

# **Anatomy of a Grantor Trust**

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## I. Introduction

The purpose of this outline is to delineate the interests and powers, and the parties holding them, that will cause the income interest and/or corpus of a trust to be treated as owned by its grantor, or any other individual, for federal income tax purposes pursuant to Subchapter J, Part I, Subpart E (§§671 through 679) of the Internal Revenue Code<sup>1</sup>. This outline does not address the rules related to ownership of trusts by foreign grantors and foreign trusts having one or more beneficiaries of the United States under §§672(f) and 679, respectively. Nor does this outline address in detail the taxation or computation of taxable income, pursuant to §671 and corresponding provisions, of any taxpayer treated as the owner of a trust under §§671 through 679.

§671 provides, in pertinent part, that where the Grantor is treated as the owner of a portion (the corpus or the income therefrom) of a trust pursuant to Subpart E (§§671-679), such Grantor shall include in computing his taxable income all items of income, deduction and credits against tax with respect to such portion of the trust. Such a trust is commonly referred to as a “defective grantor trust.”

The criteria for determining whether a trust will be treated as a defective grantor trust are outlined in §§671 through 679. Such a determination may be made by:

- Identifying the parties; and
- Analyzing the interests and powers created in the trust which may, depending on the parties involved, cause it to be treated as a defective grantor trust.

The remainder of this outline is organized according to the foregoing.

## II. Identification of the Parties

The parties pertinent to the determination of defective grantor trust status and their respective meanings are as follows:

**Grantor** – A grantor is any person to the extent such person either creates a trust, or directly or indirectly makes a gratuitous transfer (i.e. any transfer other than a transfer for fair market value) of property to a trust. (§1.671-2(e)).

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<sup>1</sup> This outline is adapted from a memorandum prepared by Matthew D. Williamson, J.D., to provide attorneys in The Bowden Spratt Law Firm, P.C. with a decision tree to analyze the income tax attributes of trusts.

**Adverse Party** – An adverse party, as defined in §672(a), is any person:

- (i) who has a beneficial interest in the trust – such an interest includes a general power of appointment over trust property and a right to share in the trust income or corpus, either at the present time or in the future;
- (ii) whose beneficial interest is substantial – a person’s interest is substantial if its “value in relation to the total value of the property subject to the power is not insignificant” (§1.672(a)-1(a)). The implication of the foregoing is that the threshold for determination of whether an interest is substantial is low because the interest need only be “not insignificant.”; and
- (iii) whose beneficial interest would be adversely affected by the exercise or nonexercise of the power held by the grantor or a nonadverse party – the interest in the trust, not the owner of the interest, must be recognized as adverse to the grantor’s or nonadverse party’s powers. A party’s interest is only adverse to the exercise or nonexercise of a power to the extent that such exercise or nonexercise will affect the amount of income or principal received by such party. Ordinarily a beneficiary will be an adverse party, but if his right to share in the income or corpus of the trust is limited to only a part, he may be an adverse party only as to that part. Note that a trustee is not an adverse party merely because of his interest as trustee. (§1.672(a)-1).

**Nonadverse Party** – pursuant to §672(b), a nonadverse party is any person who is not an adverse party. Thus, a trustee with no beneficial interest in the trust is a nonadverse party with respect to the trust. The grantor’s spouse will necessarily be a nonadverse party because her interest is imputed to the grantor pursuant to §672(e). (See “Powers Held by The Grantor’s Spouse” at III. below.)

**Related or Subordinate Party** – a party is related or subordinate to the grantor if he or she is a:

- (i) nonadverse party; and
- (ii) the grantor’s
  - (a) spouse (if living with the grantor);
  - (b) parent;
  - (c) issue;
  - (d) sibling;
  - (e) employee (the grantor’s attorney and accountant should not be related or subordinate parties because they are typically treated as independent contractors rather than employees); or

- (f) corporation (including an employee of such corporation) in which the grantor and trust have significant holdings from the viewpoint of voting control. (An employee of a corporation of which the grantor serves as an executive is also deemed a related or subordinate party.)

For purposes of §§674 and 675, a related or subordinate party shall be presumed to be subservient to the grantor in respect of the exercise or nonexercise of the powers conferred on him unless such party is shown not to be subservient by a preponderance of the evidence. (§672(c)).

### **III. Analysis of the Interests And Powers Created in the Trust**

For purposes of this analysis, if *all* of the following italicized questions (1) through (11) can be answered “no,” the trust will not be treated as a defective grantor trust with respect to anyone (excluding consideration of §679 regarding foreign trusts). Conversely, if *any one or more* of the following questions must be answered in the affirmative, the trust will be treated as a defective grantor trust, and §671 will be applicable. Thus, in order to create an intentionally defective grantor trust, the trust agreement should be drafted so as to require a “yes” to at least one of the questions that follow.

But first, a discussion of some specific rules with respect to the powers to be considered in the analysis that follows is in order:

**Powers Subject to a Condition Precedent** – A person is considered to have one of the powers enumerated below even if the exercise of such power is subject to a condition precedent of giving notice. A person is also considered to have one of the powers enumerated below even where such power takes effect only on the expiration of a certain period provided the power’s value would have exceeded 5% of the value of the trust’s assets at the trust’s inception if the power were instead treated as a reversionary interest (i.e. a defective grantor trust pursuant to §673(a)). (§672(d) and §1.672(d)-1).

**Powers Held by The Grantor’s Spouse** – Any power or interest held by the grantor’s spouse is imputed to the grantor. This applies to all powers or interests held by the grantor’s spouse at the time of creation of such powers and interests as well as all powers and interests held by a person who becomes the grantor’s spouse after their creation, but only as to the time period beginning after such person became the grantor’s spouse. (§672(e)). This rule prevents the grantor’s spouse from classification as an adverse party because any interest or power held by the grantor’s spouse would be imputed to the grantor. Thus, for purposes of performing the following analysis, the grantor’s spouse will always be considered a nonadverse party provided such spouse is not legally separated from the grantor pursuant to §672(e)(2), and the grantor’s spouse will always be considered a related or subordinate party provided such spouse is living with the grantor pursuant to §672(c)(1).

**Question 1 – Reversionary Interest – §673**

*Does the Grantor (or his spouse) hold a reversionary interest in the corpus of the trust or income therefrom where:*

- (i) the value of such reversionary interest exceeds 5% of the total value of trust assets as of the date of inception of the trust (§673(a)); and*
- (ii) such reversionary interest is not effective only upon the death, before age 21, of a beneficiary who is the Grantor’s lineal descendant holding all present interests in the trust (§673(b))?*

**Question 2 – Power to Control Beneficial Enjoyment – §674(a)**

*Is the beneficial enjoyment of the corpus of the trust, or income therefrom, subject to a power of disposition exercisable by:*

- (i) the Grantor (or his spouse);*
- (ii) a Nonadverse Party; or*
- (iii) Both*

*without the approval or consent of any Adverse Party?*

A power of disposition includes any power of disposition that “can affect” the beneficial enjoyment of a portion of the trust. (§1.674(a)-1(a)). Thus, a power to allocate income between or among beneficiaries is a power of disposition over beneficial enjoyment. Likewise, a power to add beneficiaries (other than after-born or adopted children) may constitute a power of disposition over beneficial enjoyment if it results in a power to shift beneficial interests. The right to use trust property without adequate compensation is also a power of disposition over beneficial enjoyment.

*If the answer to this question is “no,” proceed to question (3) below. Otherwise, perform the following analysis to determine whether any of the exceptions in §674(b), (c) and (d) apply.*

The following powers are excepted from classification as powers of disposition over beneficial enjoyment under §674(a) regardless of by whom they are held. For purposes of this analysis, if the answer to the foregoing question with respect to §674(a) is “yes” by virtue of the existence of one or more of the powers enumerated below, that answer may be changed to “no.” Conversely, if all questions below are answered in the negative, the trust shall be considered a defective grantor trust pursuant to §674(a).

**Question 2A – Power to Apply Income to Support of a Dependent - §674(b)(1)**

*Is the power to control beneficial enjoyment a power to apply income to the support of a dependent?*

The income of a trust will not be considered as taxable to the grantor merely because, in the discretion of the trustee or grantor, acting in a fiduciary capacity as trustee or co-trustee, it may be used for the support of a beneficiary to whom the grantor is legally obligated to support, except to the extent that it is in fact used for that purpose. (§1.674(b)-1(b)(1)).

**Question 2B – Power Affecting Beneficial Enjoyment Only After a Period - §674(b)(2)**

*If the power to control beneficial enjoyment is effective only after the occurrence of a certain event, would the value of such power be equal to or less than 5% of the value of the trust's assets at inception if such power were treated as a reversionary interest in accordance with §673(a)?*

A postponed power affecting beneficial enjoyment of a trust creates a defective grantor trust unless such power is postponed for a period which, were it a reversionary interest, would be protected from defective grantor trust status by virtue of §673(a). Thus, where a power to affect beneficial enjoyment is postponed for a long enough period that its value would be equal to or less than 5% of the value of the trust's assets at inception if it were treated as a reversionary interest, such power does not result in defective grantor trust status.

**Question 2C – Power Exercisable Only By Will - §674(b)(3)**

*Is the power to control beneficial enjoyment only exercisable by will where the exercise of such power may never be made with respect to accumulated income?*

A power to direct beneficial enjoyment of trust property exercisable solely by will does not create a defective grantor trust. However, this exception does not apply to a testamentary power over the disposition of accumulated income whether such power to dispose of accumulated income is expressly granted in the trust or the exercise of such power would necessarily dispose of income accumulated pursuant to the trust instrument or local law (i.e. the addition of capital gains to corpus). The portion of the trust treated as a defective grantor trust (i.e. deemed to be owned by the grantor) with respect to a power to direct beneficial enjoyment of accumulated income is limited to those items of trust

income, deduction and credit properly allocated to the trust principal. (§1.674(b)-1(b)(3)).

**Question 2D – Power to Allocate Among Charitable Beneficiaries - §674(b)(4)**

*Is the power to control beneficial enjoyment a power to allocate corpus, or the income therefrom, which is irrevocably payable, currently or in the future, among charitable beneficiaries, all of which are described in §170(c), or to an employee stock ownership plan (defined in §4975(e)(7)) in a qualified gratuitous transfer (as defined in §664(g)(1))?*

**Question 2E – Power to Distribute Corpus - §674(b)(5)**

*Is the power to control beneficial enjoyment a power to distribute corpus either:*

- (i) to or for a beneficiary or beneficiaries or to or for a class of beneficiaries (whether or not income beneficiaries) where the power is limited to a reasonably definite standard (§674(b)(5)(A)); or*
- (ii) to or for a current income beneficiary where such distribution of corpus must be chargeable against such beneficiary's proportionate share of the corpus held in the trust for the payment of income to such beneficiary as if that proportionate share of corpus constituted a separate trust (§674(b)(5)(B));*

*where no person has the power to add beneficiaries (including addition to a class of beneficiaries) designated to receive income or corpus except for after-born or after-adopted children?*

“Reasonably definite standard” – a reasonably definite standard for this purpose is one which constitutes a clearly measurable standard under which the power holder is legally accountable. The entire context of a provision granting the power must be considered in determining whether the power is limited by a reasonably definite standard. Thus, if the trust instrument provides that the determination of the trustee is conclusive with respect to the exercise or nonexercise of the power, the power is not limited by a reasonably definite standard. However, the fact that such a trustee has discretion with respect to the exercise or nonexercise of the power is not in itself an indication that the standard is not reasonably definite. A power to distribute corpus limited to the following would comply with the required standard:

- (i) for the education, support, maintenance or health of the beneficiary;*
- (ii) for the beneficiary's reasonable support and comfort;*

- (iii) to enable the beneficiary to maintain his accustomed standard of living; or
- (iv) to meet an emergency. (§1.674(b)-1(b)(5)(ii)).

The limitation on the power of any person to add to the beneficiaries or class of beneficiaries to receive the income or corpus, except where the action is to provide for after-born or after-adopted children, does not apply to a power held by a beneficiary to substitute other beneficiaries to succeed his interest in the trust because such person (the beneficiary) is by definition an adverse party with respect to the exercise or nonexercise of such power. Nor does the limitation apply to a power to add beneficiaries pursuant to a testamentary power because such power is excepted under §674(b)(3). (§1.674(d)-2(b)).

**Question 2F – Power to Withhold Income Temporarily - §674(b)(6)**

*Is the power to control beneficial enjoyment a power to distribute, apply or accumulate income for a beneficiary where such accumulated income must ultimately be distributed:*

- (i) *to the beneficiary from whom it was withheld, his estate, or his appointees (or takers in default of appointment) under a power of appointment held by the beneficiary which does not exclude from any possible class of possible appointees any person other than the beneficiary, his estate, his creditors or the creditors of his estate (§1.674(b)-1(b)(6)(i)(a));*
- (ii) *to the beneficiary from whom it was withheld, or in the case of a beneficiary who does not survive a date of distribution which could reasonably be expected to occur within such beneficiary's lifetime, to such beneficiary's appointees (or takers in default of appointment) under any power of appointment, general or special, or to one or more designated alternate takers (other than the grantor or grantor's estate) whose shares have been irrevocably specified in the trust instrument if such beneficiary has no power of appointment (§1.674(b)-1(b)(6)(i)(b)); or*
- (iii) *to the current income beneficiaries in shares which have been irrevocably specified in the trust instrument upon:*
  - a. *termination of the trust;*
  - b. *a distribution of corpus which is augmented by the accumulated income; or*
  - c. *in the case of a beneficiary who does not survive a date of distribution which could reasonably be expected to occur within such beneficiary's lifetime, to such beneficiary's appointees (or takers in default of appointment) under any power of*

*appointment, general or special, or to one or more designated alternate takers (other than the grantor or grantor's estate) whose shares have been irrevocably specified in the trust instrument if such beneficiary has no power of appointment (§1.674(b)-1(b)(6)(i)(c));*

where:

- (a) *such power is not designed to shift ordinary income from one beneficiary to another (§1.674(b)-1(b)(6)(i)(c)); and*
- (b) *no person has the power to add beneficiaries (including addition to a class of beneficiaries) designated to receive income or corpus except for after-born or after-adopted children (§674(b)(6))?*

The import of the foregoing is that where the trust instrument provides for the accumulation of income, such accumulated income must be payable directly to the income beneficiary at the date of distribution of such income or upon termination of the trust provided such beneficiary is then living. If the beneficiary is not living at the date of distribution, the accumulated income must be payable to either: (i) the beneficiary's estate or his appointees under a testamentary power of appointment which may not exclude any persons other than the beneficiary, his estate, his creditors or the creditors of his estate; or (ii) the beneficiary's appointees under a general or special power of appointment, or in the absence of such a power, to one or more designated alternate takers (other than the grantor or grantor's estate) whose shares have been irrevocably specified in the trust instrument. If the trust instrument does not provide for a date of distribution which could reasonably be expected to occur during the beneficiary's lifetime, then in order to qualify under this exception, the instrument must specify that any accumulated income be payable to the beneficiary's estate or his appointees under a testamentary power of appointment which may not exclude any persons other than the beneficiary, his estate, his creditors or the creditors of his estate.

§1.674(b)-1(b)(6)(i)(c) makes clear that the broad power referred to in (i) above, which would permit the grantor to benefit from the accumulation of income as an appointee, will not cause the trust to be treated as a defective grantor trust under §677. That same section also permits a limited power to shift ordinary income among current income beneficiaries provided the trust clearly defines their shares. A shift of ordinary income effected by an accumulation of income withheld from an income beneficiary and added to corpus to be ultimately distributed to a remainder beneficiary is expressly prohibited.

The limitation on the power of any person to add to the beneficiaries or class of beneficiaries to receive the income or corpus, except where the

action is to provide for after-born or after-adopted children, does not apply to a power held by a beneficiary to substitute other beneficiaries to succeed his interest in the trust because such person (the beneficiary) is by definition an adverse party with respect to the exercise or nonexercise of such power. Nor does the limitation apply to a power to add beneficiaries pursuant to a testamentary power because such power is excepted under §674(b)(3). (§1.674(d)-2(b)).

**Question 2G – Power to Withhold Income During Period the Beneficiary is Under Age 21 or Legally Disabled - §674(b)(7)**

*Is the power to control beneficial enjoyment a power to distribute, apply or accumulate, as an addition to corpus, the income to or for the beneficiary with such power being exercisable only during:*

- (i) the existence of a legal disability of such current income beneficiary (§674(b)(7)(A)); or*
- (ii) the period such income beneficiary is under 21 (§674(b)(7)(B))*

*where no person has the power to add beneficiaries (including addition to a class of beneficiaries) designated to receive income or corpus except for after-born or after-adopted children?*

Unlike the §674(b)(6) power discussed above, §674(b)(7) does not require a specific disposition of the income withheld and accumulated during the permitted period. Nor does it require that the trust instrument specify the ultimate disposition of the accumulated income. Thus, the accumulated income may be added to corpus and ultimately distributed to others. (§1.674(b)-1(b)(7)).

Neither the statute nor regulations define “legal disability,” but it may be reasonable to assume that the beneficiary must be adjudicated incompetent for that exception to apply.

The limitation on the power of any person to add to the beneficiaries or class of beneficiaries to receive the income or corpus, except where the action is to provide for after-born or after-adopted children, does not apply to a power held by a beneficiary to substitute other beneficiaries to succeed his interest in the trust because such person (the beneficiary) is by definition an adverse party with respect to the exercise or nonexercise of such power. Nor does the limitation apply to a power to add beneficiaries pursuant to a testamentary power because such power is excepted under §674(b)(3). (§1.674(d)-2(b)).

**Question 2H – Power to Allocate Between Corpus and Income - §674(b)(8)**

*Is the power to control beneficial enjoyment a power to allocate receipts and disbursements between corpus and income?*

Such a power, even where it is expressed in broad terms, does not constitute a power to control the beneficial enjoyment of trust corpus, or the income therefrom, under §674(a).

**Question 2I – Independent Trustees – Powers Over Corpus and/or Income - §674(c)**

*Is the power to control beneficial enjoyment a power solely exercisable (without the consent or approval of any other person) by a trustee or trustees to:*

- (i) distribute, apportion or accumulate income to or for a beneficiary or beneficiaries, or to, for or within a class of beneficiaries (§674(c)(1)); or*
- (ii) pay out corpus to or for a beneficiary or beneficiaries or to a class of beneficiaries (whether or not income beneficiaries) (§674(c)(2))*

*where such trustee(s) does not include:*

- (1) the grantor;*
- (2) the grantor's spouse (as defined in §672(e)); or*
- (3) persons more than half of whom are related or subordinate to the grantor*

*and:*

- (a) no person has the power to add beneficiaries (including addition to a class of beneficiaries) designated to receive income or corpus except for after-born or after-adopted children; and*
- (b) the grantor does not have the power to add, remove or substitute trustees where the exercise of such power could provide that any of the foregoing persons designated in (1), (2) or (3) above who are otherwise prohibited from serving may serve as trustee?*

In order for such a power to fall within this exception, it must be exercisable solely (without the approval or consent of any other person) by a trustee or trustees, none of whom is the grantor or the grantor's spouse and no more than half of whom are related or subordinate parties who are subservient to the wishes of the grantor. (§1.674(c)-1). (See II. above for the definition of "related or subordinate parties.")

The grantor may hold the power to remove, substitute, or add trustees provided such power is limited so that its exercise would not otherwise disqualify it under this exception. Thus, if the power to add or substitute trustees is conditioned on the requirement that the grantor substitute one independent trustee for another, the exception would still be applicable. Additionally, a power to remove, substitute or add trustees upon limited conditions which do not exist during the taxable year such as the death or resignation of, or breach of fiduciary duty by, an existing trustee will not automatically create a defective grantor trust until such event actually occurs. (§1.674(d)-2(a)).

The limitation on the power of any person to add to the beneficiaries or class of beneficiaries to receive the income or corpus, except where the action is to provide for after-born or after-adopted children, does not apply to a power held by a beneficiary to substitute other beneficiaries to succeed his interest in the trust because such person (the beneficiary) is by definition an adverse party with respect to the exercise or nonexercise of such power. Nor does the limitation apply to a power to add beneficiaries pursuant to a testamentary power because such power is excepted under §674(b)(3). (§1.674(d)-2(b)).

**Question 2J – Power to Allocate Income Limited by a Standard - §674(d)**

*Is the power to control beneficial enjoyment a power to distribute, apportion or accumulate income to or for a beneficiary or beneficiaries, or to, for or within a class of beneficiaries where the trust instrument provides that:*

- (i) such power is limited by a reasonably definite external standard;*
- (ii) no person has the power to add beneficiaries (including addition to a class of beneficiaries) designated to receive income or corpus except for after-born or after-adopted children;*
- (iii) such power is solely exercisable (without the approval or consent of any other person) by a trustee or trustees, none of whom are the:
  - a. Grantor; or*
  - b. the Grantor's spouse living with the Grantor;*and*
- (iv) the Grantor does not have the power to add, remove or substitute trustees where the exercise of such power could provide that any of the foregoing persons otherwise prohibited from serving may serve as trustee?*

This exception is available without regard to the satisfaction of §674(b)(6) or (7). Unlike the §674(c) exception discussed above, any of the trustees may be related or subordinate to the grantor, but as is the case with §674(c), the trustees must be able to exercise this power without any other person's consent or approval.

Although the language "reasonably definite external standard" is not identical to that of "reasonably definite standard" contained in §674(b)(5)(A), §1.674(d)-1 refers the reader to §1.674(b)-1(b)(5), the regulation under §674(b)(5), for what constitutes such a standard. Thus, the terms are identical in their meanings. A reasonably definite standard for this purpose is one which constitutes a clearly measurable standard under which the power holder is legally accountable. The entire context of a provision granting the power must be considered in determining whether the power is limited by a reasonably definite standard. Thus, if the trust instrument provides that the determination of the trustee is conclusive with respect to the exercise or nonexercise of the power, the power is not limited by a reasonably definite standard. However, the fact that such a trustee has discretion with respect to the exercise or nonexercise of the power is not in itself an indication that the standard is not reasonably definite. A power to distribute income limited to the following would comply with the required standard:

- (i) for the education, support, maintenance or health of the beneficiary;
- (ii) for the beneficiary's reasonable support and comfort;
- (iii) to enable the beneficiary to maintain his accustomed standard of living; or
- (iv) to meet an emergency. (§1.674(b)-1(b)(5)(ii)).

The grantor may hold the power to remove, substitute, or add trustees under this exception provided such power is limited so that its exercise would not disqualify it under this exception. Thus, if the power to add or substitute trustees is conditioned on the requirement that the grantor substitute one independent trustee for another, the exception would still be applicable. Additionally, a power to remove, substitute or add trustees upon limited conditions which do not exist during the taxable year such as the death or resignation of, or breach of fiduciary duty by, an existing trustee will not automatically create a defective grantor trust until such event actually occurs. (§1.674(d)-2(a)).

The limitation on the power of any person to add to the beneficiaries or class of beneficiaries to receive the income or corpus, except where the action is to provide for after-born or after-adopted children, does not apply to a power held by a beneficiary to substitute other beneficiaries to succeed his interest in the trust because such person (the beneficiary) is by

definition an adverse party with respect to the exercise or nonexercise of such power. Nor does the limitation apply to a power to add beneficiaries pursuant to a testamentary power because such power is excepted under §674(b)(3). (§1.674(d)-2(b)).

**Question 3 – Power to Deal For Less Than Adequate and Full Consideration - §675(1)**

*Does any person (including the Grantor) have the power to purchase, exchange or otherwise deal with or dispose of the corpus or the income therefrom for less than adequate consideration in money or money's worth where such power is exercisable by:*

- (i) *the Grantor (or his spouse);*
- (ii) *a Nonadverse Party; or*
- (iii) *both*

*without the approval or consent of any Adverse Party?*

The mere fact that a power exercisable by a trustee is described in broad language does not indicate that the trustee is authorized to purchase, exchange, or otherwise deal with or dispose of the trust property or income for less than an adequate and full consideration in money or money's worth. However, such authority may be indicated by the actual administration of the trust. (§1.675-1(c)).

If the grantor retains a power to amend the administrative provisions of the trust instrument which is broad enough to permit an amendment which would require an affirmative answer to the question above, the trust will be treated as a defective grantor trust with respect to the applicable portion (corpus and/or income) from its inception. (§1.675-1(a)).

**Question 4 – Power to Borrow Money Without Adequate Interest or Security - §675(2)**

*Is there a power which enables the Grantor to borrow the corpus or income, directly or indirectly, without:*

- (i) *adequate interest; or*
- (ii) *adequate security*

*where such power is exercisable by:*

- (i) *the Grantor (or his spouse);*
- (ii) *a Nonadverse Party; or*
- (iii) *both,*

*and such power is not a general lending power authorizing a trustee, who is not the Grantor or the Grantor's spouse, to make loans to any person without regard to interest or security?*

The power to borrow trust assets without adequate interest or security will cause the trust to be treated as a defective grantor trust unless the trustee, who is not the

grantor or the grantor's spouse, has the authority to lend trust assets to any person without regard to the adequacy of interest or security. A general fiduciary lending power in the grantor, even where the grantor is acting alone as trustee, under which the grantor has the power to determine interest rates and the adequacy of security is not in itself an indication that the grantor has the power to borrow the corpus or income without adequate interest or security. It is possible that state law would prohibit the exercise of such power. (§1.675-1(b)(2)).

The mere fact that a power exercisable by a trustee is described in broad language does not indicate that the trustee is authorized to lend the trust property or income to the grantor without adequate interest. However, such authority may be indicated by the actual administration of the trust. (§1.675-1(c)).

If the grantor retains a power to amend the administrative provisions of the trust instrument which is broad enough to permit an amendment which would require an affirmative answer to the question above, the trust will be treated as a defective grantor trust with respect to the applicable portion (corpus and/or income) from its inception. (§1.675-1(a)).

#### **Question 5 – Borrowing of the Trust Funds - §675(3)**

*Has the Grantor actually borrowed, directly or indirectly, the corpus or income without completely repaying the loan, including interest, before the beginning of the taxable year where such borrowing was:*

- (i) without adequate interest; or*
- (ii) without adequate security*

*and made by a trustee who is:*

- a. the Grantor;*
- b. the Grantor's spouse; or*
- c. a Related or Subordinate Party?*

Actual borrowing should not create a defective grantor trust with respect to the amount borrowed where either: (i) such amount is repaid before the beginning of the taxable year succeeding the taxable year in which the amount was borrowed; or (ii) the borrowing was for adequate interest and security and was made by a trustee who was not the grantor, his spouse, or a related or subordinate party subservient to the wishes of the grantor. (See II. above for the definition of a related or subordinate party.)

An example of indirect borrowing would be where a partnership, of which the grantor is a general partner, borrows from the trust. (*Bennett v. Comr.*, 79 T.C. 470, 1982).

**Question 6 – Administrative Power to Vote Certain Stock Owned by the Trust - §675(4)(A)**

*Does any person have the power, exercisable in a non-fiduciary capacity and without the approval or consent of any person in a fiduciary capacity, to vote or direct the voting of stock or other securities of a corporation in which the holdings of the Grantor and the trust are significant from the viewpoint of voting control?*

A power is exercisable in a fiduciary capacity if it is exercisable primarily in the beneficiary's interest. If a power is exercisable by a person as trustee, it is presumed that the power is exercisable in a fiduciary capacity primarily in the interests of the beneficiaries. Such presumption may be rebutted only by clear and convincing evidence that the power is not exercisable primarily in the interests of the beneficiaries. The determination as to whether any power held by someone other than a trustee is exercisable primarily in the beneficiary's interest (i.e. in a fiduciary capacity) depends on all the terms of the trust and the circumstances surrounding its creation and administration. (§1.675-1(b)(4)(iii)).

The regulations do not specify what constitutes "significant" with respect to holdings and do not indicate whether rules of attribution are applicable to such determination. Thus, where the trust and grantor's family hold more than a nominal interest in a corporation and the drafter desires to avoid defective grantor trust status, the trust instrument should provide that only the trustee may exercise any voting rights and that all powers with respect to the stock be exercised in a fiduciary capacity and in the best interests of the beneficiaries.

If the grantor retains a power to amend the administrative provisions of the trust instrument which is broad enough to permit an amendment which would require an affirmative answer to the question above, the trust will be treated as a defective grantor trust with respect to the applicable portion (corpus and/or income) from its inception. (§1.675-1(a)).

**Question 7 – Administrative Power to Control Certain Investments - §675(4)(B)**

*Does any person have the power, exercisable in a non-fiduciary capacity and without the approval or consent of any person in a fiduciary capacity, to control the investment of the trust's funds either by directing, or vetoing proposed, investments or reinvestments where such funds consist of stocks or securities of corporations in which the holdings of the Grantor and trust are significant from the viewpoint of control?*

A power is exercisable in a fiduciary capacity if it is exercisable primarily in the beneficiary's interest. If a power is exercisable by a person as trustee, it is presumed that the power is exercisable in a fiduciary capacity primarily in the

interests of the beneficiaries. Such presumption may be rebutted only by clear and convincing evidence that the power is not exercisable primarily in the interests of the beneficiaries. The determination as to whether any power held by someone other than a trustee is exercisable primarily in the beneficiary's interest (i.e. in a fiduciary capacity) depends on all the terms of the trust and the circumstances surrounding its creation and administration. (§1.675-1(b)(4)(iii)).

The regulations do not specify what constitutes "significant" with respect to holdings and do not indicate whether rules of attribution are applicable to such determination. Thus, where the trust and grantor's family hold more than a nominal interest in a corporation and the drafter desires to avoid defective grantor trust status, the trust instrument should provide that only the trustee may exercise any powers with respect to the stock and that such powers be exercised in a fiduciary capacity and in the best interests of the beneficiaries.

If the grantor retains a power to amend the administrative provisions of the trust instrument which is broad enough to permit an amendment which would require an affirmative answer to the question above, the trust will be treated as a defective grantor trust with respect to the applicable portion (corpus and/or income) from its inception. (§1.675-1(a)).

#### **Question 8 – Administrative Power to Reacquire Trust Assets - §675(4)(C)**

*Does any person have the power, exercisable in a non-fiduciary capacity and without the approval or consent of any person in a fiduciary capacity, to reacquire the trust corpus by substituting other property of an equivalent value?*

A power is exercisable in a fiduciary capacity if it is exercisable primarily in the beneficiary's interest. If a power is exercisable by a person as trustee, it is presumed that the power is exercisable in a fiduciary capacity primarily in the interests of the beneficiaries. Such presumption may be rebutted only by clear and convincing evidence that the power is not exercisable primarily in the interests of the beneficiaries. The determination as to whether any power held by someone other than a trustee is exercisable primarily in the beneficiary's interest (i.e. in a fiduciary capacity) depends on all the terms of the trust and the circumstances surrounding its creation and administration. (§1.675-1(b)(4)(iii)).

The right to substitute assets is the most innocuous power and thus is commonly used where defective grantor trust status is desired. However, if the power is held in a fiduciary capacity or requires the approval of any person in a fiduciary capacity, the trust will not be treated as a defective grantor trust under §675(4)(C).

In order to avoid having the trust corpus included in the grantor's estate under §2036 or §2038, the trustee must have a fiduciary duty under the trust instrument to ensure the grantor complies with the terms of the power (i.e. substituted assets are of equal value to the assets reacquired). (Rev. Rul. 2008-22). Additionally,

the Service provided in Rev. Rul. 2008-22 that the grantor must not be able to exercise the power to shift benefits among beneficiaries. A power cannot be exercised to shift benefits among beneficiaries if: (i) the trustee has both the power (under the trust instrument or local law) to reinvest trust corpus and a duty of impartiality as to the trust beneficiaries; or (ii) the nature of the trust investments or level of income produced by some or all of the trust investments does not affect the beneficiaries' respective interests, such as when a trust is administered as a unitrust or when trust distributions are limited to discretionary distributions of principal and income.

If the grantor retains a power to amend the administrative provisions of the trust instrument which is broad enough to permit an amendment which would require an affirmative answer to the question above, the trust will be treated as a defective grantor trust with respect to the applicable portion (corpus and/or income) from its inception. (§1.675-1(a)).

### **Question 9 – Power to Revoke - §676**

*Is there a power to revest title to trust property in the Grantor exercisable by:*

- (i) the Grantor (or his spouse);*
- (ii) a Nonadverse Party; or*
- (iii) both*

*without the approval or consent of an Adverse Party (§676(a)); and where such power would not otherwise be excepted under §673 if it were treated as a reversionary interest (§676(b))?*

If the title to a portion of the trust will revest in the grantor upon the exercise of a power by the grantor (or his spouse), a nonadverse party, or both, without the approval or consent of an adverse party, the grantor shall be treated as the owner of that portion regardless of whether the power is a power to revoke, to terminate, to alter or amend, or to appoint. (§1.676(b)-1)). However, where the exercise of such power can only affect the beneficial enjoyment of the income of a trust received after the expiration of a period of time which is such that the grantor would not be treated as the owner under §673 if the power were a reversionary interest, such power will not result in defective grantor trust status under §676(a). (§1.676(b)-1)). Thus, a postponed power to revoke will not result in defective grantor trust status pursuant to §676(b) provided it is postponed for a period which, were it treated as a reversionary interest under §673, would be valued at 5% or less of the total value of the trust's assets at inception. However, unless such power is relinquished after the period of postponement, defective grantor trust status may result at the end of such period. (§676(b)).

The determination as to whether the trust will be treated as a defective grantor trust after any such period of postponement is to be made pursuant to §1.673(d)-1 which provides that a new transfer to the trust results at the date any additional postponement for the reacquisition of possession or enjoyment of any

reversionary interest is effected. Thus, assuming a trust is excepted from treatment as a defective grantor trust under §676 by virtue of §673, that trust may be treated as a defective grantor trust after the period of postponement unless either: (i) the power to revest title to trust property in the grantor is relinquished; or (ii) the period for exercise of the power is postponed for another period of time which would except the trust from treatment as a defective grantor trust under §673 if the exercise of such power were treated as a reversionary interest the value of which is 5% or less of the value of the trust's assets at the commencement of the new period. (§§1.673(d)-1 and 1.676(b)-1)).

The power to revest title to trust property in the grantor may encompass items not so obvious to the drafter. For example, the Service in Rev. Rul. 66-161 provided that the grantor's ability to request payment of the trust's capital gains to him constituted a power to revest the trust's assets under §676. Defective grantor trusts have also resulted under §676 where the trusts' only significant assets were funds received in exchange for demand notes payable to the grantor. (*Kushner v. Comr.*, T.C. Memo 1991-26; and *McGinnis v. Comr.*, T.C. Memo 1993-45).

#### **Question 10 – Income for the Benefit of Grantor - §677**

*Is the trust's income:*

- (i) *distributed (actually or constructively<sup>2</sup>) to the Grantor or the Grantor's spouse;*
- (ii) *held or accumulated for future distribution to the Grantor or the Grantor's spouse;*
- (iii) *applied (actually or constructively<sup>2</sup>) to the payment of premiums on life insurance policies of the Grantor or the Grantor's spouse where such policies are not irrevocably payable to organizations specified in §170(c); or*
- (iv) *applied or distributed (actually or constructively<sup>2</sup>) to discharge the Grantor's (or his spouse's) legal obligations<sup>3</sup>;*

*or may such income be so distributed, held or applied (actually or constructively<sup>2</sup>) as in (i) through (iv) above by exercise of a power in:*

- (i) *the Grantor (or his spouse);*
- (ii) *a Nonadverse Party; or*

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<sup>2</sup> Constructive distribution to the Grantor or to his spouse includes payment on behalf of the Grantor or his spouse to another in obedience to his or her direction. (§1.677(a)-1(c)).

<sup>3</sup> With respect to the Grantor's (or his spouse's) support obligation of a beneficiary, the trust will be treated as a defective grantor trust only with regard to amounts actually distributed to or on behalf of a beneficiary the Grantor is obligated under state law to support. (§677(b) and §1.677(b)-1). This exception is not applicable where: (i) income is distributed or applied to support the Grantor's spouse or to discharge other obligations of the Grantor and/or his spouse (§1.677(a)-1(d) and §1.677(b)-1(d)); (ii) sole discretion to distribute or apply income for a beneficiary whom the Grantor has a legal obligation to support rests in the Grantor (acting alone or in conjunction with others) unless the Grantor has such discretion as trustee or co-trustee (§1.677(b)-1(e)); or (iii) income is *required*, without any discretionary determination, to be distributed or applied to the support of a beneficiary to whom the Grantor is legally obligated to support (§1.677(b)-1(f)). In the case of (i), (ii) and (iii) above, the trust will be treated as a defective grantor trust at all times under §677(a) notwithstanding the exception in §677(b).

(iii) *both*  
*without the approval or consent of any Adverse Party where the exercise of such power over income would not otherwise be excepted under §673 if it were treated as a reversionary interest?*

Under §677(a), the grantor is treated as the owner of any portion of the trust whose income is, or may be (without the approval or consent of an adverse party), distributed to or accumulated for the benefit of the grantor or his spouse. The scope of this is very broad as it applies to a power to distribute or accumulate (unless such power is otherwise excepted under §673) regardless of whether the grantor has the ability to compel distributions or accumulations, or whether any such distributions or accumulations are actually made. The trust will be treated as a defective grantor trust under §677(a) until both the grantor and grantor's spouse divest themselves permanently and completely of every interest (excluding any possibility of inheritance from a beneficiary) causing the grantor to be treated as the owner of the trust under §677(a). (§1.677(a)-1(c)).

The interest held in the trust by the grantor determines the portion of the trust he owns. For example, in the case of an income interest, if the trust instrument specifies that the trust's income is to be distributed to the grantor (or his spouse) or that such income *may* be distributed, held or applied for such distribution (without the approval or consent of any adverse party), the grantor is taxable only on the ordinary income items of the trust. Conversely, in the case of a remainder interest, if the grantor holds a reversionary interest in the trust's corpus and under the trust instrument or local law capital gains are allocated to trust corpus, the grantor is taxable only on the capital items of the trust. (See §1.677(a)-1(g)). If trust income is, or may be (without the approval or consent of an adverse party), distributed to or accumulated for the benefit of the grantor or his spouse and the grantor holds both an income and remainder interest, or a portion of one or both, he will be taxed on both ordinary and capital items, respectively, in proportion to his ownership. (See Example 2 of §1.677(a)-1(g)). If the grantor is included in a class of beneficiaries for whom income may be distributed or accumulated (without the approval or consent of an adverse party) in the sole discretion of the trustee, the grantor is currently taxed on all items of income even where distributions are never actually made to the grantor. (See *Loeb v. Comr.*, 1072 (1945); *Ewald v. Comr.*, 2 T.C. 384 (1943); *Wells v. Comr.*, 42 T.C.M. 1305 (1981); and PLRs 8213004 and 8037116).

With respect to income that is, or may be (without the approval or consent of an adverse party), distributed to or accumulated for the benefit of the grantor's spouse, the trust will only be treated as a defective grantor trust during the marriage of such spouse to the grantor. Thus, if the grantor and his spouse divorce or separate, distributions to, or accumulations for, such spouse will cease to cause the trust to be treated as a defective grantor trust under §677(a). In such a case, the trust will be taxed in accordance with §682 or §71. (§1.677(a)-1(b)(2)). However, this is in contradiction with the application of §672(e) which

requires attribution to the grantor of any interest or power in the trust held by the grantor's spouse at the time the interest or power was created or at any time after the marriage of the grantor to his spouse if such marriage occurs after the creation of such interest or power. This conflict is resolved in Example 10(ii) of §1.1361-1(k)(1) wherein the Service provides that under §682 a trust ceases to be treated as a defective grantor trust under §677(a) when the grantor and his spouse divorce.

The right to deferred distributions and accumulations must be distinguished from any limitation on the period of exercise of a power to accumulate income which, were it treated as a reversionary interest, would except the trust from defective grantor trust treatment under §673 due to the value of the reversion being 5% or less of the total value of the trust's assets at inception. To illustrate, if the trust instrument provides that the trustee may accumulate income (without the approval or consent of an adverse party) to be paid to the grantor at the end of a period, the length of which would otherwise except the trust from defective grantor trust treatment under §673, the grantor is taxed currently on all items of income notwithstanding the period of deferral before receipt of such income. (§1.677(a)-1(f)). Conversely, if the trust instrument provides for a power to distribute or accumulate trust income for the benefit of the grantor which is deferred for a period which would except the trust from defective grantor trust treatment pursuant to §673, the grantor is not taxed on items of trust income until the end of the period of deferral provided the power is not relinquished or postponed.

The determination as to whether the trust will be treated as a defective grantor trust after any such period the power is postponed is to be made pursuant to §1.673(d)-1 which provides that a new transfer to the trust results at the date any additional postponement for the reacquisition of possession or enjoyment of any reversionary interest is effected. Thus, assuming a trust is excepted from treatment as a defective grantor trust under §677 by virtue of §673, that trust may be treated as a defective grantor trust after the period of postponement unless either: (i) the power to distribute to, or accumulate income for, the grantor or his spouse is relinquished; or (ii) the period for exercise of the power is postponed for another period of time which would except the trust from treatment as a defective grantor trust under §673 if the exercise of such power were treated as a reversionary interest the value of which is 5% or less of the value of the trust's assets at the commencement of the new period. (§§1.673(d)-1 and 1.677(a)-1(e)).

### **Question 11 – Person Other Than Grantor Treated as Substantial Owner - §678**

*Does any person (other than the Grantor) have:*

- (i) a power which is solely exercisable by him to vest the corpus or income therefrom in himself or for his behalf (§678(a)(1)); or*
- (ii) a power in (i) above which has been released or partially modified such that he retains an interest or power in the trust which would,*

*if such interest or power had been retained by a grantor, subject a grantor to treatment as the owner of the trust under §§673 through 677 after such release or modification (§678(a)(2));*

*where:*

- (i) the Grantor is not treated as the owner of the trust under the provisions of §§671 through 679 (excluding this section, §678) where such power is a power over income<sup>4</sup> (678(b));*
- (ii) such power is not a power in such person, acting as trustee or co-trustee, merely to apply the income of the trust to the support or maintenance of a beneficiary whom such person is obligated to support<sup>5</sup> (§678(c)); and*
- (iii) such power has not been renounced or disclaimed within a reasonable time after such person first became aware of its existence<sup>6</sup> (§678(d))?*

If any person, other than the grantor, has a power solely exercisable by him to vest a portion of the trust's corpus or income therefrom in him or for his behalf, or if such person would otherwise be treated as the owner of a portion of the trust under §§673 through 677 notwithstanding the release or modification of such a power, such person will be treated as the owner of that portion of the trust. (§1.678(a)-1(a)). However, such person will not be treated as the owner of a portion of the trust where: (i) his power, as originally granted or thereafter modified, relates to income only, and the trust is treated as a defective grantor trust under §§671 through 679 (excluding §678) (§1.678(b)-1); (ii) he has the power, in his capacity as trustee or co-trustee only, to apply income to the support or maintenance of a beneficiary to whom he is obligated to support under state law (Note this exception does not apply to amounts actually distributed or applied.) (§1.678(c)-1(a) and (b)); or (iii) he renounces or disclaims his power to vest trust corpus or income in himself within a reasonable time of first becoming aware of its existence. (§1.678(d)-1).

There is no limitation (except as to the grantor) as to who may own a portion of the trust under §678. All that is required is that a person, other than the grantor, hold a power to vest trust corpus or the income therefrom, without the consent of

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<sup>4</sup> If any person has a power solely exercisable by him to vest only the income of the trust in himself and the trust's Grantor is treated as the owner of the trust pursuant to §§671 through 679 (excluding §678), §678(a) will not cause the trust to be treated as a defective grantor trust with respect to such person. However, where such person has a power to vest the corpus of the trust in himself and the Grantor is treated as the trust's owner under §§671 through 679 (excluding §678), §678(a) would be applicable and result in both the Grantor and such person being treated as owners of their respective portions of the trust.

<sup>5</sup> The trust will be treated as a defective grantor trust only with regard to amounts actually distributed or applied to the support of a beneficiary the Grantor is obligated under state law to support. (§1.678(c)-1(a)). This exception is not applicable to a power solely exercisable by any person (other than the Grantor) to apply the corpus or income for the satisfaction of such person's legal, non-support obligations. (§1.678(a)-1(b)).

<sup>6</sup> The regulations do not provide guidance as to what constitutes a valid disclaimer or when such disclaimer is made within a "reasonable time." It is reasonable to assume that the standards under §2518 pertaining to disclaimers made for estate and gift tax purposes should meet the requisite standard under §678(d).

any other person, in himself, or in the case where such power has been relinquished or modified, that such person be treated as the owner of the trust under §§671 through 679 (excluding §678) if he were the trust's grantor. Powers that fall within the scope of §678 include the power to use trust funds to discharge legal obligations (other than support obligations) and withdrawal rights (i.e. *Crummey* and "five or five" powers). (§1.678(a)-1(b) and Rev. Rul. 81-6, respectively).

A withdrawal right exercisable in a beneficiary's sole discretion would constitute a power to vest a portion of the corpus of the trust in himself under §678(a). If that beneficiary allows such withdrawal right to lapse and he is a residual beneficiary of the trust, he would then become an owner of that portion of the trust under §678(a)(2) and §677(a)(2) if he were treated as the trust's grantor under §677 based on his right to the future distribution of accumulated income attributable to the corpus which was subject to the lapsed withdrawal right. This assumes of course that such accumulation is made without the approval or consent of an adverse party pursuant to §677(a) and that the grantor is not otherwise the owner of the trust pursuant to §678(b) and §677(a).

Thus, under §678(a)(1), a beneficiary having sole discretion to withdraw any amount of trust corpus is treated as the owner of such corpus during the period the withdrawal right is active. When that withdrawal right lapses, the beneficiary is treated as the owner of the corpus subject to such lapsed withdrawal right under §678(a)(2) provided that: (i) the income is accumulated without the approval or consent of an adverse party for future distribution to such beneficiary under §677(a)(2); and (ii) the grantor of the trust is not treated as its owner pursuant to §678(b) by reason of application of §677(a). (Note that if the grantor is treated as the owner of the trust, or portion thereof, under §677(a), §678(b) trumps the application of §678(a), and the beneficiary is not treated as the owner of the corpus after lapse of the withdrawal right. In such a case, both the interests of the beneficiary and the grantor relate to a power over income under §677(a) and fall within the scope of §678(b).) Assuming the beneficiary is deemed the owner of trust corpus pursuant to §678(a)(2) and §677 after the lapse of any withdrawal rights, his ownership in the corpus of such trust is increased proportionately after each lapse by an amount equal to the product of the value subject to the withdrawal right multiplied by the proportion of the value of the corpus not yet owned by the beneficiary to the total value of the trust corpus. The beneficiary is taxable on all ordinary income items attributable to the corpus he owns as well as his proportionate share of capital gains allocable to corpus. However, this is of no consequence where the corpus of the trust generates no income (i.e. term life insurance). (See generally PLRs 8142061, 8521060, 8809043, 9034004, 9541029, 200022035 and 200104005).