) (same).

⁴⁸ See, e.g., Priv. Ltr. Rul. 6406221750A (June 22, 1964) (trust provided that funds may be applied to pay premiums of insurance policies on grantor’s life, therefore, under § 677(a)(3), grantor is taxable on such part of the trust income that is or may be applied to the payment of such premiums); and Priv. Ltr. Rul. 5603015410A (Mar. 1, 1956) (trust income used to pay premiums on insurance policies should be included in computing the grantor’s net income for 1952 and 1953, under § 167(a)(3) of the 1939 Code, and he is considered the owner of that portion of the trust and taxable on the income therefrom for years 1954 and 1955, under § 677(a)(3) of the 1954 Code).

⁴⁹ I.R.S. Field Att’y Advice Mem. 20062701F (July 7, 2006).

⁵⁰ DANFORTH ET AL., *supra* note 12, at XII.E.5.

1. As such, if one wants to intentionally create a wholly owned grantor trust, it would be wise not to rely on a right to pay premiums on such life insurance policies to do so, as such structure will seemingly only cause grantor trust status with respect to the portion of trust income actually used for such payments.⁵¹
- c. **Funds Other Than Income Used by Trustee to Pay Insurance Premiums.** If the trustee uses sources of funds other than trust income to pay insurance premiums, such as principal or loan proceeds, the grantor may not be taxable.⁵²
- d. **Grantor Trust Status When Premiums Paid by Trust Beneficiaries.** Section 677(a)(3) can also cause the grantor to be taxable on trust income when life insurance premiums on policies held on the grantor's or grantor's spouse's life are paid by someone other than the trustee if the person paying the premiums is apparently using trust income to make payments as agent for the grantor or trustee.⁵³

VII. Section 677(b): Income Applied or Distributed in Satisfaction of the Grantor's or Grantor's Spouse's Legal Obligation of Support for a Trust Beneficiary

- a. **Generally.** Under Section 677(b), income of a trust is not taxable to the grantor merely because trust income may, in the discretion of another person or the grantor acting as trustee or co-trustee, be distributed or applied for the support or maintenance of a trust beneficiary whom the grantor or the grantor's spouse is legally obligated to support or maintain (other than the grantor's spouse).⁵⁴ However, any trust income that actually is distributed or applied to satisfy the grantor's or grantor's spouse's legal obligation of support for a trust beneficiary will cause the grantor to be taxed on such income under Section 677(a).⁵⁵
 - i. This statutory exception to Section 677(a) allows for trusts often created by parents for the benefit of their children, which provide that income is accumulated for the benefit of the children until a specific event occurs, such as

⁵¹ STEPHEN R. AKERS, JONATHAN G. BLATTMACHR & F. LADSON BOYLE, CREATING INTENTIONAL GRANTOR TRUSTS, 44 REAL PROP., PROB. & TR. J. 265 (Summer 2009).

⁵² *Chandler v. Comm'r*, 41 B.T.A. 165 (1940), *aff's without discussion on this point*, 119 F.2d 623 (3d Cir. 1941) (grantor not taxable when trustee used nontaxable insurance dividends and principal contributions to pay premiums).

⁵³ ZARITSKY ET AL., *supra* note 27, at ¶ 10.05[4], *comparing Dunning v. Comm'r*, 36 B.T.A. 1222 (1937), *nonacq.* 1938-1 CB 40, *app. dismissed*, 97 F.2d 999 (4th Cir. 1941) (where trust income is payable to grantor's wife and trusts did not require that she expend the income in any way but, at suggestion of grantor, she applied part of the income from the trust to fully pay premiums on life insurance policies on grantor's life, such income was taxable to the grantor under the terms of § 167(a)(3)), *with Booth v. Comm'r*, 3 T.C. 605 (1944) (income from trust created by grantor for his wife and applied by her without his direction or control to payment of insurance premiums on his life held not taxable to grantor under § 167(a)(3)).

⁵⁴ Although there is no mention of the support obligation of a grantor's spouse in § 677(b), it is incorporated into the code by Treasury Regulation § 1.677-(b)1.

⁵⁵ Treas. Reg. § 1.677(b)-1(a).

reaching the age of majority or getting married, but may be distributed for current support in the trustee's discretion (for example, Section 2503(c) trusts). By virtue of Section 677(b), the grantor is taxed only if, and to the extent that, trust income is actually applied or distributed to satisfy the grantor's or grantor's spouse's legal obligation to support or maintain the beneficiary.⁵⁶

b. **Income Distributed in Satisfaction of Nonsupport Legal Obligations.** As mentioned above (see Section III.c), the discretion of a nonadverse trustee to use trust income to discharge any legal obligation of the grantor or grantor's spouse other than support or maintenance without the consent of an adverse party can cause grantor trust status with respect to the entire trust under Section 677(a), even if such a distribution is never made, because Section 677(b) will not apply to protect such unexercised power.

- i. Section 1.677(b)-1(d) provides, in part, that the exception provided in Section 677(b) relates solely to the satisfaction of the grantor's legal obligation to support or maintain a beneficiary. Consequently, the general rule of Section 677(a) is applicable when, in the discretion of the grantor or nonadverse party, income of a trust is or may be applied in discharge of a grantor's obligations other than his obligation of support or maintenance falling within Section 677(b). Thus, if the grantor creates a trust the income of which may in the discretion of a nonadverse party be applied to the payment of the grantor's debts, such as the payment of his rent or other household expenses, he is treated as the owner of the trust regardless of whether the income is actually so applied.
- ii. For example, in Revenue Ruling 75-257,⁵⁷ the IRS held that although the trust instrument did not specifically provide that the trustees had the power to distribute income to the grantor, under the authority inherent in the instrument, the trustees exercised the power to distribute income to the grantor by discharging certain of his obligations for housing and health care. Therefore, the grantor was the owner of the trust under Section 677.
- iii. As with an actual distribution in satisfaction of a support obligation, actual use of trust income to discharge a nonsupport obligation of either the grantor or grantor's spouse will constitute a constructive distribution to the grantor or the grantor's spouse, which will cause the grantor to be taxed under Section 677.⁵⁸ It will also likely raise estate tax concerns under Section 2036 and/or Section 2038 (discussed below in Section X.b).

c. **Discretionary v. Mandatory Distributions in Satisfaction of Support Obligation.** Section 677(b) will not prevent the application of Section 677(a) if a nonadverse trustee is required, as opposed to having the discretion, to distribute trust income for the support

⁵⁶ BORIS I. BITTKER, MARTIN J. MCMAHON, JR. & LAWRENCE A. ZELENAK, *FEDERAL INCOME TAXATION OF INDIVIDUALS* ¶ 38.04 (3d ed. 2002)

⁵⁷ 1975-2 CB 251.

⁵⁸ Treas. Reg. § 1.677(b)-1(d)

or maintenance of someone the grantor or grantor's spouse is legally required to support.⁵⁹ The grantor will be taxed under Section 677(a) on any trust income that is required to be paid and applied as well as any additional amounts that are actually paid or applied to satisfy the grantor's support obligation.

- i. Again, it is important to note that the requirement that trust assets be used to satisfy the grantor's obligation of support would cause the assets of the trust to be included in the grantor's estate under the provisions of Section 2036 and/or Section 2038.

d. **Use of Trust Income v. Principal in Satisfaction of Support Obligation.** Section 677(b) will also be inapplicable if the nonadverse trustee may use trust principal or accumulated income to satisfy the grantor's or grantor's spouse's legal obligation of support, as Section 677(b) applies only to potential distributions of trust income.⁶⁰ A distribution of trust principal or accumulated income made in satisfaction of the grantor's or the grantor's spouse's legal obligation of support will cause the grantor to be treated as a beneficiary of the trust and the amounts so applied are treated as an amount "paid or credited" for purposes of the trust's distribution deduction under Section 661(a)(2) and will be taxed to the grantor under Section 662.⁶¹

- i. The trust therefore can deduct such support payments to the extent of its distributable net income (DNI) and the grantor will be taxable on the income to the extent of the grantor's share of DNI.⁶²
- ii. In any year in which there is a distribution made for the support of the grantor's dependent, the income of the trust is deemed to be distributed first, regardless of when the income is received. For example, if in 2011 a trust makes a \$10,000 distribution for the support of the grantor's dependent and later receives \$5,000 in dividends and \$1,000 in expenses, the grantor will be taxed on \$4,000 of ordinary income and \$6,000 of principal. According to Treasury Regulation Sections 1.677(b)-1(b) and (c), this may mean that the grantor will be taxed on an accumulation distribution under Section 665 et seq. (the "throwback rules"⁶³); however, since the Taxpayer Relief Act of 1997, the throwback rules are no longer applicable to almost all domestic trusts making distributions after August 5, 1997.

e. **What are Payments for "Support and Maintenance"?** For purposes of Section 677(b), the pertinent question is whether a payment by a trust satisfies the grantor's or

⁵⁹ Treas. Reg. § 1.677(b)-1(f).

⁶⁰ *Id.* § 1.677(b)-1(b).

⁶¹ *Id.*

⁶² DANFORTH ET AL., *supra* note 12, at IX.E.

⁶³ Generally, under the throwback rules, a beneficiary receiving a distribution of accumulated income is taxed as if the trust had made the distribution in the year it accumulated the income.

grantor's spouse's legal obligation of support and maintenance. The existence of a legal support obligation is a matter of state law, and thus one will need to review the law of the state in which the grantor or the grantor's spouse is domiciled to make a determination. When making this determination, there are generally two points to consider:

- i. Who must be supported? Parents generally have a legal obligation to support and maintain their children while the children are under the age of majority – most commonly, age 18.⁶⁴ In some states, this support obligation can extend past the age of majority. Also, some states provide that adult children have a legal obligation to support disabled or indigent parents.
- ii. What types of payments are legally obligated under a duty to support and maintain? Generally, payments for such items as food, shelter, clothing, medical and dental care, and education should be considered as payments made in satisfaction of a grantor's or grantor's spouse's legal obligation of support.⁶⁵
- iii. Often the greatest difficulty in defining support is determining whether “luxury” items, such as summer camp, private school or college tuition, are outside the scope of “support” for purposes of Section 677(b). When courts make a determination as to whether a “luxury” item falls under the support obligation, they tend to review the parents' financial situation; for example, in New Jersey and California, courts have held that where parents are financially capable of paying for college and/or secondary private school tuition for their children, such payments are part of a parent's support obligation and thus such payments from trusts caused the application of Section 677(a).⁶⁶
- iv. If there is no legal support obligation (and no power in the grantor or grantor's spouse to direct distributions), the grantor will not be taxed under Section 677(a) merely because a nonadverse trustee can distribute income to one of the grantor's dependents. Thus, a grantor will not be taxed on income paid to the grantor's

⁶⁴ Several states, for instance Arkansas and Ohio, provide that the age of majority is 18 or graduation from high school, whichever is later. Others, such as Alabama and Nebraska, provide that the age of majority is generally age 19; while the age of majority in Mississippi is 21. In the District of Columbia, Virginia and Maryland, the age of majority is 18.

⁶⁵ See I.R.C. § 151 and Treas. Reg. § 1.152-1(a)(2), which provide an income tax deduction to a taxpayer who provides a dependent (as such term is defined in the Code) with more than half of such dependent's “support”, which is stated to include, shelter, clothing, medical and dental care, education, and the like.

⁶⁶ See, e.g., *Stone v. Comm'r*, 54 T.C.M. 462 (1987) (use of trust income to pay the expenses of private school for the grantor's minor children constituted a constructive distribution to the grantor under § 677 because California law imposes an obligation on parents to support a child “in a style and condition consonant with the parent's financial ability and position in society” – considering the parents' earnings and earning capacity); *Braun v. Comm'r*, 48 T.C.M. 210 (1984) (New Jersey Supreme Court held that where the income from trusts created by the grantor was distributed to pay college tuition, room, and board for the grantor's emancipated children and private secondary school tuition for the grantor's minor children, the grantor was taxable on such income because state law holds that a financially capable parent can be required to pay college expenses of emancipated children).

children who, because of age or otherwise, the grantor is not legally required to support.⁶⁷

- A. So, if local law provides that there is no duty to support dependents who have sufficient resources of their own, a grantor's obligation to support or maintain a beneficiary is ignored for tax purposes as long as the dependent's resources are adequate.⁶⁸
- B. Or, if trust income can only be used to provide those whom the grantor is legally obligated to support (other than his or her wife) with items that are beyond the grantor's support obligation, the income is not taxed to the grantor under the general rule of Section 677(a).⁶⁹

VIII. Divestiture of Powers Triggering Section 677. If the grantor and/or the grantor's spouse has any interest in a trust that triggers grantor trust status under Section 677(a), they may avoid the application of the Section if they divest themselves "permanently and completely" of "every interest" that could cause the grantor to be taxable as the trust's owner under 677(a).⁷⁰ Divesting such an interest, however, can have more consequences than just terminating grantor trust status; for example, if a spouse divests an income interest in a trust, it could be a disqualified disclaimer and thus a taxable gift under Section 2518.

IX. Taxable Portion Under Section 677

- a. Section 677(a) provides that the grantor is treated as the owner of "any portion of a trust ... whose income" is or may be distributed to, or accumulated for, the benefit of the grantor or the grantor's spouse. The examples in Treasury Regulation § 1.677(a)-1(g) help clarify this rather ambiguous statement and indicate that a grantor who has only an income interest in the trust is taxable only on the ordinary income items, and the grantor who has only an interest in the principal of the trust is taxable only on capital items.
- b. For example:
 - i. Grantor creates an irrevocable trust and retains the right to all of the trust's ordinary income for life and upon his death the trust will continue for the benefit of his issue; Grantor has no interest in the trust's principal nor does he retain any other right or power that would cause him to be treated as an owner under Sections 671-677. Under local law, all capital gains are allocated to trust

⁶⁷ DANFORTH ET AL., *supra* note 12, at IX.E.

⁶⁸ BORIS I. BITTKER & LAWRENCE LOKKEN, *FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS* ¶ 80.4.4 (3d ed. 2005).

⁶⁹ *Id.*; see, e.g., *Brooke v. U.S.*, 468 F.2d 1155 (9th Cir. 1972) (under Montana law, payments for children's health, education, travel, and music, swimming and public-speaking lessons were not within a parent's support obligation).

⁷⁰ Treas. Reg. § 1.677(a)-(1)(c).

principal. Because Grantor is entitled to all the trust income, under Section 677(a) he owns the entire income interest. Thus, Grantor reports on his Form 1040 all items of income not allocable to principal (*e.g.*, dividend income, interest income, income expenses, etc). Grantor has no remainder interest in the trust so the trust must report on its Form 1041 any items of income allocable to principal, such capital gains or losses.⁷¹

- ii. Grantor creates a trust which provides that ordinary income is payable to his son for 10 years; thereafter the principal reverts to Grantor. Additionally, Grantor retains a discretionary right to receive \$5,000 of the trust's ordinary income each year. Grantor does not retain any other right or power that would cause him to be treated as an owner under Sections 671-677. Under local law, all capital gains are allocated to trust principal. Since capital gains are held or accumulated for future distribution to Grantor, he is taxed on any such gains under Section 677(a)(2). Additionally, because of Grantor's discretionary right to \$5,000 of trust ordinary income (whether exercised or not), Grantor is taxed on a percentage of the trust's ordinary income equal to the value of his income interest (*i.e.*, \$5,000) divided by the trust's distributable net income.

A. Thus, if the trust had dividends of \$10,000, capital gain of \$2,000; income expenses of \$400, and principal expenses of \$200, Grantor would be taxed on the \$2,000 in capital gain, \$5,208.33 of the dividends ($[\$5,000 / (\$10,000 - \$400)] \times \$10,000$) and \$208.33 of the income expenses ($[\$5,000 / (\$10,000 - \$400)] \times \400). He would also be able to take into account \$104.17 of the expenses allocable to principal when computing his income taxes ($[\$5,000 / (\$10,000 - \$400)] \times \200).⁷²

X. Estate, Gift and Generation Skipping Transfer Tax Implications of Section 677

a. Gift Tax Consequences of Transfers to Trusts in which the Grantor or Grantor's Spouse Retains a Section 677(a) Income Interest.

- i. Is it a Completed Gift? The gift tax will be imposed only on transfers in which the donor completely terminates dominion and control over the property. A transfer is thus not a taxable gift if the grantor retains any interest or power (exercisable alone or in conjunction with a nonadverse party) permitting the grantor to change the disposition of the gift, whether for the benefit of himself or someone else.⁷³ Thus, to determine if a gift is complete one must review the terms and effects of any powers or interests retained by the grantor.

A. For instance, if a grantor transfers assets to a trust and retains no other right than the right to receive trust income, only the gift of the remainder

⁷¹ Treas. Reg. § 1.677(a)-1(g), Ex. 1.

⁷² *Id.* § 1.677(a)-1(g), Ex. 2.

⁷³ *Id.* § 25.2511-2.

interest will be complete.⁷⁴ Likewise, if the grantor transfers assets to a trust and retains only a reversionary interest, the gift of the income interest will be complete.

B. Conversely, if the grantor transfers assets to a trust, naming his son as remainderman and retaining for himself the right to receive trust income as well as limited testamentary power of appointment over the trust principal, the gift of the remainder interest is incomplete because Grantor can alter who receives the trust principal. Similarly, if the grantor named his son as the net income beneficiary and retained for himself a reversionary interest as well as the right to demand that the trustee distribute trust income to himself, the gift of the income interest is incomplete.

C. Additionally, if the trustee retains a discretionary right to distribute trust income to the grantor, state law may allow the grantor's creditors to reach the maximum amount of income that the trustee could in its discretion pay to the grantor. The grantor could thus effectively enjoy all the trust income by relegating the creditors to the trust for settlement of their claims. Therefore, a gift to such trust would not be complete.⁷⁵

ii. How to Value a Completed Gift? Generally, the transfer of property to a trust is a taxable gift, even if the grantor retains the right to income distributions or grants the use of trust income for the benefit of the grantor's spouse; however, the retention of such interests can affect the amount of the gift. When valuing such a gift, one must first determine if the gift in trust is for the benefit of a third party or a family member.

A. *Gift in Trust to Unrelated Party:* Generally, when a grantor transfers property in trust to or for the benefit of an unrelated party and retains an interest therein, the value of the gift is the value of the property transferred less the value of the grantor's retained interest.⁷⁶ But if the grantor's retained interest cannot be measured using generally accepted valuation principles, the gift tax will probably be applicable to the entire value of the transferred property.⁷⁷ When valuing a gift to a trust in which the grantor has retained an interest, the value of any taxable gift is the fair market value of the interest given the donee on the date the transfer is completed. The fair market value of life estates, terms for years, remainders, and

⁷⁴ Treas. Reg. § 25.2511-2(e).

⁷⁵ See *Paolozzi v. Comm'r*, 23 T.C. 182 (1954), acq. 1962-1 C.B. 4 and Rev. Rul. 76-103, 1976-1 CB 293.

⁷⁶ Treas. Reg. § 25.2512-5T(d)(2).

⁷⁷ *Id.* § 25.2511-1(e); see also *Robinette v. Helvering*, 318 U.S. 184 (1943), 1943 C.B. 1141 (if a donor's reversionary interest is preceded by contingencies with respect to the disposition of the principal of a trust that render the reversionary interest incapable of valuation, the Supreme Court has held that the donor may not reduce the value of the gift by taking into account the donor's reversionary interest).

reversions is their present value determined under Section 2512 and its accompanying regulations.⁷⁸

B. *Gift in Trust to Family Member*: If the grantor transfers property in trust to or for the benefit of a member of the grantor's family while retaining an interest therein, the value of the gift is the value of the property transferred less the value of the grantor's retained interest as determined under Section 2702.

iii. Gift Valuation of Zero under Section 2702. Section 2702(a) of the Code deals generally with the valuation, for gift tax purposes, of an interest transferred in trust to or for the benefit of a member of the grantor's family where the grantor retains an interest in the trust. In valuing such interests, Section 2702 provides that the Treasury tables ordinarily used to value trust interests are disregarded, and retained interests are valued at **zero** unless they take a form comparable to an annuity (*i.e.*, a fixed dollar amount payable at least annually) or unitrust interest (*i.e.*, an amount payable at least annually equal to a fixed percentage of the trust's fair market value determined annually).

A. Specifically, Section 2702(a) applies if there is a transfer in trust to or for the benefit of a member of the grantor's family⁷⁹ and the grantor or an applicable family member⁸⁰ retains an interest in the trust. If the grantor creates for himself a term interest, such as a life estate or term-for-years, the regulations provide that any such interest held by the grantor after the transfer constitutes a retained interest, whether or not it was held by the grantor prior to the transfer.⁸¹ However, for purposes of determining whether the grantor retains an interest in a trust after a transfer, an interest created in a transferee by the grantor is not attributable to the grantor; thus, if a grantor transfers property to a trust granting an income interest to his or her spouse (and retaining no interest in the trust for the grantor), Section 2702 will not apply.⁸²

⁷⁸ See Treas. Reg. § 25.2512-5T(d).

⁷⁹ A member of a transferor's family includes the transferor's spouse, any ancestor or lineal descendant of the transferor or transferor's spouse, the brother or sister of the transferor (but not the transferor's spouse) and the spouse of any such ancestor, descendant, brother or sister. *Id.* § 25.2702-2(a)(1); I.R.C. §§ 2702(e) and 2704(c)(2).

⁸⁰ An applicable family member includes a transferor's spouse, an ancestor of the transferor or the transferor's spouse, and the spouse of such ancestors. I.R.C. §§ 2702(a)(1) and 2701(e)(2).

⁸¹ Treas. Reg. § 25.2702-2(a)(3).

⁸² *Id.* § 25.2702-2(d), Ex. 3 (D transfers property to an irrevocable trust under which the income is payable to D's spouse for life. Upon the death of D's spouse, the trust is to terminate and the trust principal is to be paid to D's child. D retains no interest in the trust. Although the spouse is an applicable family member of D under § 2702, the spouse has not retained an interest in the trust because the spouse did not hold the interest both before and after the transfer. § 2702 does not apply because neither the transferor nor an applicable family member has retained an interest in the trust. The result is the same whether or not D elects to treat the transfer as a transfer of qualified terminable interest property under § 2056(b)(7)).

B. Hence, if a grantor retains an income interest or a reversionary interest in a trust which he created for the benefit of a family member, he will likely have to pay gift tax on the entire value of the assets transferred thereto due to Section 2702. Conversely, if the grantor gives his spouse an income interest or reversionary interest in the trust and retains no interest for himself, Section 2702 should not apply; and provided the gift is otherwise complete, the value of the gift should be the entire value of the property transferred (unless the grantor's spouse is given an interest which qualifies as a qualified terminable interest such that it is eligible for the gift tax marital deduction,⁸³ in which case the value of the gift would be reduced by the value of the spouse's interest).⁸⁴

- iv. Effect of Section 677 Interest on Applicability of the Annual Exclusion? The annual gift tax exclusion does not apply to a gift of a future interest, which is any interest or right of enjoyment which commences at some time in the future, even if fully vested.⁸⁵ Therefore, if a grantor transfers assets to a trust retaining an income interest for himself and naming someone else as remainder beneficiary, no transfer to the trust will qualify for the annual exclusion despite the fact that a transfer is made that benefits the remainder beneficiary.⁸⁶

b. Estate Tax Consequences of Triggering the Application of Section 677.

- i. Section 2036 and Section 677(a)(1) Right to Income: Under Section 2036(a), if a grantor transfers property to a trust and retains for life the use, possession, enjoyment, or the right to the income of the transferred property, the property will be included in the grantor's taxable estate upon death.⁸⁷ The classic case included under Section 2036(a)(1) is a trust under which the trust income must be paid to the grantor annually for life, which falls under Section 677(a)(1). Thus, triggering grantor trust status by granting the grantor an income interest in the trust will have very negative estate tax consequences.

⁸³ I.R.C. § 2523(b).

⁸⁴ § 2702(a) does not apply to an "incomplete" transfer. I.R.C. § 2702(a)(3)(A)(i); Treas. Reg. § 25.2702-1(c)(1). *See, e.g.*, Treas. Reg. § 25.2702-2(d), Ex. 4 (A transfers property to an irrevocable trust, under which the income is to be paid to A for life. Upon termination of the trust, the trust principal is to be distributed to A's child. A also retains certain powers over principal that cause the transfer to be wholly incomplete for federal gift tax purposes. § 2702 does not apply because no portion of the transfer would be treated as a completed gift). However, § 2702(a) will apply if the transfer is complete as to some interests but not others. *See e.g.*, Treas. Reg. § 25.2702-2(d), Ex. 5 (A transfers property to an irrevocable trust, under which the income is to be paid to A for life. Upon termination of the trust, the trust principal is to be distributed to A's child. The trust is divided into separate fractional shares and A has retained certain powers over one fraction of the principal that causes the transfer to be wholly incomplete for federal gift tax purposes. § 2702 applies except with respect to the share of the trust as to which A's retained powers cause the transfer to be an incomplete gift).

⁸⁵ I.R.C. § 2503(b)(1).

⁸⁶ Treas. Reg. § 25.2503-3.

⁸⁷ *Id.* § 20.2036-1(a).

- A. Conversely, if a trustee who is not related or subordinate to the grantor (within the meaning of Section 672(c)⁸⁸) is given the authority to make *discretionary* distributions of trust income to the grantor, without the consent of an adverse party, the trust funds are not necessarily includible in the grantor's taxable estate upon death. Because the trustee possesses the power to distribute trust income to the grantor, the grantor has not retained for life the use, possession, enjoyment, or the right to the income of the transferred property which triggers the application of Section 2036.⁸⁹
1. If, however, local state law allows creditors of the grantor to compel the trustee to apply trust funds to satisfy the grantor's debt, the grantor will be deemed to have retained a beneficial interest in the trust which causes the trust assets to be includable in the grantor's gross estate under Section 2036(a) (see subparagraph b.ii immediately below). But, if local state law does not allow the grantor's creditors to reach trust assets (*i.e.*, if the state recognizes self-settled trusts), the assets of the trust will not be included in the grantor's estate.⁹⁰
 2. However, keep in mind that if a trustee has the authority to distribute or accumulate trust income for the benefit of the grantor, and the grantor has the power to remove and replace the trustee with a successor trustee who is related or subordinate to the grantor (within the meaning of Section 672(c)), then the grantor will be deemed to possess the same powers as the trustee for estate tax purposes.⁹¹
- ii. Section 2036 and Section 677(b) Distributions for Legal Obligation: Under Section 2036, the grantor is considered to have retained the "use, possession, right to income, or other enjoyment of the transferred property" if the grantor's interest can be applied toward the discharge of his or her legal obligations, including a legal obligation to support a dependent during the grantor's lifetime.⁹² Thus, if a trustee is required to satisfy the grantor's legal obligations, including support obligations, the assets of the trust will be included in the grantor's gross estate. If, however, the trustee is authorized, but clearly not

⁸⁸ Under § 672(c), a related or subordinate party is any nonadverse party who is the grantor's spouse if living with the grantor, the grantor's father, mother, issue, brother or sister, an employee of the grantor, a corporation or any employee of a corporation in which the stock holdings of the grantor and the trust are significant from the viewpoint of voting control, or a subordinate employee of a corporation in which the grantor is an executive.

⁸⁹ ZARITSKY ET AL., *supra* note 27, at ¶ 10.08[1][c].

⁹⁰ *Id.*

⁹¹ *Id.*

⁹² Treas. Reg. § 20.2036-1(b)(2).

required, to expend trust funds in a manner that discharges the grantor's personal nonsupport obligations, the trust assets should not be includable in the grantor's estate.⁹³

iii. Section 2038. Section 2038 provides that a grantor's gross estate will include the value of all property transferred by the grantor, in trust or otherwise, over which he holds at the date of his death, either alone or in conjunction with any other person, the power to alter, amend, revoke, or terminate the enjoyment of the beneficial interest. It is immaterial in what capacity the power is exercisable or when or from what source the decedent acquired such power.

A. In the context of Section 677, if the grantor retains the right in any capacity to determine who will receive distributions from a trust, such as whether to distribute trust income to any beneficiary, one of whom is his spouse, then the grantor will be taxable under Section 677(a)(1) and have retained a Section 2038 power. Similarly, if the grantor retains the right to determine whether to accumulate income or distribute it to the income beneficiary when the grantor's spouse possesses a reversionary interest in the trust, the grantor will be taxable under Section 677(a)(2) and possess a Section 2038 power.

B. Additionally, in circumstances in which creditors can reach the grantor's interest in the trust, the grantor may be deemed to have an indirect power to revoke or terminate the trust under Section 2038 because the grantor could thus effectively enjoy all the trust income by relegating his or her creditors to the trust for settlement of their claims. Thus, if a trustee is required to satisfy the grantor's legal obligations, including support obligations, the assets of the trust may be included in the grantor's gross estate due to both Sections 2036 and/or 2038.

iv. Estate Tax Ramifications of Section 677(a)(3) Payment of Insurance Premiums: Using trust income to pay premiums on insurance policies on the life of the grantor or the grantor's spouse held in trust will not cause the trust assets to be included in the grantor's estate. In *First National Bank of Birmingham v. Commissioner*, the court held that the mere payment of premiums by a trust on insurance policies on the life of a decedent but owned by the trust is not sufficient to subject the principal of the trust to estate tax as part of the decedent's gross estate.⁹⁴ Note, however, if the grantor retains any interest in the insurance policy itself, the insurance proceeds are likely includable in the grantor's estate under Section 2041 of the Code.

v. Means to Trigger Grantor Trust Status Using Section 677(a) Without Causing Estate Tax Problems. Estate tax inclusion concerns may be avoided while using

⁹³ ZARITSKY ET AL., *supra* note 27, at ¶ 10.08[1][b].

⁹⁴ 36 B.T.A. 651 (1937), *acq.*, 1937-2 C.B. 24; *see also*, Rev. Rul. 81-164, 1981-1 CB 458.

Section 677 to create a wholly owned grantor trust if the grantor creates a trust in which his or her spouse is a discretionary beneficiary of income and principal, provided that the trustee is not the grantor, the spouse or an adverse, related or subordinate party. Since the spouse is not the grantor, he or she may have interests in the trust that the grantor could not without risking the application of Sections 2036 and 2038. The spouse can be a permissible beneficiary of the trust even if the split gift election is made under Section 2513 because the split gift election applies only for gift tax purposes and not for estate tax purposes (unless the spouse's interest in the trust cannot be quantified).⁹⁵

A. There are downsides to this means of triggering the application of Section 677, however.

1. First, naming the spouse as a beneficiary will cause problems if it is decided to terminate grantor trust status. To do so, the spouse would have to divest his or her right as a discretionary beneficiary, which would be treated as a taxable gift (unless such relinquishment constituted a qualified disclaimer under Section 2518).
2. The second downside is that grantor trust status will terminate if the spouse predeceases the grantor unless some other grantor trust rule applies to continue grantor trust status.⁹⁶ Moreover, if the couple were to divorce, it would seem as though Section 678 would prevent the grantor from being taxable on income distributable to the grantor's ex-spouse.⁹⁷

c. The Generation-Skipping Transfer Tax Exemption

- i. Required Deferral in Allocating GST Exemption. Under the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010⁹⁸, each individual has a \$5 million lifetime generation-skipping transfer tax exemption (GST exemption) that can be applied to generation-skipping transfers. Usually, the GST exemption is allocated to a gift in trust on the gift tax return reporting the transfer to the trust. The percentage of the trust then exempt applies to the trust fund permanently, even if the trust increases substantially in value (*e.g.*, if a grantor transfers \$1 million to a trust and allocates \$1 million of his GST exemption, the trust will remain 100% GST exempt despite any appreciation in the trust's principal). However, if property transferred to a trust is subject to an

⁹⁵ AKERS ET AL., *supra* note 46, at 266. The gift-splitting election under § 2513 applies “for purposes of this chapter.” § 2513 is found in Chapter 12 of the Code (gift tax), and the estate tax provisions are found in Chapter 11.

⁹⁶ *Id.*

⁹⁷ *See supra* Section II.b.

⁹⁸ Pub. L. No. 111-312, 124 Stat. 3296 (2010).

“estate tax inclusion period” (“ETIP”), which is the period after the transfer during which the value of the property would be included in the transferor’s gross estate if the transferor died immediately, GST tax exemption may not be effectively allocated to property until the ETIP has ended.⁹⁹

A. Because any allocation of GST exemption to the initial gift in trust will not be effective until the ETIP terminates, if the amount of the allocated GST exemption is not sufficient to cover the value of the gift as of the ETIP termination, the trust will have a inclusion ratio greater than 0.¹⁰⁰ This delayed allocation of the grantor’s GST exemption precludes the use of the GST exemption to shelter from GST tax the appreciation in the trust fund that accrues between the time of the original gift in trust and the termination of the ETIP.¹⁰¹

B. Therefore, a grantor should refrain from retaining an income interest in a trust which is intended to be GST exempt unless the grantor is certain he or she will have sufficient GST exemption to allocate to the trust upon the termination of the ETIP. And with the recent fluctuation in the estate, gift and GST exemptions, how can anyone be that certain?

ii. GST Annual Exclusion. Additionally, the grantor’s retention of an income interest taxable under Section 677(a) precludes the use of the GST tax annual exclusion.¹⁰²

⁹⁹ I.R.C. §§ 2642(f)(1) and 2642(f)(3).

¹⁰⁰ Treas. Reg. § 26.2632-1(c)(1).

¹⁰¹ See ZARITSKY ET AL., *supra* note 27, at ¶ 10.08(3)(b).

¹⁰² A gift in trust qualifies for the GST tax annual exclusion only if the trust can distribute income and principal solely to the skip-person beneficiary and if the trust principal will be included in said beneficiary’s estate if the beneficiary died during the trust term. Thus, retention of an income interest or the authority in a trustee to pay income to the grantor or the grantor’s spouse will preclude the availability of the annual exclusion for GST tax purposes. See *id.*, ¶ 10.08(3)(a).