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June 24, 2021

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Re: ACTEC Report on Grantor Trusts: Alternative Proposals for Change

Dear Ladies and Gentlemen:

The American College of Trust and Estate Counsel ("ACTEC") is pleased to submit this report examining several possible alternative proposals to address the important issues related to the so-called "grantor trust rules" in Subpart I of Subchapter J of the Internal Revenue Code (Sections 671 through 679). As Congress considers legislative proposals related to the transfer tax system, the enclosed report provides several alternatives that, in the opinion of ACTEC, would allow efficient restructuring of the grantor trust rules if they are to be modified.

ACTEC is a professional organization of approximately 2,400 lawyers from throughout the United States. Fellows of ACTEC are elected to membership by their peers on the basis of professional reputation and ability in the fields of trusts and estates and on the basis of having made substantial contributions to those fields through lecturing, writing, teaching, and bar activities. Fellows of ACTEC have extensive experience in providing advice to taxpayers on matters of estate and generation-skipping transfer tax and business succession planning. ACTEC offers technical comments about the law and its effective administration but does not take positions on matters of policy or political objectives.

ACTEC's comments and recommendations are set forth in the attached report, which is the product of significant research, discussion, and analysis on this topic.

If you or your staff would like to discuss the contents of this report with the ACTEC Fellows who created it, please contact Beth Kaufman (202.862.5062, bkaufman@capdale.com), Chair of the Tax Policy Study Committee, or Deborah McKinnon, ACTEC Executive Director, at (202.684.8460, domckinnon@actec.org).

Respectfully submitted,

Ann B. Burns, President

Attachment: ACTEC Report on Grantor Trusts: Alternative Proposals for Change

ACTEC REPORT ON GRANTOR TRUSTS:
ALTERNATIVE PROPOSALS FOR CHANGE

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INTRODUCTION

This report of the American College of Trust and Estate Counsel ("ACTEC") examines several important alternatives for changing the so-called "grantor trust rules" in Subpart E of Subchapter J of the Internal Revenue Code ("IRC") (Sections 671 through 679). The grantor trust rules often no longer serve their original purpose as a result of the compression of the income tax rate brackets applicable to estates and trusts and the so-called "kiddie tax" in IRC Sections 1(e) and 1(g), respectively, enacted about 35 years ago. Instead, taxpayers often now use the grantor trust rules to reduce income, gift, and estate taxes. Accordingly, as part of any gift and estate tax reform, it may be appropriate to review whether and to what extent the grantor trust rules should be modified or eliminated and how the gift and estate tax rules should be modified, to address this interplay. Five different approaches are presented below. In addition, several previous proposals by others are summarized in the five Exhibits in Part VI at the end of this report.

The income tax grantor trust rules are substantially different from the estate, gift, and generation-skipping transfer ("GST") tax trust rules in IRC Sections 2036 through 2038, 2511, and 2642(f). Consequently, an irrevocable transfer in trust can be treated as complete for transfer tax[1] purposes but the trust property is still treated as being owned by the grantor for income tax purposes, and *vice versa*; and a completed gift in trust for gift tax purposes will not always prevent the trust property from being included in the grantor's gross estate for estate purposes or allow for allocation of the grantor's GST exemption for GST tax purposes. The compression of the income tax rate brackets without eliminating most of the income tax grantor trust rules, and the publication of Revenue Ruling 85-13, 1985-7 I.R.B. 28,[2] have led to the widespread establishment of grantor trusts (often called "Intentionally Defective Grantor Trusts" or "IDGTs") that are completed-gift trusts. These trusts enable grantors to achieve two often criticized advantages that currently are used in much of transfer tax planning for high-net-worth individuals (referred to below as the "GT Tax Advantages"). The GT Tax Advantages are that the grantor may (a) essentially make tax-free

[1] As used in this report, transfer tax refers to the federal estate, gift, and generation-skipping transfer taxes.

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

gifts to the IDGTs by paying the income tax attributable to the trusts' taxable income and (b) avoid the realization of income and recognition of gain or loss with respect to transactions between grantors and their grantor trusts.

The following parts of this report describe several ways in which the rules might be revised and improved. Part I describes current law and suggests changes that would address existing problems if the grantor trust rules were not fundamentally changed. Part II describes a proposal to make the grantor trust rules elective. Part III describes a proposal to specifically target the GT Tax Advantages. Part IV describes a proposal to largely eliminate the grantor trust rules without aligning them with the transfer tax rules. Part V outlines a proposal to correlate the income tax and transfer tax rules. The Exhibits in Part VI describe prior proposals to modify the grantor trust rules, none of which this project has proposed. ACTEC is presenting these options for consideration without endorsing any of them. The proposals in Parts I and III could be adopted together. The proposals in Parts II and II could be adopted together. The proposals in any one of the five parts could be adopted separately without adopting any other alternative.

ACTEC has not examined all of the collateral effects of the five proposals. The alternatives proposed here could affect applications or provisions outside of the estate planning context, and ACTEC believes that a thorough study is required to ensure the sound administration of our tax laws if any change in the grantor trust rules is pursued. In particular, prior to adopting any of the five proposals, Congress should consider the impact on (1) non-estate planning trusts, such as so-called "rabbi trusts," unit investment trusts, and Qualified Subchapter S Corporation Trusts, and (2) several kinds of estate planning trusts that are sanctioned by the Internal Revenue Code and Treasury Regulations, such as Grantor Retained Annuity Trusts ("GRATs"), Grantor Retained Unitrusts ("GRUTs"), Qualified Personal Resident Trusts ("QPRTs"), Charitable Lead Annuity Trusts ("CLATs"), and Charitable Lead Unitrusts ("CLUTs"). Consideration also should be given to addressing taxation to the grantor under assignment of income principles when the trust exercises compensatory stock options.

I. MINIMALIST APPROACH THAT AVOIDS FUNDAMENTAL CHANGES TO THE GRANTOR TRUST RULES OR THE TRANSFER TAX TRUST RULES.

A. IRC Section 671

Section 671 sets forth the general tax consequences of a trust being a grantor trust.

§ 671 – Trust income, deductions, and credits attributable to grantors and others as substantial owners.

Where it is specified in this subpart that the grantor or another person 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 or the other person 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. Any remaining portion of the trust shall be subject to subparts A through D. No items of a trust shall be included in computing the taxable income and credits of the grantor or of any other person solely on the grounds of his dominion and control over the trust under section 61 (relating to definition of gross income) or any other provision of this title, except as specified in this subpart.

Comment. IRC Section 671 provides that grantor trust status causes a trust's income, deductions, and credits to be reported by the grantor on the grantor's income tax return. However, it has long been settled that grantor trust status causes the grantor and a wholly owned grantor trust to be treated as one and the same taxpayer for all income tax purposes. *See* Rev. Rul. 85-13; Treas. Reg. 1.1001-2(c) Example 5.

Suggestion. IRC Section 671 should be revised to incorporate the holding of Rev. Rul. 85-13.

B. IRC Section 672

IRC Section 672 provides definitions and rules for Subpart E. Specifically, IRC Section 672(e) provides rules on the treatment of a grantor's spouse.

§ 672 – Definitions and Rules. . . .

(e) Grantor treated as holding any power or interest of grantor's spouse.—

(1) In general. – For purposes of this subpart, a grantor shall be treated as holding any power or interest held by--

(A) any individual who was the spouse of the grantor at the time of the creation of such power or interest, or

(B) any individual who became the spouse of the grantor after the creation of such power or interest, but only with respect to periods after such individual became the spouse of the grantor.

(2) Marital status. – For purposes of paragraph (1)(A), an individual legally separated from his spouse under a decree of divorce or of separate maintenance shall not be considered as married.

Comment. Pursuant to IRC Section 672(e), once an individual who has any power over or interest in property held in trust is the grantor's spouse, whether at the time of creation or subsequently, the tying of that individual's power or interest to the grantor is permanent until death, or release or termination of the power or interest. In effect, once a spouse, always a spouse. A consequence of the existing rule is that if a married couple divorces and, prior to divorce, one spouse had established a trust and named the other spouse as trustee, after divorce, the transferor could remain subject to income tax on trust assets over which an ex-spouse has a power or interest. This provision is especially problematic, in view of the repeal of Section 682, which was generally effective after December 31, 2018.

That result is inconsistent with the general rules in the tax code. IRC Section 7703(a)(1) provides that persons are married based on their status at the close of a taxable year. Moreover, the income tax as an annual, recurring tax supports determining this treatment annually. The unusual result under IRC Section 672(e) could trigger tax contrary to taxpayers' expectations.

Suggestion. This surprise provision should be modified to provide that a grantor is treated as holding any power or interest held by the grantor's spouse as defined in IRC Section 7703(a). That rule would incorporate the timing issue inherent in IRC Section 7703(a) (the status as a spouse being determined at the close of the taxable year) and retain the rules of IRC Section 672(e)(2) regarding legal separation. Another possible variation would be to create an election allowing the grantor to elect irrevocably to continue to be treated as having the powers or interests of the ex-spouse while providing a default rule under which termination of marriage terminates application of IRC Section 672(e) as of the next taxable year.3 Please also see ACTEC Comments to Joint Committee on Taxation, House Ways and Means, and Senate Finance Committee re Repeal of I.R.C. Section 682 (July 5, 2018) and ACTEC Comments on guidance in connection with the Repeal of Section 682 (Notice 2018-37) (July 2, 2018).

C. IRC Section 673

IRC Section 673 provides rules governing when a reversionary interest will trigger the grantor trust rules.

§ 673 – Reversionary interests.

(a) General rule. --The grantor shall be treated as the owner of any portion of a trust in which he has a reversionary interest in either the corpus or the income therefrom, if, as of the inception of that portion of the trust, the value of such interest exceeds 5 percent of the value of such portion.

(b) Reversionary interest taking effect at death of minor lineal descendant beneficiary. --In the case of any beneficiary who--

(1) is a lineal descendant of the grantor, and

(2) holds all of the present interests in any portion of a trust, the grantor shall not be treated under subsection (a) as the owner of such portion solely by reason of a reversionary interest in such portion which takes effect upon the death of such beneficiary before such beneficiary attains age 21.

(c) Special rule for determining value of reversionary interest. --For purposes of subsection (a), the value of the grantor's reversionary interest shall be determined by assuming the maximum exercise of discretion in favor of the grantor.

(d) Postponement of date specified for reacquisition. --Any postponement of the date specified for the reacquisition of possession or enjoyment of the reversionary interest shall be treated as a new transfer in trust commencing with the date on which the postponement is effective and terminating with the date prescribed by the postponement. However, income for any period shall not be included in the income of the grantor by reason of the preceding sentence if such income would not be so includible in the absence of such postponement.

[3] The definitions in IRC Sections 672(a), (b), and (c) should be reviewed if other changes discussed in this Part I are adopted, as such changes may render some definitions superfluous. If IRC Section 672(c)(2) is retained, it should be revised to include entities such as partnerships and limited liability companies, as well as corporations.

Comment. A reversionary interest is the right retained by a transferor to receive the transferred property after occurrence of one or more events. One example of a reversion is when a grantor transfers property into trust for 10 years and one day, and then upon expiration of that time the property is returned to the grantor. Another example is when a grantor transfers property into trust for a grandchild until the grandchild attains age 21, but if the grandchild dies before age 21, the property is returned to the grantor.

The determination of what discretion exists and its maximum impact under IRC Section 673(c) creates situations that creative taxpayers and their advisors can exploit. As interest rates can vary by month, inadvertent triggering of the greater than 5% rule could be caused by minor fluctuations in the relevant interest rate.

Suggestion. To provide simplicity and minimize manipulation, IRC Section 673(a) should be modified to provide that any reversionary interest that is not so remote a possibility as to be negligible[4] triggers grantor trust status. This would eliminate an actuarial test, thereby eliminating any need for IRC Sections 673(c) and 673(d), and they should be deleted. The existing exclusion for reversionary interests in gifts in trust for lineal descendants in Section 673(b) should be retained to avoid defeating expectations of taxpayers. This exclusion might also reasonably be broadened to provide that a reversion would also be ignored if it was a reversion that occurred only if all of the grantor's lineal descendants predeceased the grantor.[5]

D. IRC Section 674

IRC Section 674 is too long to be quoted in full here. IRC Section 674 classifies as a grantor trust any trust (or portion thereof) over which a grantor or a nonadverse party can control beneficial enjoyment, unless the terms of the trust require the approval or consent of an adverse party. Given the extremely broad language of IRC Section 674, this rule would operate to cause

[4] The "so remote a possibility as to be negligible" standard is suggested instead of simply zero because of the possibility that a clause disposing of inter vivos trust assets at the trust's termination, in the unlikely event of the untimely death of the intended beneficiaries, is sometimes drafted inadvertently in a less than comprehensive manner, resulting in an actuarially small interest in the grantor being unintentionally retained under the common law. Making a trust a grantor trust because of such a mistake would be a harsh result. Keeping the test subjective, as opposed to objective, would minimize the potential for intentional abuse of the provision.

[5] A similar 5 percent test is used in IRC Section 2037(a)(2), where it suffers from the same frailties (or worse, because the test is not applied until an uncertain future date of death, when there is no control over the applicable IRC Section 7520 rate). The provision in IRC Section 2037(a)(2) also merits revision.

nearly every trust to be a grantor trust since the grantor would be unlikely to grant the control described in IRC Section 674 to an adverse party. To limit its over-breadth, the rule provides numerous exceptions in IRC Section 674(b), some with exceptions to the application of the exceptions. These rules are exceedingly complicated, and many tax professionals do not understand many of them.

Comment and Suggestion: In the interest of simplification, current IRC Section 674 should be replaced by a rule correlated with the estate tax inclusion rules.

E. IRC Section 675

IRC Section 675 provides that certain administrative powers cause the grantor to be treated as the owner of the portion of the trust over which the power exists.[6]

> **675(1) Power to deal for less than adequate and full consideration. --** A power exercisable by the grantor or a nonadverse party, or both, without the approval or consent of any adverse party enables the grantor or any person to purchase, exchange, or otherwise deal with or dispose of the corpus or the income therefrom for less than an adequate consideration in money or money's worth.

Comment and Suggestion. This power presumably would be created by the grantor when the trust was established. Such a power allows the trust assets to be used for the benefit of the grantor rather than the trust beneficiaries. Accordingly, it would seem to be more akin to a power of revocation, and should be moved to IRC Section 676.

> **675(2) Power to borrow without adequate interest or security. --** A power exercisable by the grantor or a nonadverse party, or both, enables the grantor to borrow the corpus or income, directly or indirectly, without adequate interest or without adequate security except where a trustee (other than the grantor) is authorized under a general lending power to make loans to any person without regard to interest or security.

Comment. This power presumably would be created by the grantor when the trust was established. A power to borrow without adequate interest or security is inherently not an arms' length transaction. Accordingly, it would seem to be more akin to a power of revocation, and

[6] If this section is revised, its numbering should be conformed to the typical numbering scheme of the IRC.

should be moved to IRC Section 676. What is “adequate” may vary by circumstances including creditworthiness, and such a fact-specific rule is appropriate.

> **675(3) Borrowing of the trust funds. --** The grantor has directly or indirectly borrowed the corpus or income and has not completely repaid the loan, including any interest, before the beginning of the taxable year. The preceding sentence shall not apply to a loan which provides for adequate interest and adequate security, if such loan is made by a trustee other than the grantor and other than a related or subordinate trustee subservient to the grantor. For periods during which an individual is the spouse of the grantor (within the meaning of section 672(e)(2)), any reference in this paragraph to the grantor shall be treated as including a reference to such individual.

Comment and Suggestion. As this provision does not apply to a loan which provides for adequate interest and adequate security, if it is made by an independent trustee, it does not add much to IRC Section 675(2). As a mere power to borrow without adequate interest or security is sufficient to trigger grantor trust status under IRC Section 675(2), IRC Section 675(3) only would add to the situations in which the grantor trust rules apply if the trustee was not independent. It is questionable why a loan made by a related trustee that provides for adequate interest and adequate security to either the grantor or the grantor’s spouse should result in grantor trust status. Further, given that the grantor trust status under IRC Section 675(3) lapses in the year following repayment, this provision would seem to lend itself to “toggling” grantor trust status. Given that the Service has otherwise expressed concern with toggling being used for abusive purposes by taxpayers, it would seem that this provision is likely to cause more mischief than it is worth. Accordingly, it should be repealed.

> **675(4) General powers of administration. --** A power of administration is exercisable in a nonfiduciary capacity by any person without the approval or consent of any person in a fiduciary capacity. For purposes of this paragraph, the term “power of administration” means any one or more of the following powers: (A) a power 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; (B) a power to control the investment of the trust funds either by directing investments or reinvestments, or by vetoing proposed investments or reinvestments, 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; or (C) a power to reacquire the trust corpus by substituting other property of an equivalent value.

Comment to (A) and (B). These powers relate to certain nonfiduciary controls over corporate securities in which the holdings of the grantor and the trust are significant from the viewpoint of voting control. This provision is somewhat similar to the anti-Byrum rule found in IRC Section 2036(b), although this provision is somewhat broader in that it applies to power held in both fiduciary and non-fiduciary capacities. We question why the estate tax provision and the grantor trust provision are not correlated. It is also questionable why these provisions, if they are going to exist, should only apply to corporate securities, and not to partnership or LLC interests. Presumably, the disparate treatment among different kinds of business entities is because partnerships were not widely used when these provisions were included in the Code, and limited liability companies were created long after these provisions were included in the Code. We suggest that, as these provisions have not applied to partnerships or limited liability companies without much outcry, they could be repealed in the name of simplification.

Comment to (C). This provision is widely used in estate planning to obtain grantor trust status without adverse transfer tax consequences. Accordingly, unless the grantor trust provisions are going to be dramatically narrowed (for example, applied only to trusts to which IRC Section 676 or 677 apply), then this provision should be retained, but clarified. The law as it has developed makes it clear that a power to acquire trust corpus is sufficient, and that there need be no <u>re</u>acquisition of property. Accordingly, the word "acquire" should replace the word "reacquire" in the provision for clarity. The provision should also be narrowed by adding the following sentence at the end of IRC Section 675: "Clause (C) shall only apply when a power to acquire is held by the grantor."

F. IRC Section 676

IRC Section 676 provides that revocable trusts and certain irrevocable trust are grantor trusts.

> **676(a)** General **rule**. The grantor shall be treated as the owner of any portion of a trust, whether or not he is treated as such owner under any other provision of this part, where at any time the power to revest in the grantor title to such portion is exercisable by the grantor or a nonadverse party, or both.

Comment. This provision is the primary grantor trust provision that allows trusts to be established to avoid onerous judicially supervised estate administrations without requiring the grantor to give up any control over the trust property. Accordingly, this is an important provision that should be retained.

G. IRC Section 677

IRC Section 677 provides that a trust will in certain circumstances be a grantor trust if the income can be distributed to the grantor.

> **677(a) – General rule. --** The grantor shall be treated as the owner of any portion of a trust, whether or not he is treated as such owner under section 674, whose income without the approval or consent of any adverse party is, or, in the discretion of the grantor or a nonadverse party, or both, may be—
>
> (1) distributed to the grantor or the grantor's spouse;
>
> (2) held or accumulated for future distribution to the grantor or the grantor's spouse; or
>
> (3) applied to the payment of premiums on policies of insurance on the life of the grantor or the grantor's spouse (except policies of insurance irrevocably payable for a purpose specified in section 170(c) (relating to definition of charitable contributions)).
>
> This subsection shall not apply to a power the exercise of which can only affect the beneficial enjoyment of the income for a period commencing after the occurrence of an event such that the grantor would not be treated as the owner under section 673 if the power were a reversionary interest; but the grantor may be treated as the owner after the occurrence of the event unless the power is relinquished.

Comment and Suggestion. Similar to IRC Section 676, IRC Section 677(a) provides for grantor trust treatment if a person establishes an irrevocable self-settled trust. In accordance with rules generally applicable with respect to spouses, IRC Section 677(a) extends to trusts created for a grantor's spouse.[7]

Subsection (3) applies to income that might be used to pay premiums on life insurance on the life of the grantor or the grantor's spouse. This provision should be deleted from the IRC in the interest of simplicity. The fact that income may be used to pay life insurance premiums should

[7] While beyond the scope of our group's expertise, it should be noted that IRC Section 677(a) has also come to play an important role with respect to the income taxation of unit investment trusts. *See, e.g.,* Rev. Rul. 61-175 and Rev. Rul. 75-192. A "unit investment trust," commonly referred to as a "UIT," is one of three basic types of investment company (the other two types are mutual funds and closed-end funds). https://www.sec.gov/fast-answers/answersuithtm.html.

not be sufficient to trigger grantor trust treatment. Moreover, the provision can be avoided by providing for insurance premiums to be paid from principal. The flush language of IRC Section 677(a) will need to be coordinated with IRC Section 673.

> **677(b) – Obligations of support. --** Income of a trust shall not be considered taxable to the grantor under subsection (a) or any other provision of this chapter merely because such income in the discretion of another person, the trustee, or the grantor acting as trustee or co-trustee, may be applied or distributed for the support or maintenance of a beneficiary (other than the grantor's spouse) whom the grantor is legally obligated to support or maintain, except to the extent that such income is so applied or distributed. In cases where the amounts so applied or distributed are paid out of corpus or out of other than income for the taxable year, such amounts shall be considered to be an amount paid or credited within the meaning of paragraph (2) of section 661(a) and shall be taxed to the grantor under section 662.

Comment. This is an important limited exception to IRC Section 677(a) that avoids grantors having to include complicated savings clauses in their trust instruments. In addition, any such application or distribution presumably would create a right by the trustee to recover such amounts from the grantor. The provision should be retained.

H. IRC Section 678

IRC Section 678 addresses when a person other than the grantor is treated as the owner under the grantor trust rules.

> **678(a) – General rule. --** A person other than the grantor shall be treated as the owner of any portion of a trust with respect to which:
>
> (1) such person has a power exercisable solely by himself to vest the corpus or the income therefrom in himself, or
>
> (2) such person has previously partially released or otherwise modified such a power and after the release or modification retains such control as would, within the principles of sections 671 to 677, inclusive, subject a grantor of a trust to treatment as the owner thereof.

Comment. Under IRC Section 678(a), a beneficiary with a power of withdrawal can become the tax owner of an increasingly larger percentage of a trust (if the trust is not a grantor trust as to the actual grantor.) It is rare to see this result followed in practice because many tax professionals do not understand it, and, some who do, do not think it worth the effort.

Suggestion. Consideration should be given to adding a $5,000 or 5% annual power of withdrawal exception to IRC Section 678, consistent with IRC Sections 2514 and 2041. IRC Sections 2514 and 2041 provide that, generally, the lapse of a general power of appointment will result in a taxable gift or an asset of the gross estate in the amount of the lapse. *See* IRC §§ 2514(b) & 2041(a)(2). However, these sections provide that when the power lapses due to the failure to exercise it, such lapse will constitute a release, and thus be subject to tax, <u>only to the extent</u> that the property exceeds in value on the date of the lapse of the greater of (a) $5,000, or (b) 5% of the aggregate value of the assets out of which the exercised powers could have been satisfied. *See* IRC §§ 2514(e) & 2041(b)(2); Treas. Reg. §§ 25.2514-3(c)(4) & 20.2041-3(d)(3).

IRC Section 678 provides that a person other than the grantor shall be treated as the owner of any portion of a trust with respect to which such person has previously partially released or otherwise modified that person's power to vest trust corpus or income in himself. IRC § 678(a)(1)-(2). The effect of this section is to impose on the holder of this vesting power an income tax as imposed in IRC Sections 671 through 677. Treas. Reg. § 1.678(a)-1(a). The IRS has treated the owner of a power to demand trust income or corpus in an amount equal to the greater of five percent of the value of the trust corpus or $5,000 as subject to section 678. *See* Rev. Rul. 67-241. In that ruling, a widow possessed a "five or five" power granted to her under the terms of a will. *Id.* The IRS ruled that where a grantor or another person is treated as owner of any portion of a trust under IRC Section 678, that person is subject to the income taxation rules found under IRC Section 671. *Id.* Because the widow had a power exercisable solely by herself to vest a portion of the trust corpus in herself, she was treated as owner of that portion of the trust under IRC Section 678.

The IRS further expounded on this position in a private letter ruling and determined that for each year that a deemed owner fails to exercise the $5,000 or 5% power, thereby allowing the power to lapse, the power holder will be deemed to have partially released this power to withdraw under IRC Section 678(a)(2). PLR 200104005 (Sept. 11, 2000). For each succeeding year in which the owner fails to exercise the withdrawal power, the power holder will be treated as the owner of an increasing portion of the corpus of the trust. *Id.* The annual increase of the corpus for which the owner will be treated as owning is "the product of the amount which [she] could withdraw multiplied by a fraction, the numerator of which is the portion of the trust corpus that

[she] is not already treated as owning, and the denominator of which is the total trust corpus from which the withdrawal could be made." *Id.*

There is a disconnect between the treatment of the owner of a "$5,000 or 5%" annual power of withdrawal for purposes of estate and gift taxes on the one hand and income taxes on the other. Thus, a taxpayer is granted a reprieve from any estate and gift tax consequences for allowing the lapse of a power of appointment up to the $5,000 or 5% limit. However, that same taxpayer is granted no such reprieve from income taxation when that same power of appointment is allowed to lapse. This dichotomy can have a chilling effect on the use of a $5,000 or 5% annual power of withdrawal in estate planning.

A consideration in the addition of a $5,000 or 5% annual power of withdrawal exception to IRC Section 678 is the impact on trusts for which all contributions are subject to Crummey powers. When all contributions to a trust are subject to a beneficiary's right to withdraw the corpus from trust, the trust is likely to be considered a grantor trust and the beneficiary to be deemed an owner under IRC Section 678. *See, e.g.*, PLR 9810008, PLR 9625031. As such, the beneficiary is subject to items of income, loss, deduction, and credits as found in section 671. *Id.* The IRS has ruled that a beneficiary of a trust is treated as the owner of any portion of the trust with respect to which the beneficiary has the power to vest the corpus or income in himself, in this case the lesser of all the amount added to the trust during a calendar year by the grantor or the sum of $3,000 (which was then the annual exclusion amount). Rev. Rul. 81-6; *see also* PLR 9810008, PLR 9625031. As such, the holder of powers of withdrawal is likely considered an owner under IRC Section 678, even upon a lapse, and will be responsible for income taxes imposed under IRC Section 671 to the extent they are considered an owner over the corpus of the trust.[8]

> **678(b) –Exception Where Grantor is Taxable. --** Subsection (a) shall not apply with respect to a power over income, as originally granted or thereafter modified, if the grantor of the trust or a transferor (to whom section 679 applies) is otherwise treated as the owner under the provisions of this subpart other than this section.

[8] In any situation in which a change in law might cause a trust that has been a grantor trust to cease to be a grantor trust, transition relief may be required in order to avoid an inadvertent S election termination where a trust has been relying on its grantor trust status to make it an eligible S corporation shareholder. Consideration also should be given to providing for an automatic ESBT election for any trust that is no longer a grantor trust.

Comment and Suggestion. The general rule in IRC Section 678(a)(1) applies to a power to vest either the corpus or the income therefrom in the grantor. However, IRC Section 678(b) only references a power over income, and says nothing about corpus. There does not seem to be any reason for this difference, and IRC Section 678(b) should be revised to include a power over corpus, as well as income.

II. OFFERING AN ELECTION IN OR OUT OF GRANTOR TRUST RULES.

As demonstrated by the foregoing "minimalist" approach, the grantor trust rules are complex, and in many instances unclear. Because these rules no longer serve the purpose for which they were enacted, one possible approach would be to eliminate the grantor trust rules entirely. However, there are a number of other areas where the grantor trust rules are used, such as to allow a trust to hold S stock, rabbi trusts, trusts created by foreign grantors, and unit investment trusts. Completely eliminating grantor trust status could cause hardships and involves many interested parties beyond wealthy individuals. Rather than attempting to address all of the problems currently identified with the grantor trust provisions, thereby introducing possibly even more complexity, an election system should be considered.[9]

Essentially, we currently have an election system for grantor trusts in that a grantor can choose to create an IDGT as described above or to create a trust that is not a grantor trust by not retaining any prescribed grantor trust powers.[10] In addition, certain rules allow or require a trust to change back and forth between grantor and non-grantor trust status. This is referred to as "toggling" and the IRS has indicated that it considers this to be a possible abuse, despite the grantor trust rules not only allowing it, but in some cases requiring it, such as when a change in trustees occurs.[11] However, these manipulations serve no public or tax policy and yet incentivize a grantor

[9] In 1996, the IRS issued final regulations regarding an election system for the classification of business entities (referred to commonly as the "check the box" election) that similarly replaced a complex and unpredictable approach for determining the income tax status of these entities.
[10] An IDGT (intentional defective grantor trust) is the term frequently used for a grantor trust that has been created by retaining one or more of several powers over the trust that result in grantor trust status but which do not cause the trust to be an incomplete gift for gift tax purposes or includable in the gross estate of the grantor for estate tax purposes. These powers are typically not crucial to a grantor so that if an IDGT is subsequently not desired, creating a trust that is not a grantor trust by releasing the included power is perfectly acceptable.
[11] See Notice 2007-73, 2007-2 C.B. 545.

to do this. The rules result in confusion and incorrect reporting in many cases due to their complexity and uncertainty.

One way to reform and simplify this area would be to eliminate the complex rules of grantor trusts and instead allow a grantor to elect a trust to be a grantor trust or a non-grantor trust at inception. This retains the existing ability to create grantor trusts without the useless complexity of the grantor trust rules. This option makes more sense than further attempts at fixing all of the issues currently identified with the rules.

This election of course makes is simpler to achieve the GT Tax Advantages described above, but this is not particularly difficult currently and is being done routinely. If the GT Tax Advantages are the target, they have little if anything to do with the classification rules, and could be addressed as described in III below. Even ignoring the GT Tax Advantages, one can argue that an election allows the grantor to use the grantor's rates when lower than the maximum rates applicable to non-grantor trusts or allows the use of the grantor's deductions or losses that can be offset with trust income. However, we have that situation currently, and it is no worse than having the grantor keep the income. The highest income rates are now imposed on trusts at a low bracket threshold, which prevents the use of trusts to get lower rates – using the grantor's rates was never a targeted abuse. Ignoring the GT Tax Advantages, while electing into the grantor trust rules would have advantages for some taxpayers, but it is not an advantage that would apply broadly given that wealthy grantors usually pay income tax at the top rates. Whether or not the GT Tax Advantages are addressed, an election system would result in certainty and simplicity to the extent that the grantor trust rules will be retained for any purpose. However, some ideas are discussed below that could address toggling or impose other restrictions on such an election. Default rules where no election is made are also addressed below.

The election in or out of grantor trust status could be irrevocable to prevent any toggling; however, an irrevocable election should be made available to convert a previously elected grantor trust to a non-grantor trust because non-tax circumstances often change and grantors need to have a way to terminate the grantor trust status short of dying. Instead of an irrevocable election, another way to control toggling would be to allow a change in any election only after a certain time period has passed, such as five years. If the trust was elected as non-grantor but acquires S stock after creation, the grantor could elect to have the S stock treated as a separate trust with a grantor trust election for that separate trust only regardless of the election for the trust as a whole. This proposal does not include any other changes to the rules for trusts holding S stock. If there is more than one grantor to the trust, each grantor should be able to elect with respect to his or her fractional contribution to the trust.

Consideration could be given to making the election to be a non-grantor trust applicable only if the gift to the trust is wholly complete for gift tax purposes. If that rule were adopted, if any part of the gift is incomplete, the trust would be a grantor trust until the gift is wholly complete. This would eliminate the use of incomplete gift trusts to avoid state income tax, usually referred to as DINGs, NINGs and WINGs.

One other suggestion is that if a trustee makes a further distribution in trust, the new trust must have the same grantor trust election as the distributing trust and the new trust cannot be a grantor trust with respect to the distributing trust, but only with respect to the grantor who created the distributing trust. After the death of the grantor, grantor trust status would cease for all trusts created by the grantor (or by a distribution in further trust from such a trust).

Eliminating the grantor trust rules could also eliminate the ability to make a non-grantor trust into a grantor trust as to a beneficiary who did not originally create the trust by using IRC section 678.[12] However, the right to withdraw trust property would need to be addressed. A possible proposal would be to treat any right to withdraw trust property as if immediately exercised and then recontributed if the right to withdraw lapses or is released. This rule should be coordinated with the $5,000 or 5% annual power of withdrawal exception in IRC Sections 2514 and 2041 so that this exception would apply for income tax purposes.[13] Thus nontaxable lapses of a power to withdraw would no longer allow a trust to be a grantor trust with respect to a beneficiary who was not the original grantor. If a right to withdraw was taxable in part and nontaxable in part, the portion attributable to the taxable lapse would be treated as a grantor trust with respect to the power holder and the nontaxable portion would not.

[12] *See* discussion of this section at pages 12 and 13, above.
[13] *See* discussion of this at pages 11 and 12, above.

However, a helpful proposal would be to allow an election to treat a trust as a grantor trust with respect to a beneficiary if the trust is for a single beneficiary during the life of that beneficiary and if the trust remaining at the beneficiary's death will be includable in the beneficiary's gross estate under all circumstances. This election gives the same income and transfer tax result as an outright gift to the beneficiary and would be useful where there are reasons not to make distributions of income to a beneficiary to result in a lower tax rate. For example, this could apply to a trust for a disabled person or minor. There does not seem a tax policy reason to force income distributions to a minor or disabled person to get a lower income tax rate. Trusts should not be penalized by applying the highest tax rate if the trust cannot be used to move income among beneficiaries or to keep the income in the trust to avoid estate tax. Decanting such a trust would have to be restricted to a trust for the same beneficiary meeting the same restrictions as the distributing trust.

How the election would apply to a trust to which gifts are partly complete and partly incomplete would have to be considered further and may depend on whether or how the GT Tax Advantages are addressed.

If no election is made, a default rule must apply for both domestic as well as foreign trusts.

A. Domestic Trusts-Default Rule.

For domestic trusts, the simplest approach would be to classify all trusts that are wholly revocable by the grantor (or by the grantors if spouses are filing a joint return) as grantor trusts with all other trusts classified as non-grantor trusts. As explained above, how the grantor trust rules should apply to charitable lead trusts should be considered further.

B. Foreign Trusts-Default Rule.

The classification of foreign trusts likely should mirror current law, so that a foreign trust established by a U.S. person should be classified as a grantor trust with no election allowed to the contrary. Similarly, to also mirror current law, a trust created by a foreign grantor could not elect to be a grantor trust unless either revocable by the foreign grantor (i.e., the power to revest title in the grantor must be exercisable solely by the foreign grantor) or for the sole benefit of the foreign grantor, or the grantor or the grantor's spouse must be the only persons to whom income or principal of the trust may be distributed during the grantor's lifetime.

C. Effective Date.

When the final check the box regulations were issued in December 1996, the Service made application of the new rules prospective and generally respected an eligible entity's claimed classification if the entity had a reasonable basis for it and its classification was not otherwise the subject of IRS examination. The adoption of a similar approach to the grantor trust election would seem appropriate, so that if no election were made to the contrary, the method of reporting in the first year after the election regime is adopted would be treated as the election, provided that result is consistent with the limitations on elections in the new rules. Alternatively, the method of reporting in the year immediately prior to the adoption of the election regime would determine grantor or non-grantor trust status.

Notwithstanding the prospective application of the rules, current trusts should be able to elect to be taxed under the simplification approach. A change in classification may have income tax consequences, such as may be the case for negative basis assets.

III. TARGETING TWO OFTEN-CRITICIZED TAX ADVANTAGES OF GRANTOR TRUSTS.

The grantor trust rules often no longer serve the purpose for which they were enacted, which was to prevent taxpayers from using trusts to reduce income tax on income that the donor would otherwise shift to a lower bracket trust. The best tax policy would be to revise the rules completely to accomplish current goals. However, given the complexity that this would entail, and the collateral effects on other areas, such as foreign grantors, trust holding S stock, unit investment trusts, rabbi trusts and other trusts described above, a targeted approach could address the two most often criticized tax advantages of grantor trusts described above as GT Tax Advantages, without any significant overhaul of the grantor trusts rules, namely that (1) the income tax attributable to trust income of a grantor trust is paid by the grantor, creating a tax-free gift to the trust, and (2) the grantor is able to transact with his or her grantor trust without the recognition of income.[14] This targeted approach could eliminate the GST Tax Advantages immediately while more comprehensive changes to the grantor trust rules could be considered.

A. Grantor's Income Tax Payment.

To address the first GT Tax Advantage, the government could consider enacting a new statutory provision creating a federal right of reimbursement in the grantor from the trust in the amount of any federal or state income tax paid with respect to the trust.

- This right of reimbursement would arise annually when the grantor has paid income tax and would lapse at the end of the calendar year in which the income tax is due.

- If the right of reimbursement is waived or lapses, the grantor would be treated as making a gift in the year that the tax was paid on the date of the waiver or lapse.

- The reimbursement right would arise on the due date of the tax payment and if reimbursement is not made by the end of 30 days after the due date, the reimbursement right would be treated as a loan and bear interest at the short-term annual federal AFR for the month of in existence on the due date of the tax imposed from that date until payment is made or until the right is waived or lapses.

- The right to be reimbursed would not arise and thus could not be waived until a tax payment is due. The grantor could waive the right annually or could waive for all future years until the waiver is revoked, but any prospective waiver would be revocable until the due date of tax for each subsequent year. This makes the amount of the gift certain because the waiver does not occur until the tax liability is known.

- Because the right of reimbursement would be treated as a debt owed to the grantor while the reimbursement right is outstanding and unpaid for federal estate, gift and GST tax purposes, it would not be treated as a retained interest or right for federal estate tax purposes or an interest for GST tax purposes.

- The reimbursement debt is computed on a marginal basis by computing the grantor's tax with and without the trust income. If there is more than one grantor trust, the reimbursement rights would be computed through the same marginal method, but then allocated among each trust based on net taxable income.

[14] *See* text accompanying footnote 1, *supra*.

- If the grantor dies while the reimbursement right is outstanding, the amount of the reimbursement would be an asset of the grantor's gross estate, like any unpaid debt.

B. Grantor's Transactions with Trust.

To address the second GT Tax Advantage, the government could consider adopting a rule that transactions between a grantor and his or her grantor trust will cause recognition of income. This could be done by statute but possibly could be done through regulations even without a change to the statute.[15]

- Thus a sale of property with a basis less than its sale price by the grantor to the trust or from the trust to the grantor would generate capital gain, taxable to the grantor.
- Interest paid on notes by the grantor to the trust or by the trust to the grantor would generate taxable interest or create interest expense for the grantor.
- The rules for related parties would apply to capital losses or sales of depreciable property.
- Deductions applicable to the grantor trust would be recognized, but only to offset taxable income.

Effective Date. These two rules would apply to all grantor trusts created that are completed gifts, including those currently in existence, for tax years beginning after the date of enactment. Thus, these new rules would not apply to wholly revocable trusts. Any portion of a trust attributable to assets transferred where the transfer is wholly incomplete would be treated as revocable for this purpose until any part of the transfer becomes complete. Applying these new rules to existing irrevocable trusts would not work a hardship on anyone because the first rule merely puts the burden of the income tax on the trust that has the taxable income, and the second rule would apply only to income recognized after enactment.[16]

[15] It may be possible to make this second change without a statute because the current treatment of a grantor trust as the alter ego of the grantor was adopted by the government and is contrary to the Rothstein case, discussed in the text accompanying footnote 2, *supra*.

[16] A transition rule may be needed for outstanding notes between a grantor and the grantor trust and for existing GRATs.

To avoid hardship, a grantor could elect at any time to have his or her grantor trust treated as a non-grantor trust for all calendar years ending after the date of the election, but this election would be irrevocable.

IV. DRAMATICALLY NARROW THE SCOPE OF THE INCOME TAX GRANTOR TRUST RULES BY REPEALING THE BULK OF THOSE RULES WITHOUT CORRELATING THE INCOME TAX GRANTOR TRUST RULES WITH THE TRANSFER TAX TRUST RULES.

In 1954, when Congress codified most of the grantor trust rules, the highest marginal income tax bracket was 91%, and almost all noncharitable trusts were full-fledged taxpayers, entitled to their own "runs up the brackets." Many taxpayers chose, therefore, to create trusts, in whole or in part to reduce their income tax liability. After the courts struggled for years with when a trust should be treated as the grantor for income tax purposes, Congress responded with the grantor trust rules, which, despite their many warts, worked reasonably well, until 1986, when Congress invented a better mouse trap. The Tax Reform Act of 1986 generally reduced the number of income tax brackets to two for individuals, 15% and 28%. For estates and trusts, IRC Section 1(e) compressed the income tax brackets of taxpaying estates and trusts and subjected them to the higher 28% marginal rate on all but the first $10,000 or so. No longer is there any incentive to create a taxpaying trust to save income taxes. Subsequent tax acts that raised the top marginal rates generally continued to tax estates and trusts at the top marginal rate at this relatively low taxable income threshold.

After there were no longer any income tax savings to be wrung from a taxpaying trust, taxpayers began to stand the grantor trust rules on their head, and use the rules to make sure that their trusts would *not* be taxpayers so that the trust assets could grow free of any income tax burden. The grantor trust rules allow the trusts of the well-counselled the option of shifting the income tax burden to the grantor in many relatively painless ways, such as by including a swap power or by selecting trustees with an eye to whether the trust will be a grantor trust. Further, installment sales between the settlor and the settlor's grantor trust permit the settlor to enter into transactions with the trust without income tax consequences, in effect facilitating estate tax freeze transactions. In short, the grantor trust rules, conceived as an income tax shield for the government, are often now used by taxpayers as an estate and gift tax sword.

Given that the grantor trust rules often no longer serve their intended purpose and are used to reduce tax collections, it is hardly surprising that several commentators have proposed that they be curtailed substantially. Professor Mark Ascher, in a detailed article published in the Iowa Law Review in 2011, proposed repealing most of the grantor trust rules. He would retain IRC Section 676, to allow revocable trusts to continue to escape the harshness of § 1(e), and to spare them from new and arguably unnecessary reporting requirements. He also would consider retaining IRC Section 677, as discussed below. He would also retain IRC Section 679, a late addition to subpart E that has almost nothing in common with the rest of it. The operative and definitional provisions of IRC Sections 671 and 672 would be retained, as necessary. But every other provision of subpart E (IRC Sections 673-675, 677, 678) would be repealed, and the formerly-grantor trusts would be taxed under the generally-applicable provisions of Subchapter J.[17]

We reproduce below, with the author's permission, an excellent summary of Ascher's lengthy proposal, written by Professor Kerry Ryan, which appeared in Trusts & Estates JOTWELL, The Journal of Things We Like (LOTS), on March 14, 2012:[18]

> It is not a matter of the cure being worse than the disease. It is rather, that the cure has become the disease."[19] This line, written by Leo Schmolka, is quoted in Mark Ascher's recently published article calling for repeal of (most of) the grantor trust rules. I quote Schmolka here too because he so pithily captures "the irony of using anti-abuse rules to abuse the tax system." The tax avoidance vehicle of choice is known as an "intentionally defective grantor trust" or "IDGT" (sardonically pronounced "I dig it"). As noted by Ascher, "even their name seethes with irony."
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> Ascher's article makes three main points: 1) the grantor trust rules are obsolete; 2) their continued existence leads to significant erosion of our income and transfer tax bases; and 3) as a result the grantor trust rules (or at least most of them) should be repealed. To be sure, most of these points are not new, and indeed, two other recent articles cover similar ground.[20] However, Ascher's is by far the most comprehensive and, in my opinion, persuasive of the three.

[17] *See* Ascher, Mark L., *The Grantor Trust Rules Should Be Repealed*, 96 Iowa L. Rev. 885-940 (2011), at SSRN: https://ssrn.com/abstract=1794205

[18] Professor Ryan's summary is available online at trustiest.jotwell.com/repeal-the-grantor-trust-rules/

[19] Schmolka, Leo L., *FLPs and GRATs: What to Do?*, 86 Tax Notes 1490 (March 13, 2000).

[20] Ricks, Daniel L., *I Dig It, But Congress Shouldn't Let Me: Closing the IDGT Loophole*, 36 ACTEC L.J. 641 (2010), Cunningham, Laura E. & Noël B. Cunningham, *Tax Reform Paul McDaniel Style: The Repeal of the Grantor Trust Rules*, available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1804364

Trust income is normally taxable either to the trust or its beneficiaries, unless the settlor (aka "grantor") retains too much "dominion and control" over the trust — in which case items of trust income, deductions and credits are attributed to the settlor and reportable on his or her own tax return. The statutory grantor trust rules (aka "subpart E") identify which interests or powers retained by or on behalf of a trust's settlor will cause a trust to be ignored for income tax purposes. The reader of Part I of Mark Ascher's article will understand that the statutory grantor trust rules were a codification of Treasury regulations designed to supplant the vague and ultimately unworkable "dominion and control" standard articulated by the Supreme Court in the *Clifford* case.

Part I of Ascher's article also describes the original purpose of the grantor rules ("to prevent high-income taxpayers from avoiding the impact of the progressive nature of the federal income tax by creating certain types of inter vivos trusts with which to splinter income") and then persuasively argues that these rules are no longer needed for this purpose. Why? According to Ascher, the tax world is significantly different now than it was in 1954 when the bulk of subpart E was enacted. Ascher cites compression of the tax brackets applicable to trusts as the single most important change making subpart E obsolete. Since 1986, trusts hit the maximum marginal tax rate at extremely low levels of income, as compared to individual taxpayers. Thus, there is little to no tax benefit in shifting income to an inter vivos trust when that income would be taxed at the trust level.

Part II of Ascher's article discusses how taxpayers are taking advantage of the grantor trust rules to achieve spectacular tax savings. The game, so to speak, is to create an inter vivos trust (IDGT) that is ignored for income tax purposes, but respected for transfer tax purposes. Taxpayers can achieve this incongruous tax result by exploiting the difference between the transfer and income tax definitions of "dominion and control." The transfer tax benefits include those associated with most estate freeze techniques. For little to no gift tax cost, a settlor can remove the transferred property and all subsequent appreciation from the gross estate. The IDGT kicker, however, is that for as long as the trust remains a grantor trust, the settlor is able to make an additional annual tax-free gift to the trust beneficiaries in the amount of the income tax paid.

Ascher's discussion of the ostensible income tax benefits of using an IDGT is particularly insightful. He first observes that the income tax regime applied to any inter vivos trust is implicitly elective. The problem for Ascher is not electivity *per se*, but that the grantor trust rules "regularly produce diametrically different results based on truly trivial differences." Next, Ascher highlights how subpart E fails to deal with all of the collateral tax consequences of grantor trust status. In particular, it is virtually silent on how to account for transactions between the settlor and his or her grantor trust.

Out of this statutory void grew a popular estate planning technique wherein a settlor sells appreciated property to his or her grantor trust in return for an installment note. While the astonishing transfer tax savings garner most of the press, Ascher

> distinguishes himself by engaging in a thoughtful and thorough discussion of the transaction's uncertain income tax consequences. As he points out, for income tax purposes, the most important question may be what is the trust's basis in the "purchased" assets? As long as we get that answer right, any untaxed gain will eventually be accounted for. However, by Ascher's account, some practitioners are taking the questionable (although not entirely unsupportable) position that under certain circumstances nobody has to "pay the piper."
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> After requesting more administrative guidance (and expressing doubt that it will be forthcoming), Ascher calls for repeal of most of the grantor trust rules. Under his proposal, revocable trusts would be the only domestic trusts subject to the grantor trust regime. All other domestic irrevocable trusts would be treated as separate taxpayers. He argues that revocable and irrevocable trusts are sufficiently different to justify different tax treatment. I prefer Ascher's proposal to those calling for wholesale repeal of subpart E because it preserves the statutory overrule of the *Clifford* case. Ascher's case is so persuasive and the number of calls for reform so numerous, one wonders in this fiscal environment how much longer policymakers can continue to ignore such low-hanging revenue fruit?

It has been suggested that Ascher's proposal might be improved by also retaining IRC Section 677 (other than (a)(3)), a refinement Ascher has said he would be willing to accept, to allow continued grantor trust treatment of the following:

1. Irrevocable trusts held only for the grantor and taxable in grantor's estate (such as an irrevocable follow-on trust to an IRC Section 2503(c) trust);

2. Unit investment trusts;

3. Retirement accounts treated as trusts for income tax purposes; and

4. Some or all trusts that are now grantor trusts holding S Corp stock.

Without IRC Section 677, the grantor could create an irrevocable trust for the grantor, grantor's spouse, and grantor's descendants and authorize the trustee, who can be the grantor, to sprinkle distributions among them, allowing the trust income to be taxed at the descendants' lower income tax rates.[21]

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[21] If IRC Section 677 were retained, a decision would need to be made about whether split-interest trusts, such as GRATs and QPRTs, should also be treated as grantor trusts, whether there should be a more complicated rule that treats them as split grantor/non-grantor trusts using the concept presently in the grantor trust regulations for split-interest trusts, or whether they should just be subject to the Subchapter J rules for non-grantor trusts.

Professor Jay Soled has published a proposal that is similar to Ascher's, in that it would generally do away with the grantor trust rules but preserve concepts embodied in IRC Sections 676 and 677(a)(1), but define grantor trust status by whether the gift was complete and deny some distribution deductions to non-grantor trusts.[22]

V. CORRELATION OF THE INCOME TAX GRANTOR TRUST RULES WITH REVISED TRANSFER TAX TRUST RULES.

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

In order to determine who should be taxable on the net income with respect to property given to an irrevocable trust, it seems logical and appropriate to (1) generally correlate the income tax grantor trust rules with the transfer tax trust rules, in furtherance of the principal referred to above, i.e., that the net income with respect to property is generally taxable to the person to whom the property belongs, and (2) revise and simplify the way in which property ownership is determined for both income and transfer tax purposes.

For example, under current law, if the grantor of an IDGT transfers $1,000,000 to the trust and the money is invested in property that produces net income (including capital gains) totaling $2,000,000 during the period that the trust is a grantor trust, the grantor rather than the trust would be liable for the amount of the tax attributable to the trust's $2,000,000 of net income because of the grantor trust provisions of the code, and those provisions do not give the grantor a right of

[22] Soled, Jay, *Reforming the Grantor Trust Rules*, 76 Notre Dame L. Rev. 375 (2001), available at https://scholarship.law.nd.edu/cgi/viewcontent.cgi?article=1544&context=ndlr. This proposal is described in Exhibit IV hereto.

reimbursement from the trust for paying the tax attributable to its net income. This would result in a reduction in the value of the grantor's gross estate for estate tax purposes equal to the amount of the tax paid, enhancing the value of the trust by enabling it to grow income tax-free because the grantor, not the trust, is liable for the tax attributable to the trust's net income. However, the value of this enhancement would not be subject to gift tax because the grantor trust provisions require the grantor to pay the tax attributable to the trust's net income without a right of reimbursement. In addition, because current law also treats the grantor as owning the trust property for income tax purposes, the grantor and the trust would be able to sell or exchange appreciated assets with each other without any recognition of gain. Under the proposal described in this Part V, the same standard would be used for determining when a trust is a grantor trust and a completed gift. Thus, (1) the tax-free enhancement of the grantor paying the trust's income tax would no longer be possible because a grantor could not own the trust property for income tax purposes if the trust constitutes a completed gift, and (2) no tax-free exchange would be possible between the grantor and a trust that is a completed gift.

A. Determination of Property Ownership for Income and Transfer Tax Purposes.

(1) Completed Gifts for Income and Transfer Tax Purposes.

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

By comparison, under current law (i) a gift of property in trust generally is incomplete for gift tax purposes so long as the grantor has a significant power to affect the beneficial enjoyment of the trust property, and (ii) trust property generally is included in the grantor's gross estate for estate tax purposes if the grantor had a significant beneficial interest in the trust at the time of his or her death and/or a significant power to affect the beneficial enjoyment of the trust property at that time.[23] Determining whether the grantor has or had such a significant beneficial interest or power also can be complicated.

In an effort to correlate and simplify income and transfer tax laws, it is submitted that (i) a lifetime gift of property to an irrevocable trust in which the grantor does not have a significant[24] beneficial interest as of the date of the transfer should be a completed gift for both income and gift tax purposes, (ii) the value of the trust property should not be included in the grantor's gross estate on his or her later death for estate tax purposes, and (iii) the power of the grantor to affect the beneficial enjoyment of the trust property with a fiduciary power or a special power of appointment should be irrelevant with respect to (A) the completion of the gift by the grantor for income and gift tax purposes and (B) the inclusion of the trust property in the grantor's gross estate for estate tax purposes.

In support of the proposition that the power of the grantor to affect the beneficial enjoyment of the trust property generally should be irrelevant for income and transfer tax purposes, the Treasury Department proposed the following in November 1984:[25]

> <u>Retained powers</u>. In determining whether a gift is complete for transfer tax purposes, the proposal would treat a retained power to control the beneficial enjoyment of the transferred property as irrelevant where the power could not be used to distribute income or principal to the donor. Thus, the fact that the transferor as trustee or custodian can exercise control over the identity of the distributee of the property or over the amount or timing of a distribution would be irrelevant in determining whether a gift is complete (although such factors may be relevant in determining whether the transfer qualifies for the annual gift tax exclusion). Under this rule, a transfer would be complete for gift tax purposes where the grantor creates an irrevocable trust but retains the absolute right to determine who (other than himself) will receive the trust income or principal.

[23] The retention of a beneficial interest by the grantor will not keep the gift from being complete, but may result in the property in which the interest is retained being included in the grantor's gross estate for estate tax purposes.

[24] *See* Subpart C of Part I, above, for a discussion of how small retained interests should be treated and Subpart E of Part I, above, for how retained powers to deal with trust assets at less than arms' length terms should be treated.

[25] Treasury Department Report to the President, entitled "Tax Reform for Fairness, Simplicity, and Economic Growth," Volume 2, Chapter 19, Section 19.01 (the Proposal for the Unification of Gift and Estate Taxes), on p. 379.

The power of the grantor of a trust to affect the beneficial enjoyment of the trust property by determining which beneficiaries will receive trust income and/or principal, and how much, should be irrelevant for the following reason. A grantor of a trust may name as trustee a friendly individual or trust company, neither being a "related or subordinate party," as defined in IRC Section 672(c), but who, because of a personal or business relationship with the grantor, will administer the trust in accordance with his or her wishes that are consistent with the trustee's fiduciary duties. In light of that reality, it seems appropriate to simply let the grantor of a trust act as the trustee or have a special power of appointment and personally exercise the power to affect beneficial enjoyment of the trust as long as it cannot be exercised in favor of the grantor, directly or indirectly, alone or in conjunction with any other person, and to acknowledge that such power will not cause the grantor to be treated as the owner of the trust property for tax purposes.[26]

(2) Incomplete Gifts for Income and Transfer Tax Purposes.

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

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

As is the case with current law, following the grantor's death the non-grantor trust DNI mechanism would apply to all trusts established by the grantor, including any incomplete gift trusts.

B. Income Taxation of Trusts.

The grantor's income tax liability should be determined as though he or she owned the property of an incomplete gift trust, and the trust should be disregarded for income tax purposes. The income tax liability of a completed gift trust generally should be determined in the usual manner, in accordance with its applicable (compressed) rate brackets, including any deduction for DNI distributed to beneficiaries.[27]

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

If a beneficiary has a general power of appointment or withdrawal over a portion of a trust, the beneficiary should be treated as though he or she were the grantor with respect to that portion. If such a beneficiary releases the power or allows it to lapse and does not retain any beneficial interest, except as noted below, the trust would become a completed gift trust. However, if such a beneficiary releases the power or allows it to lapse but the beneficiary continues to have a beneficial interest, except as noted below, the release or lapse should be treated as an incomplete gift by the beneficiary; and the income of the beneficiary and that portion of the trust generally should be taxed as though the beneficiary were the grantor with respect to that portion, as provided in Subpart B of this Part V. However, if a beneficiary has the power to withdraw no more than $5,000 or 5 percent of the value of the trust property annually, whichever is greater, as provided in IRC Section 2514(e), or the grantor does not have a significant (or any) beneficial interest in that portion of the trust as of the date of the release or lapse of the power, the release or lapse should be disregarded for income tax purposes as well as transfer tax purposes. Limited beneficial

[27] Because of the harsh income tax liability with respect to completed gift trusts, the beneficiary and the trustee of certain trusts, such as (1) an IRC Section 2503(c), a 2642(c)(2) trust, a terminating trust following the terminating event, or any other trust of which one or more beneficiaries have vested interests, might be allowed to elect to have the trust's undistributed taxable income taxed at the vested beneficiary's marginal income tax rates; and (2) a "family-pot trust" or "dynasty trust," described in footnote 22, above, also might be allowed to elect to have the trust's undistributed taxable income taxed at the marginal income tax rates of (a) the issue of the grantor or other individual, determined on a per stirpes basis, or (b) the child of the grantor or other individual who is the primary beneficiary, respectively, similar to the "kiddie tax" under IRC Section 1(g).

interests that were retained by a beneficiary as discussed in Subpart C of Part I, above, should not cause the release or lapse to be treated as an incomplete gift.

D. Income Taxation of Grantor Retained Interest Trusts.

The establishment of a GRAT, GRUT or QPRT generally should be treated as provided in Subparts A(2) and B of this Part V, until the first to occur of the end of the fixed term or the grantor's death. However, if the remainder beneficiary(s) has (have) a vested remainder interest in the trust as of the date of the transfer, the actuarial value of that interest (a) should be treated as a completed gift for gift tax purposes, (b) if the grantor dies during the fixed term, only the actuarial value of the remaining fixed term at the date of the grantor's death should be included in the grantor's gross estate for estate tax purposes, and (c) if the grantor survives past the end of the fixed term, the trust income thereafter should be taxed as a completed gift trust in the same manner as provided in Subpart B of this Part V, above.

E. Proceeds of Life Insurance Policies Owned by Trusts.

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

F. Income Taxation of Charitable Lead Trusts.

The income with respect to a CLAT or CLUT generally should be taxed as a completed gift trust in the same manner as provided in Subpart B of this Part V, above. However, an election might be made to obtain grantor trust treatment where the grantor elects to take an upfront income tax deduction for the present value of the charitable lead interest.

G. Income Taxation of Charitable Remainder Trusts.

The income with respect to a CRAT or CRUT should be taxed in the same manner as under present law.

VI. COLLECTION OF VARIOUS OTHER APPROACHES.

Exhibits I through V describe other published proposals for revision of the grantor trust income tax rules.

EXHIBIT I

THE 1984 A.L.I. FEDERAL INCOME TAX PROJECT

The 1984 American Law Institute "Proposals on the Taxation of Trust and Estate Income and Income in Respect of Decedents" (the "Proposals") was a Reagan era "simplification" of fiduciary income taxation which contemplated a wholesale rewriting and rethinking of the approach to fiduciary income taxation, generally and specifically the grantor trust rules in particular. The object of the Proposals was to make a trust neutral insofar as possible in regard to the income taxation of trust income. Trust income tax neutrality was achieved for grantor trusts (1) by eliminating the benefit of a grantor paying tax on property held for the benefit of someone other than the grantor or the grantor's spouse, (2) causing all trusts that did not fit within the narrowed definition of grantor trusts to pay tax and (3) by combining the income of all trusts created by the same grantor and calculating the income tax liability of such trusts at the marginal income tax rate of the grantor if the grantor were alive or as one trust for tax calculation purposes if the grantor were deceased. In developing its principles, the Proposals seek a correlation between the income taxation of trust income and the federal gift and estate rules so that one set of income tax rules apply when a transfer is a completed gift not includable in the grantor's estate and another set of rules apply, namely the grantor trust income tax rules, if a transfer is not complete for transfer tax purposes.

The Proposals set forth a series of transformative general rules consistent with the aforestated objective of trust neutrality. These general rules modify the current grantor trust rules by narrowing those circumstances under which the grantor of a trust is taxed as the owner of trust property. The rules limit traditional grantor trust taxation (i.e., the taxation of grantor trusts in the manner currently in effect) to circumstances where the trust is held for the pecuniary benefit of the grantor and/or the grantor's spouse. Specifically, traditional grantor trust treatment is only available (a) when payments are required to be made to the grantor or to the grantor's spouse or (b) when the grantor or the grantor's spouse acting alone or in conjunction with any person can either cause the trust to be revoked or amended or cause a discretionary distribution to be made to the grantor or the grantor's spouse.

How then do the Proposals achieve income tax neutrality when the trust is not for the benefit of the grantor or the grantor's spouse? Given the separate property law status of such trusts, the Proposals make the trusts separate taxpaying entities, but eliminate the separate taxpayer status of such trusts by aggregating all trusts created by a single grantor for tax calculation purposes and then calculating the amount of tax by adding the taxable income of each trust to the grantor's income for income tax calculation purposes. Only mandatory distributions of income to individuals and any distribution of income to charity reduce the amount on which tax is calculated.

By limiting the liability of the grantor for income tax payable on trust income to a trust where the grantor or the grantor's spouse is a current beneficiary or can cause themselves to become a current beneficiary, the Proposals simplify the grantor trust rules by making many of its current concepts, like adverse party, related or subordinate party and independent trustee, irrelevant. The correlation principal of the Proposals requires any transfer to a trust where the grantor is treated as the owner for income tax purposes and liable for tax attributable to its income, be an incomplete transfer for gift tax purposes and includable in the estate of grantor at the grantor's death.

The Proposals also modify the reversionary interest grantor trust rules and since these Proposals predate the Tax Reform Act of 1986, the focus is on repeal of the income shifting rules then in effect for trusts of ten or more years. The approach taken, however, is not one in which the income tax is paid by the grantor when there is a reversionary interest. Rather, income is taxed at the marginal rate of the grantor and is taxed to the trust. Significantly, the concept of a reversionary interest is expanded to include Section 675 powers that under current law would result in the grantor being treated as the owner of the trust. In addition, a reversionary interest is deemed created and the trust taxable at the grantor's marginal tax rate when, in the absence of the grantor or grantor's spouse retaining a current beneficial interest in income or principal (a) a nongeneral power of appointment is held by the grantor or grantor's spouse, (b) a trustee has the authority to make current or future distributions to the grantor or the grantor's spouse if the grantor or grantor's spouse is not a trustee or (c) any person, including a trustee, has the authority to effect a distribution in discharge of a grantor's legal obligation for support.

Although beyond the scope of this review of the grantor trust aspects of the Proposals, the tax neutrality goal of the Proposals leads to the elimination of the DNI rules, the tiering rules, the charitable deduction rules under 642(c) and the multiple trust rules. Instead, the Proposals mandate trust income aggregation with only limited relief for mandatory trust distributions or distributions to charity.

Finally, the Proposals modify the current beneficiary owned trust rules under Section 678. During the grantor's lifetime, a beneficiary's right to withdraw less than the entire trust is ignored. If the power is exercised by the beneficiary and transferred to a new trust, then the beneficiary/grantor is treated as the grantor of that new trust. However, a beneficiary who has a power to withdraw the entire trust estate is treated as the grantor of the trust and the grantor trust rules apply as if such beneficiary established the trust. This rule is modified slightly in the case of a general power of appointment under a testamentary trust in that the trust's status is not affected during the powerholder's lifetime but is treated as having been created by the powerholder at death.

The effective date provisions apply the Proposals (a) to trusts created under an instrument executed after enactment, (b) to post-enactment additions to pre-enactment trusts, (c) to trusts amended or reformed post-enactment and (d) to other trusts five years after enactment or the death of the grantor, if earlier.

EXHIBIT II

THE 1985 PRESIDENT'S TAX PROPOSALS TO THE CONGRESS FOR FAIRNESS, GROWTH AND SIMPLICITY

One of President Reagan's tax proposals in 1985 (the "1985 President's Proposal") was a proposal to reform the income tax treatment of grantor and non-grantor trusts and estates. This proposal seems to be roughly modelled on the 1984 American Law Institute "Proposals on the Taxation of Trust and Estate Income and Income in Respect of Decedents" (the "ALI Proposal"), discussed in Part _ above. The 1985 President's Proposal (a) changes which trusts are treated as grantor trusts, (b) causes the income of most lifetime non-grantor trusts to be taxed at the grantor's marginal tax rates and eliminates any distribution deduction except in limited circumstances, and (c) taxes trust income in the year of the grantor's death to the grantor/decedent (or at least at the grantor's tax rates) regardless of the date of death in that year. The stated goal of the proposal was to "limit the use of trusts as an income-splitting device," and "reinforce the integrity of the progressive rate structure" to "enhance the fairness of the tax system."

The list of trusts that remain treated as grantor trusts is somewhat longer than what was proposed in the ALI Proposal. Under the 1985 President's Proposal, the grantor would be treated as the owner of a trust to the extent that:

(1) Payments of property or income are required to be made currently to the grantor or grantor's spouse;

(2) Payments of property or income may be made currently to the grantor or the grantor's spouse under a discretionary power held in whole or in part by either of them;

(3) The grantor or grantor's spouse has any power to amend or to revoke the trust and cause distributions of property to be made to either one of them;

(4) The grantor or the grantor's spouse has any power to cause the trustee to loan trust income or corpus to either the grantor or grantor's spouse;

(5) The grantor or the grantor's spouse has borrowed trust income or corpus and has not completely repaid the loan or any interest thereon before the beginning of the taxable year.

For purposes of these rules, the fact that a power held by the grantor or the grantor's spouse could be exercised only with the consent of another person or persons would be irrelevant, regardless of whether such person is an "adverse party." The proposal retains the rules under which a person other than the grantor may be treated as the owner under Section 678. Transactions between the trust and its owner would be disregarded for Federal income tax purposes "where appropriate" (no explanation given of those circumstances).

The proposal also modifies some of the provisions dealing with non-grantor trusts. In general, during the grantor's lifetime and in the year of his or her death, non-grantor trusts are subject to tax at the grantor's marginal rate as if the income had been reported on the grantor's return (it is a rate-determining, not liability determining – that is the trustee still pays the tax, but at the grantor's marginal rate). The grantor's NOLs are ignored for this purpose. If a grantor has created more than one non-grantor trust, each trust would be liable for a proportionate share of the tax that would result from adding their aggregate taxable income to the greater of zero or the grantor's taxable income.

During the grantor's lifetime, non-grantor trusts receive a distribution deduction only for "mandatory" distributions of a "fixed or ascertainable amount of trust income or property." This could be expressed as a portion or percentage of trust income, including a requirement that a distribution be *per capita* or *per stirpes*. A distribution will also be considered mandatory if it is required upon the occurrence of an event beyond the grantor, grantor's spouse, or trustee's control. Property required to be set aside for a beneficiary would be treated as a mandatory distribution. Thereafter, it appears that the income of the set-aside portion would be taxed at the beneficiary's marginal rate, rather than the grantor's marginal rate.

Another exception applies to deny the distribution deduction even if the distribution is mandatory if (1) any person has the discretionary power to make distributions of corpus or income to the grantor or the grantor's spouse, (2) any portion of the trust may revert to the grantor or the grantor's spouse, unless the reversion can't occur (a) prior to the death of the income beneficiary and the income beneficiary is younger than the grantor or (b) prior to the expiration of a term of years that is greater than the life expectancy of the grantor at the creation or funding of the trust, (3) any person has the power exercisable in a non-fiduciary capacity to control trust investments, to deal with the trust for less than full and adequate consideration, or to exercise any general administration powers in a non-fiduciary capacity without the consent of a fiduciary, (4) to the extent that an otherwise deductible mandatory distribution satisfies a legal obligation of the grantor or the grantor's spouse, or (5) trust income or corpus can be used to pay premiums on life insurance policies on the life of the grantor or the grantor's spouse with respect to which the grantor or the grantor's spouse possesses any incident of ownership. Thus, in all of these situations, the 1985 President's Proposal ensures that trust income will be taxed at the grantor's marginal rate, even though the trust is not treated as a grantor trust.

The 1985 President's Proposal sets forth a final set of rules for trusts the grantor of which has died. Beginning in the year after the grantor's death, all trusts established by the decedent would compute their taxable income as in the case of an individual, but with no zero bracket amount, no personal exemption, and with a distribution deduction for all distributions, mandatory or discretionary. This Proposal, which predates the compression of trust income tax rates, proposed to tax trusts using the married filing separately rate schedule.

Virtually all new trusts would be required to use the calendar year.

The 1985 President's Proposal was to be effective as to irrevocable trusts created after 1985 and to trusts that were revocable on January 1, 1986, for taxable years beginning after January 1, 1986. New contributions to old trusts would also be subject to these rules. The Proposal would also generally apply to irrevocable trusts that were treated as grantor trusts, effective January 1, 1986. Existing non-grantor trusts were grandfathered such that several of the new rules would not affect them.

EXHIBIT III

THE 1996 AMERICAN TAX POLICY INSTITUTE'S PROPOSAL FOR THE INCOME TAXATION OF TRUSTS AND ESTATES, THEIR GRANTORS AND THEIR BENEFICIARIES

In 1996 Sherwin Kamin, Esq. of New York prepared a Proposal for the Income Taxation of Trusts and Estates, their Grantors and their Beneficiaries, sponsored by the American Tax Policy Institute. Comments with respect to the proposal were submitted by Bernard Barrett, Esq., Professor Joseph Dodge, and the AICPA.

A. Main Objective of the Proposal:

The main objective of the proposal is to neutralize the impact of the trust or estate tax bracket by either eliminating it entirely or at least limiting it to the smallest number of cases. The proposal is designed, in addition, to greatly simplify the IRC and to reduce the complexities of the trust income tax return. However, the proposal does not attempt to generally correlate the rules for when gifts are complete for income tax purposes with the rules under the estate and gift tax laws.

B. Other Objectives of the Proposal:

1. Disallowance of a deduction for distributions to beneficiaries and eliminating the need for a definition of DNI and the creation of a tier system.

2. Eliminate tax consequences turning on the identity of the trustees and situs of a trust.

3. Avoid having the choice of taxpayer depend on the nature of the income or the allocations under state laws that differentiate between income and principal gains.

4. Eliminate the use of grantor trusts, enabling the grantor to make tax-free gifts by paying the trust's income tax.

C. Summary of the Proposal:

1. During the Grantor's Lifetime, trust income is taxed at the grantor's tax rates, except when all the economic interests are vested in a single beneficiary (a "Single Beneficiary Trust"), in which case the beneficiary's rates are used. This is accomplished in two steps:

a. Each trust will calculate its taxable income essentially the same as an individual and pay a tax based on that income at the highest applicable rate.

b. The grantor or vested beneficiary will then include the trust's income tax items in his or her return and receive a credit for the tax paid by the trust.

2. Following the Grantor's death, the beneficiaries of a trust whose tax brackets are used are the family members who are the (or potential) beneficiaries, chosen on a per stirpes basis, except for a Single Beneficiary Trust, in which case the beneficiary's rates are used.

3. Estates are treated the same as trusts. However, an estate may elect to be treated instead as a separate tax paying entity with its own bracket system for a period of two or three years after the date of the decedent's death.

4. All distribution from trusts and estates are received tax free.

5. The separate share rules are applicable.

6. The income of a charitable split-interest trust is essentially taxable to the grantor, who will be allowed to take a charitable deduction for amounts paid to charity by the trust. Certain unitrusts, however, are treated as separate shares, with the charity's share being treated as a foundation and the individual beneficiary's share treated under the proposal's regular trust rules. After the grantor's death, CRATs and CLATs are treated in a way that conforms to the estate tax treatment.

7. The taxation of trusts with foreign elements (foreign grantors, beneficiaries or situs) is the same as for domestic trusts but the tax is dependent on the status of the taxpayers whose brackets are being used; and where there are jurisdictional problems, the PFIC rules are applied.

EXHIBIT IV

PROFESSOR JAY SOLED'S 2001 PROPOSAL ON "REFORMING THE GRANTOR TRUST RULES"[28]

Purpose: To safeguard the progressive rate structure of the estate tax.

I. Reasons / Justifications / Considerations

A. Current rules are no longer needed

1. Steeply progressive brackets for individuals have been largely eliminated

2. Trust tax rate is effectively flat / Grantor's rate is often lower

3. Married couples can file jointly (and thus equalize income between them)

4. "Kiddie Tax" rules tax unearned income of children (then under 14, now potentially until age 24) at their parents' marginal rate

B. Use of grantor trust status "thwarts congressional intent and leads to significant revenue loss"

C. Choice of status should have consequences – Should Grantor have felt poorer after transfer?

D. Former abuses still warrant consideration / Giving away the income without giving away the underlying principal (forever)

1. Retained dominion and control - Power to affect beneficial enjoyment

2. Retained beneficial Interest - Reversionary interests

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[28] Professor Soled's proposal was published in 76 Notre Dame L. Rev. 375 (2001). He was then a law professor at Rutgers University.

E. Current avoidance also warrants consideration

1. Grantor's tax payment avoids gift tax

2. Permits avoidance of income tax

a) Asset sale / Annuity payment without gain recognition

b) Free basis swapping

c) Avoid transfer for value rule, three-year rule

d) Keep deductions / exclusions

(1) Taxes (current relevance given SALT limitations?)

(2) Mortgage interest (relevance / transfer tax issues?)

(3) Sale of personal residence (but no nontax reacquisition)

F. Treatment of income and wealth transfer tax should be consistent

1. (Author asserted without proof but would be simpler)

G. Treatment for outright gifts and gifts in trust should be consistent

H. Avoid unjustified administrative burden / complexity (i.e., every trust filing)

II. Proposal

A. Narrow the scope and applicability of grantor trust status so it's a Grantor Trust if:

1. Property must go to grantor or grantor's spouse, or

2. Property may go to grantor or grantor spouse because of

   a) Discretionary, revocation or amendment power exercisable grantor or grantor spouse alone or in conjunction with another

   b) Preserves concepts embodied in 676 and 677(a)(1)

B. Grantor = Incomplete / Non-Grantor = Complete

C. Deny some distribution deductions / discourage income shifting so Nongrantor Trust pays if:

1. Noncharitable distribution and grantor or grantor spouse has a reversionary interest

   a) Short term trust with reversion

   b) Grantor or grantor's spouse holds a "specified administrative power" including a right to borrow without adequate security or interest

   c) Grantor or grantor's spouse (alone or in conjunction) holds power to determine who benefits (present or future)

   d) There is a current discretionary power (not held in part by the grantor or grantor's spouse) to make current or provide for future distributions to the grantor or grantor's spouse

   e) Trust income is distributed/appointed for the support or maintenance of someone (other than a spouse) that the grantor is obligated to support

      (1) What if it's an excess payment? Not discharging the support obligation?

(2) What if paid to a person the grantor's spouse is obligated to support?

D. Identified Issues

1. 2702 Trusts would be incomplete

2. Crummey Grantor Trusts would no longer be valid S-Corporation Shareholders

EXHIBIT V

THREE MODERN PROPOSALS FOR GRANTOR TRUSTS

In recent years, there have been several proposals to address the perceived abuses available under the current grantor trust rules. This memorandum summarizes three similar proposals: the Obama Administration's proposals for fiscal year 2015 and 2016, and Senator Bernie Sanders' proposal as articulated in the "For the 99.8% Act."

A. Administration's Fiscal Year 2015 Revenue Proposals, March 2014. This proposal sought to address the "lack of coordination between the income and transfer tax rules applicable to a grantor trust" because such lack of coordination "creates opportunities to structure transactions between the deemed owner and the trust that can result in the transfer of significant wealth by the deemed owner without transfer tax consequences." The proposal does so by altering the estate inclusion rules, rather than the grantor trust rules.

Specifically, if a person who is a deemed owner under the grantor trust rules of all or a portion of a trust engages in a transaction with that trust that constitutes a sale, exchange, or comparable transaction that is disregarded for income tax purposes by reason of the person's treatment as a deemed owner of the trust, then the portion of the trust attributable to the property received by the trust in that transaction (including all retained income therefrom, appreciation thereon, and reinvestments thereof, net of the amount of the consideration received by the person in that transaction) will be subject to estate tax as part of the gross estate of the deemed owner, will be subject to gift tax at any time during the deemed owner's life when his or her treatment as a deemed owner of the trust is terminated, and will be treated as a gift by the deemed owner to the extent any distribution is made to another person during the life of the deemed owner. The transfer tax so owed would be payable from the trust.

If a trust were already includible in the grantor's estate, the proposed changes would not apply. Specifically included in this carve out are GRITs, GRATs, PRTs, and QPRTs. Rabbi trusts and insurance trusts are also excluded from this proposal.

The proposal would be effective with regard to trusts that engage in a described transaction on or after the date of enactment.

B. Administration's Fiscal Year 2016 Revenue Proposals, February 2015. The Obama Administration re-issued a nearly identical proposal a year later.

C. For the 99.8% Act. The "For the 99.8% Act" provides statutory language for what would appear to be the same proposal, which would add section 2901 to the Code.

The statutory language makes a few things clear that are not clear from Treasury's one-paragraph write up.

1. The inclusion rules (estate inclusion or gift) apply to the deemed owner, whether or not that person is the grantor (i.e., it would apply to an owner under section 678)

2. The exception for trusts already includible in the grantor's estate is written into the statute, but the exception for any other trust (such as a rabbi trust or insurance trust) is only covered by regulatory authority to create an exception for any other trust that "does not have as a significant purpose the avoidance of transfer taxes."

3. The effective date is stated as follows:

a. Trusts created on or after the date of enactment,

b. Also applies to any portion of a trust established before the date of enactment which is attributable to a contribution made on or after the date of enactment, and

c. To any portion of a trust established before the date of enactment to which the substantive provisions apply because of a transaction on or after the date of enactment.