

# Achieving Grantor Trust Status Through Code § 679

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There are many useful tools that estate planners might utilize in crafting a successful estate plan. These include, of course, the annual gift tax exclusion under I.R.C. § 2503(b), the gift and estate tax exclusion amount under I.R.C. § 2010(c) and the unlimited marital deduction under I.R.C. §§ 2056 and 2523.<sup>1</sup> However, one might posit that the single most effective tool available for suc-

cessful estate tax planning does not even relate directly to the estate, gift and generation-skipping transfer taxes. That tool is part of the income tax law—specifically, Subpart E of Part I of Subchapter J of Chapter 1 of Subtitle A of the Internal Revenue Code, entitled “Grantors and Others Treated as Substantial Owners,” and more commonly referred to as the “grantor trust” rules of I.R.C. §§ 671-679.

The grantor trust rules provide that when a trust is treated as a “grantor” trust, the grantor is personally liable for the payment of the income tax attributable to any taxable income earned by the trust. Specifically, I.R.C. § 671, entitled “Trust income, deductions, and credits attributable to grantors and others as substantial owners,” provides, in pertinent part, that:

Where it is specified in this subpart that the grantor...shall be treated as the owner of any portion of a trust, there shall then be included in computing the taxable income and credits of the grantor...those items of income, deductions, and credits against tax of the trust which are attributable to that portion of the trust to the extent that such items would be taken into account under this chapter in computing taxable income or credits against the tax of an individual.<sup>2</sup>

The effect of the grantor trust rules is to enable a grantor, through the payment of the income tax attributable to the income of the grantor trust, to effectively make transfers to the trust and, of equal importance, to do so without risk that the Internal Revenue Service might seek to characterize the payment of such income tax by the grantor as a taxable gift by the grantor to the trust.<sup>3</sup> Also important is the fact that the circumstances under which a trust would be treated as a grantor trust pursuant to I.R.C. §§ 672-679 (generally, by reason of

the grantor, either directly or through attribution, having retained an “excessive” level of control over the trust), are not necessarily coincident with the circumstances pursuant to which trust property would be included in a decedent’s gross estate under the so-called “string” provisions of the Code, such as I.R.C. § 2036.



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As noted above, the powers that would cause a trust to be treated as a grantor trust are contained in I.R.C. §§ 672-679. Although much has been written about I.R.C. §§ 672-678, curiously little attention has been paid to I.R.C. § 679, which concerns the tax treatment of certain “foreign” trusts. I.R.C. § 679 provides, in pertinent part, that:

A United States person who directly or indirectly transfers property to a foreign trust...shall be treated as the owner for his taxable year of the portion of such trust attributable to such property if for such year there is a United States beneficiary of any portion of such trust.<sup>4</sup>

The authors suspect that the reason why I.R.C. § 679 has generally been left unexplored in commentary, and is rarely utilized (at least intentionally) to cause a trust to be deemed a grantor trust, is because of the stigma that often attaches to foreign trusts. It is the intent of the authors through this article to promote the use of I.R.C. § 679 as a so-called “grantor trust power,” under appropriate circumstances, and to demonstrate the power, precision and flexibility of this section of the Code as a planning device when grantor trust status is the desired result.

## I. Background

Of significant value to the estate planner is the certainty of obtaining an intended result. Where the desired result is a grantor trust there are, in fact, most often two results sought. The first is that the trust’s income, deductions and credits will be attributed to the grantor of the trust for income tax purposes. The second is that the income tax treatment will not cause the trust fund to be included in the grantor’s gross estate for estate tax purposes.

Unfortunately, some of the most frequently used grantor trust powers set forth in I.R.C. §§ 672-678 leave

some uncertainty as to whether full grantor trust treatment has actually been attained. For example, questions exist regarding:

- whether the power of a non-adverse person to distribute or accumulate income for the grantor or the grantor's spouse results in grantor trust status pursuant to I.R.C. § 677(a)(1) and (2) only as to trust income;<sup>5</sup>
- whether the power of a non-adverse person to use trust income to pay life insurance premiums on the life of the grantor or the grantor's spouse results in grantor trust status pursuant to I.R.C. § 677(a)(3) in excess of the sums actually used to pay insurance premiums;<sup>6</sup> and
- whether the grantor's right to borrow from the trust without adequate interest or adequate security results in grantor trust status pursuant to I.R.C. § 675(3) if no loan is actually outstanding during the year.<sup>7</sup>

Conversely, the use of other grantor trust powers, which might convey greater certainty as to grantor trust status, might place the exclusion from the grantor's gross estate for estate tax purposes in doubt. For example, while a trust can clearly be structured as a grantor trust under I.R.C. § 674(a) if the grantor retains a right to the beneficial enjoyment of the trust property or the power to dispose of the trust property,<sup>8</sup> the grantor's retention of a right to the beneficial enjoyment of the trust property will result in estate tax inclusion under I.R.C. § 2036(a),<sup>9</sup> and the grantor's retention of a power to dispose of the trust property will result in estate tax inclusion under I.R.C. §§ 2036(a) and 2038.<sup>10</sup>

Similar estate tax inclusion issues exist in connection with the grantor's retention of those "administrative powers" set forth under I.R.C. § 675, including (1) the power to deal with the trust fund for less than adequate and full consideration, (2) the power to borrow from the trust fund without adequate interest or adequate security, (3) the power to vote trust stock or other securities of a corporation in which the holdings of the grantor and the trust are significant in terms of voting control and (4) the power to control the investment of the trust funds to the extent that the trust funds consist of stocks or securities of corporations in which the holdings of the grantor and the trust are significant from the viewpoint of voting control.

Even I.R.C. § 675(4)(C), which speaks to the grantor's retention of the "administrative" power to reacquire the trust corpus by substituting other property of an equivalent value, and which arguably was sanctioned by the issuance of Revenue Ruling 2008-22,<sup>11</sup> provides only a relative degree of comfort that the intended income tax and estate tax results can be obtained. For example, uncertainty may remain as to

whether a power of substitution could be exercised to acquire any voting stock of a "controlled corporation" for purposes of I.R.C. § 2036(b). Additional issues exist in guaranteeing that the substituted properties are, in fact, of equivalent value and that the substitution power not be exercised in a manner that can shift benefits among the trust beneficiaries.<sup>12</sup> However, the IRS did recently clarify that a power of substitution does not create an impermissible "incident of ownership" that would cause estate inclusion under I.R.C. § 2042 where the trust owns one or more life insurance policies on the grantor's life.<sup>13</sup>

Finally, the use of other grantor trust powers that would likely cast no uncertainty as to either the income tax or estate tax results often prove unpalatable to grantors for more visceral reasons. For example, I.R.C. § 674(a) provides that grantor trust status will result not only where the trust is subject to a power of disposition exercisable by the grantor (which would necessarily cause estate inclusion), but also where the trust is subject to a power of disposition exercisable by a "nonadverse party"<sup>14</sup> (which would not cause estate inclusion). However, grantors are often unwilling to give a third party the power to divert trust assets from the grantor's otherwise intended disposition irrespective of all assurances that the likelihood of such a power actually being exercised might, as a practical matter, be negligible.

## II. I.R.C. § 679

While the aforementioned examples illustrate some of the issues that exist with the more traditional grantor trust powers, no such uncertainty exists under I.R.C. § 679. I.R.C. § 679 merely requires that (i) the trust be a "foreign trust," and (ii) the trust have a "United States beneficiary." Both of these terms are clearly defined under the Code and the Treasury Regulations.<sup>15</sup>

The test of whether the trust is a "foreign trust" is an objective one. I.R.C. § 7701(a)(31)(B) defines a "foreign trust" as any trust that is not a United States person, and I.R.C. § 7701(a)(30)(E) provides, in pertinent part, that the term "United States person" means any trust if (i) a court within the United States is able to exercise primary supervision over the administration of the trust (known as the "court test"), and (ii) one or more United States persons have the authority to control all "substantial decisions" of the trust (known as the "control test"). Thus, a "foreign trust" is a trust that fails either one, or both, of the court test and the control test.

Under Treas. Reg. § 301.7701-7(d)(ii), the term "control" means having the power, by vote or otherwise, to make all of the "substantial decisions" of the trust, with no other person having the power to veto any such decisions. To determine who has control, it is

necessary to consider all persons who have authority to make a substantial decision of the trust, not only the trust fiduciaries.

Under Treas. Reg. § 301.7701-7(d)(ii), “substantial decisions” are those decisions that are not ministerial and that persons are authorized or required to make under the terms of the trust instrument and applicable law. Ministerial decisions concern matters such as the bookkeeping, the collection of rents and the execution of investment decisions. Substantial decisions include, but are not limited to, decisions concerning (i) whether and when to distribute income or corpus; (ii) the amount of any distributions; (iii) the selection of a beneficiary; (iv) whether a receipt is allocable to income or principal; (v) whether to terminate the trust; (vi) whether to compromise, arbitrate or abandon claims of the trust; (vii) whether to sue on behalf of the trust or to defend suits against the trust; (viii) whether to remove, add or replace a trustee; (ix) whether to appoint a successor trustee to a trustee who has died, resigned or otherwise ceased to act; and (x) investment decisions. (Note, however, that if a United States person hires an investment advisor for the trust, investment decisions made by the investment advisor will be considered substantial decisions controlled by the United States person if the United States person can terminate the investment advisor’s power to make investment decisions at will.)

A “United States beneficiary” is a trust beneficiary who is a citizen or resident of the United States.<sup>16</sup> In addition, Treas. Reg. § 1.679-2(a)(i) provides that:

[a] foreign trust is treated as having a U.S. beneficiary unless during the taxable year of the U.S. transferor (i) No part of the income or corpus of the trust may be paid or accumulated to or for the benefit of, directly or indirectly, a U.S. person; and (ii) If the trust is terminated at any time during the taxable year, no part of the income or corpus of the trust could be paid to or for the benefit of, directly or indirectly, a U.S. person.

Pursuant to Treas. Reg. § 1.679-2(a)(ii), “[t]his determination is made without regard to whether income or corpus is actually distributed to a U.S. person during that year, and without regard to whether a U.S. person’s interest in the trust income or corpus is contingent on a future event.”

### III. Issues

Since the requirements for satisfying I.R.C. § 679 are clearly set forth in the Treasury Regulations and easy to effect one way or the other (for example,

through the appointment of a foreign person as the trustee or even as a co-trustee), it is a wonder why estate planners do not employ I.R.C. § 679 more often, especially when trying to reconfigure an existing irrevocable trust that has been erroneously drafted as a non-grantor trust or that uses one or more of the grantor trust powers discussed above that leave at least some uncertainty concerning whether or not full grantor trust status has been achieved.<sup>17</sup>

The reason is that while qualification under I.R.C. § 679 may be fairly simple and certain, unique issues do exist in connection with foreign trusts. First, foreign trusts carry additional tax reporting requirements. Most significantly:

- A United States person treated as an owner of a foreign trust must file a Form 3520, *Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts*, on an annual basis. The failure to file a timely and complete Form 3520 will result in a penalty of up to thirty-five percent.
- A United States person treated as an owner of a foreign trust with one or more U.S. beneficiaries is responsible for ensuring that the foreign trust file a Form 3520-A, *Annual Return of a Foreign Trust with U.S. Beneficiaries*, setting forth a full and complete accounting of all trust activities, trust operations and other relevant information. The failure to file a timely and complete Form 3520-A will result in a penalty of up to five percent to apply.

In addition, and beyond mere reporting issues, I.R.C. § 684(a) treats any transfer of property by a United States person to a foreign trust as a sale or exchange for an amount equal to the fair market value of the property transferred. Importantly, an exception exists under I.R.C. § 684(b) for a transfer to a trust by a United States person to the extent that any person is treated as the owner of such trust under section 671. Therefore, the trick is in avoiding or minimizing the consequences of gain recognition when the trust is no longer a grantor trust (as will be the case, for example, upon the grantor’s death). Several techniques exist for addressing this issue, as follows:

- The trust can be domesticated prior to the grantor’s death by having the foreign trustee resign (or by removing the foreign trustee), perhaps at a time when the trust would be more appropriately structured as a non-grantor trust than as a grantor trust.<sup>18</sup>
- The trust can be invested and reinvested with an eye towards minimizing the capital appreciation that will exist at the grantor’s death.

- A nominally funded sister trust, structured as a domestic trust, can be created and given a general power of appointment over the assets of the foreign trust effective upon the grantor's death. The mere existence of such a power of appointment, whether or not actually exercised, should cause the foreign trust to remain a grantor trust with a United States person (i.e., the domestic sister trust), as its grantor, following the death of the individual grantor.

#### IV. Conclusion

Through the simple expedient of naming a foreign person as a trustee, or even a co-trustee, of a trust, I.R.C. § 679 ensures grantor trust status to the entire trust without the potential additional, and most certainly unwanted, side effect of estate tax inclusion. The use of I.R.C. § 679 should therefore be considered as a planning device where grantor trust status is a goal and other options leave less than certain results or are simply not available. However, care must be taken to ensure that the benefits of grantor trust status through I.R.C. § 679 are not offset, if the trust remains a foreign trust upon the grantor's death, by the effect of a deemed sale or exchange of the trust's property pursuant to I.R.C. § 684.

#### Endnotes

1. All references herein to the Code and to the I.R.C. are references to the Internal Revenue Code of 1986, as amended.
2. I.R.C. § 671.
3. See, e.g., Rev. Rul. 2004-64, 2004-27 I.R.B. 7 ("[w]hen the grantor of a trust, who is treated as the owner of the trust under subpart E, pays the income tax attributable to the inclusion of the trust's income in the grantor's taxable income, the grantor is not treated as making a gift of the amount of the tax to the trust beneficiaries.")
4. I.R.C. § 679(a)(1).
5. See Treas. Reg. § 1.677(a)-1(g) Ex.1. *But see* PLR 9504021, PLR 9451056 and PLR 9415012.
6. See *Moore v. Comm'r*, 39 BTA 808 (1939), *acq.* 1939-2 C.B. 25; *Rand v. Comm'r*, 40 BTA 233 (1939), *aff'd*, 116 F.2d 929 (8th. Cir. 1941); *Iversen v. Comm'r*, 3 TC 756 (1944); *Weil v. Comm'r*, 3 TC 579, *acq.* 1944 C.B. 29. *But see* PLR 8103074, PLR 8126047 and PLR 8118051.
7. See *Benson v. Comm'r*, 76 TC 1040 (1981); *Bennett v. Comm'r*, 79 TC 470 (1982).
8. Section 674(a) provides that "[t]he grantor shall be treated as the owner of any portion of a trust in respect of which the beneficial enjoyment of the corpus or the income therefrom is subject to a power of disposition, exercisable by the grantor or a nonadverse party, or both, without the approval or consent of any adverse party."
9. Section 2036(a) provides that "[t]he value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or

otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death (1) the possession or enjoyment of, or the right to the income from, the property, or (2) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom."

10. Section 2038(a)(1) provides that "[t]he value of the gross estate shall include the value of all property...[t]o the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, where the enjoyment thereof was subject at the date of his death to any change through the exercise of a power (in whatever capacity exercisable) by the decedent alone or by the decedent in conjunction with any other person (without regard to when or from what source the decedent acquired such power), to alter, amend, revoke, or terminate, or where any such power is relinquished during the 3 year period ending on the date of the decedent's death."
11. 2008-16 IRB 796. Rev. Rul. 2008-22 provides that "[a] grantor's retained power, exercisable in a nonfiduciary capacity, to acquire property held in trust by substituting property of equivalent value will not, by itself, cause the value of the trust corpus to be includible in the grantor's gross estate under §2036 or 2038, provided the trustee has a fiduciary obligation (under local law or the trust instrument) to ensure the grantor's compliance with the terms of this power by satisfying itself that the properties acquired and substituted by the grantor are in fact of equivalent value, and further provided that the substitution power cannot be exercised in a manner that can shift benefits among the trust beneficiaries."
12. *Id.*
13. Rev. Rule. 2011-28 (2011-49 IRB 830).
14. Section 672(b) provides that "[f]or purposes of this subpart, the term 'nonadverse party' means any person who is not an adverse party." Section 672(a) provides that "...[t]he term 'adverse party' means any person having a substantial beneficial interest in the trust which would be adversely affected by the exercise or nonexercise of the power which he possesses respecting the trust..."
15. Prior to the enactment of I.R.C. § 679, a United States person could establish a foreign trust in a no-tax jurisdiction and invest the trust assets in a manner that would generate only foreign-source income. This strategy would enable the trust to accumulate income free of United States income tax if the trust were structured as a non-grantor trust.
16. See I.R.C. § 7701(a)(30)(A).
17. Although the "decanting" of such a trust might be posited as a solution in such situations, decanting is sometimes either impracticable or impossible.
18. For reasons beyond the scope of this article, however, and irrespective of I.R.C. § 684, it may be important for the trust to be domesticated following the death of the grantor since the accumulation of income in a foreign non-grantor trust with U.S. beneficiaries can have significant adverse tax consequences.

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