

Excerpt from eBook

U.S. Pre-Immigration Tax Planning

Grantor Trust (U.S. Income Tax)

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Gary S. Wolfe has over 34 years of experience, specializing in IRS Tax Audits and International Tax Matters including: International Tax Planning/Tax Compliance, and International Asset Protection.

As of July 2016, Gary Wolfe has internationally published 15 books and 28 articles. Gary has received 14 international tax awards from five different Global expert societies in LONDON/UK including being voted one of the 100 leading world's law firms with votes from over 150,000 voters in over 160 countries with the following award: Global 100 (2016) (KMH Media Group) - CA/US International Tax Planning Law Firm of the Year.

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Chapter 7 - Grantor Trust (U.S. Income Tax)

(Subpart E of Subchapter J of Chapter 1 of Subtitle A IRC 1954)

IRC Sec. 671-679 determines whether a trust is a “grantor trust” for U.S. federal income tax purposes. If a trust is a grantor trust, all items of income, deduction and credit in respect of the trust property will be reported on the grantor’s U.S. federal income tax return, and any income tax liability will be paid by the grantor and not from the trust (Treas. Reg. 1.671-3 (a)(1)).

IRC Sec. 673-679 identify persons as “owners” of portions of trusts with which they have relationships. IRC Sec. 671 specifies the consequences of being treated as the owner [IRC Sec. 671: The neck of the funnel through which Sec. 673-678 passes].

Tres. Reg. 1.671-2(e)(1)

“A grantor includes any person to the extent such person either creates a trust or directly or indirectly makes a gratuitous transfer of property to a trust.” (A Settlor is the person who intentionally causes the trust to come into existence.)

IRC Sec. 671 identifies a grantor as owner of any “portion” of a trust; items of income, deductions and credits attributable to that portion of the trust are taken into account in computing the grantor’s taxable income and credits.

A “Portion” includes:

- Ordinary income;
- Income allocable to corpus;
- An entire trust;
- An undivided fractional interest in the trust;
- An interest represented by a dollar amount;
- Specific trust property.

IRC Sec. 671: Grantor Trust Status

The person designated by Subpart E as “owner” of a portion of a trust must take into account in computing their tax liability the items of income, deductions and credits attributable to that portion of the trust (that would otherwise be reportable by the trust itself).

Tax Compliance

IRC Sec. 6012(a)(4) requires an income tax return from “every trust having for the taxable year any taxable income, or having gross income of \$600 or over, regardless of the amount of taxable income. Subpart E may attribute part or all of a trust’s income to the grantor.

IRC Sec. 6501 statute of limitations protects a taxpayer against assessments occurring later than three years after the filing of the relevant tax return. For the statute of limitations, in the case of a grantor trust the statute begins to run only on the filing of the grantor's return (not the filing of any trust tax return). (See: *Lardas v. Commr.*, 99 T.C. 490 (1992); *Olson v. Commr.*, 64 T.C.M. 1524 (1992), *Bartol v. Commr.*, 63 T.C.M.2324 (1992), *Field Serv. adv.* 200207007 (Nov. 6 2001).

Under Treas. Reg. 1.671-4(a), items attributed to a grantor are not to be reported by the trust on Form 1041; instead such items should be "shown on a separate statement attached to Form 1041, and reported by the grantor".

Grantor Trust

If the trust is a grantor trust for income tax purposes, a sale of assets to the trust by the grantor is disregarded. (See Rev. Rul. 85-13, 1985-1 C.B. 184).

If the non-contributing spouse has a discretionary interest as to both income and principal, the trust is a grantor trust under IRC Sec. 677(a)(1) to the contributing spouse. No income tax realization event occurs and the policy proceeds are excluded from both estates (Ltr. Rul. 9413045).

Intentionally Defective Grantor Trust

An "Intentionally Defective Grantor Trust" ("IDGT") takes advantage of the differences between the estate tax inclusion rules of IRC Sections 2036-2042, and the grantor trust income tax rules of IRC Sec. 671-678. An IDGT is an irrevocable trust that effectively removes assets from the grantor's estate. As a result, a sale of assets to an IDGT can freeze an individual's estate by converting appreciating assets into a non-appreciating asset with a fixed yield.

For income tax purposes, the trust is "defective" and the grantor is taxed on the trust's income. Accordingly, sale of assets between the IDGT and the grantor are not taxable. The grantor is treated for income tax purposes to have made a sale to himself eliminating capital gain tax on sale.

(Additionally, interest payments by the IDGT to the grantor are not income.)

Since the IDGT is "defective" for income tax purposes, all of the trust's income is taxed to the grantor, which produces an additional "tax-free gift" to the IDGT (Rev. Rul. 2004-64, 2004-2(C.B. 7)).

As a grantor trust, the IDGT:

- Can be the owner of S-corporation stock (it is a permitted shareholder);
- Can purchase an existing life insurance policy on the grantor's life, without subjecting the policy to taxation under the transfer for value rule;

The sale of the policy is a sale to the grantor-insured and the transfer for value exception under IRC Sec. 101 (a)(2)(B) should apply.

If the IDGT is structured as a “Crummey Trust”, the contribution will qualify for the IRC Sec. 2503(b) gift tax annual exclusion. Under IRC Sec. 678(b), a grantor will be treated as the owner of the trust, rather than the beneficiary with respect to power over income (and corpus), which are subject to “Crummey Withdrawal” rights (See IRS PLR 200606006, 200603040, 200729005, 200942020).

Under an IDGT, Grantor Trust Status:

1. Power of Substitution: The Grantor (or spouse) has the power to reacquire trust assets in a non-fiduciary capacity (IRC Sec. 675(4); Treas. Reg. Sec. 1.675-1(b)(4). In Rev. Rul 2008-22, 2008-1 CB 796, the IRS ruled that a grantor’s retained power, exercisable in a non-fiduciary capacity, to acquire trust property by substituting property of equivalent value will not by itself cause estate tax inclusion under IRC Sec. 2036 or 2038.

2. Swapping Assets: If the grantor sells assets to the IDGT, the trust assets are excluded from the grantor’s estate at death, but the IDGT assets would not receive a tax basis step-up under IRC Sec. 1014. If the assets sold to an IDGT have a low basis, the lack of basis step-up is an income tax disadvantage which may be ameliorated by the grantor exchanging high-basis outside of the IDGT, with low-basis assets inside of the IDGT, achieving a “basis step-up”. The swap of assets with an IDGT should not be treated as a gift for purposes of IRC Sec. 1014(e).

3. Power to Make Loans without Adequate Security: The power exercisable by a grantor or a non-adverse party that permits the grantor or the grantor’s spouse to borrow trust property without adequate security (IRC Sec. 675(2)). Grantor trust status is achieved if the grantor’s spouse holds such power under IRC Sec. 672(e). Unlike Sec. 675(3), which requires an actual borrowing by the grantor, the existence of a power under IRC Sec. 675(2) may cause grantor trust status.

Even if the loan provides for adequate interest, grantor trust status is secured if the trustee has the power to lend unsecured. To avoid estate tax inclusion, the lending power should not include the authority to make loans without adequate interest. In order to minimize the risk of estate tax inclusion, the power to lend without security should be held by a non-adverse party and not the grantor (e.g. a trust protector).

4. Power to Add Beneficiaries: The power to add to the class of beneficiaries (other than the grantor’s after-born or after-adopted children) to receive the trust’s income or corpus held by the grantor, or a non-adverse party will cause grantor trust status. To avoid estate tax inclusion, the grantor should not hold such a power, but the power could be held by the grantor’s spouse without inclusion if the spouse did not contribute to the trust and is not controlled by the grantor. A marital agreement should be entered into in advance of the transfer to ensure that the spouse did not make a contribution to the IDGT. The IRS has privately ruled that the power to add beneficiaries held by a trustee triggers grantor trust status (IRS PLR 199936031; 9709001; 9010065).

5. Payment of Life Insurance Premiums: A grantor is treated as the owner of any portion of the trust whose income may be applied to the payment of premiums of life insurance policies on the grantor or the grantor's spouse (IRC Sec. 677(a)(3)). IRS Field Attorney Advice 20062701 F indicates that the power to purchase life insurance on the grantor's life results in grantor trust status. Treasury Regulations establish that the grantor is taxed on any trust income actively used to pay premiums. Under PLR 8852003, the IRS has privately ruled that the power to pay premiums is sufficient.

Income Tax - Transfer for Value (IRC Sec. 101(a)(2))

If insurance policy transferred for valuable consideration, unless exception applies, general rule that policy proceeds are not includable in gross income does not apply.

Not Income Tax Realization Event

- Rev. Rul. 85-13 (1985-1 CB 184): Transfer between grantor and his grantor trust, not an income tax realization event;

- IRC Sec. 1041: Transfers between spouses (if no NRA spouse), no income tax realization, transferee spouse "carry-over" income tax basis.

Exceptions from application of the transfer for value include transfers where the transferee takes a carry-over basis (IRC Sec. 101(a)(2)(A)), transfers to the insured, a partner of the insured, a partnership in which the insured is a partner and a corporation in which the insured is a shareholder or officer (IRC Sec. 101(a)(2)(B)).

Under Rev. Rul. 2007-13, 2007-11 IRB 684, a transfer to a grantor trust with respect to the insured qualifies as a transfer "to the insured" for purposes of the transfer for value rule. Under this Revenue Ruling, a grantor who is treated for federal income tax purposes as the owner of a trust (that owns a life insurance contract on the grantor's life) is treated as the owner of the contract for purposes of applying the transfer for value limitations under IRC Sec. 101(a)(2).

Grantor Trust - Avoids Application of Transfer for Value Rules

Treas. Reg. 1.671-2 (e)(1): A grantor includes any person to the extent such person either creates a trust or directly or indirectly makes a gratuitous transfer of property to a trust.

Under IRC Sec. 671-677, only a person who makes a gratuitous transfer to a trust can be treated as an "owner", necessary to engage in disregarded transactions with the trust. The Trust Donor is treated as the owner for grantor trust purposes.

Grantor Trust Status

IRC Sec. 677 (a)(3): Trust is a grantor trust to the extent trust income may be used to pay premiums on insurance policies on the grantor's life, or the grantor's spouse. However, grantor

trust status may apply only to the portion of the trust the income from which is currently used to pay premiums (See: Weil, 3TC 579 (1944); Iverson, 3 TC 756 (1944)).

Settlor power, held in a non-fiduciary capacity, to substitute property of equivalent value under IRC Sec. 675(4)(C), causes a trust to be a grantor trust.

Estate Tax

Where trust assets consist of an insurance policy on the grantor's life, a power to substitute assets may not result in estate tax inclusion under IRC Sec. 2042(2), if the grantor held the power in a fiduciary capacity (See: Estate of Jordahl, 65 TC 92 (1975); Aug. 1977-1, (CB 1) (See: Ltr. Rul. 200603040)).

IRS

Trust property may not be includable in the gross estate under IRC Sec. 2035, 2036, 2048 or 2039 if the power of substitution is held in a fiduciary capacity.

Grantor Trust Rules - IRC Sec. 672(e)

Spousal Unity Rule; i.e., grantor is treated as holding any power or interest held by the grantor's spouse.

Gift Tax

Creation of an irrevocable trust may subject the grantor to the gift tax: Treas. Reg. 25.2511-2(d).

Grantor Trust Status (ILIT)

A related and subordinate party could be named as trustee with the power to make discretionary distributions, not on an ascertainable standard, in order to make the ILIT a grantor trust. If the grantor cannot remove and replace the trustee, the initial appointment of a related and subordinate party trustee may not cause the powers of the trustee to be attributed back to the grantor for estate tax purposes (Ltr. Rul. 9636033).

Grantor trust status confirmed if a person who is not a contributor to, or beneficiary of, the trust, has the power to add to the class of beneficiaries (e.g. charity or other descendants (IRC Sec. 674(b)(5), 674(b)(6). See: Madorin, 84 TC 667 (1985)).

Grantor Trust - (Ownership of Assets)

Under Rev. Rul. 85-13, and Proposed Treas. Reg. Sec. 1.671-2(f) “a person that is treated as the owner of any portion of a trust under subpart E is considered to own the trust assets attributable to that portion of the trust [See: REG- 209826-96, 1996-2 (C.B. 498)].

Termination Grantor Trust Status

A grantor trust loses its status as a grantor trust on the death of its grantor (D.G. McDonald Trust, 19 TC 672 (1953), acq. 1953-2 C.B.3 (Chase Nat’l Bank v. Commr., 225 F.2d 621 (8th Cir. 1955)); Proposed Treas. Reg. Sec. 1.671-4(h)(2)).

Adverse Party

IRC Sec. 672(a) defines an “adverse party” as “any person having a substantial beneficial interest in the trust which would be adversely affected by the exercise or non-exercise of the power which he possesses respecting the trust.”

A trustee may be an adverse party if the trustee has the power to distribute all of the trust income and property to himself but is not an adverse party if the trust terms fix all the beneficial interests even if the trustee is a beneficiary (See: Johnson v. Commr., 108 TC 448 (1957), Floyd G. Paxton, 57 TC 627 (1972).

Beneficiaries can be adverse parties if they have a power the exercise or non-exercise of which would adversely affect the beneficiary’s own beneficial interest.

IRC Sec. 672(b) defines a “nonadverse party” as “any person who is not an adverse party”.

A trust is classified as a grantor trust if more than half of the trustees are related or subordinate to the grantor.

IRC Sec. 674(a) provides that the grantor of a trust is to be treated as the owner of any portion of such trust, in respect of which the beneficial enjoyment of such portion is subject to a power of disposition, exercisable by the grantor or a non-adverse party, or both, without the approval or consent of any adverse party.

IRC Sec. 674(c) provides an exception to the general rule of IRC Sec. 674(a) for distribution powers of the “independent trustee”, none of whom is the grantor, and no more than half of whom are related or subordinate to the grantor or are subservient to the wishes of the grantor (IRC Sec. 672(c) defines: “related or subordinate party”).

Related or Subordinate Party

IRC Sec. 672(c) defines a “related or subordinate party” as any “non-adverse party” which includes:

1. IRC Sec. 672(c)(1): The grantor’s spouse (only if they are living together);

2. IRC Sec. 672(c)(2): Grantor's father, mother, children, brother, sister (including half-brothers/sisters). See: Rev. Rul. 58-19, 1958-1, CB 251);

3. IRC Sec. 672(c)(2): An employee of the grantor, or the grantor's corporation.

Not Related or Subordinate Party

Under IRC Sec. 672(c) the following are not related or subordinate parties:

1. Nieces, nephews, grandparents, spouses of children, spouses of grandchildren, spouses of brothers and sisters;

2. Partners of the grantor;

3. Director of a corporate grantor (i.e. stock holdings of the grantor and the trust are significant, re voting control). See: Rev. Rul. 66-160, 1966-1, CB 164;

4. The grantor's lawyer, accountant or trust company (See: Zand v. Commr., 71 TCM 1758 (1996), 143 F.3d 1393 (11th Cir. 1998); Estate of Hilton W. Goodwyn, 35 TCM 1026, 1038 (1976) re lawyers-trustees not "related or subordinate parties" and lawyer-trustees were independent trustees under IRC Sec. 674(c).

Power Subject to Condition Precedent

IRC Sec. 672(d) states that a person is deemed to have a power described in subpart E "even though the exercise of the power is subject to a precedent giving of notice or takes effect only on the expiration of a certain period after the exercise of the power".

Grantor's Spouse

The Tax Reform Act of 1986 added IRC Sec. 672(e), which treats the grantor as holding any power or interest held by the grantor's spouse if the grantor's spouse was living with the grantor at the time of the creation of the power or interest (i.e., if the spouse and the grantor are eligible to file a joint return with respect to the period in question).

Grantor as Foreign Person - ("Inbound Trusts")

If a foreign person is an "owner" of any portion of a trust, and the trust has as a beneficiary a U.S. person who has made one or more gifts to that foreign person, IRC Sec. 672(f)(5) designates the U.S. beneficiary, not the foreign grantor-donee, as the owner of the trust to the extent of the gifts (with an exception for gifts that qualify for the annual exclusion under IRC Sec. 2503(b)).

IRC Sec. 672(f)(5) precludes foreigners immigrating to the U.S. from giving property to another foreigner, who agrees to use the property to fund a U.S. trust for the benefit of the immigrating foreigner, who then denies he was the grantor of the trust. Under IRC Sec. 672(f)(5), the

immigrating foreigner receives the same treatment he would have received had he created the trust directly (Treas. Reg. Sec. 1.672(f)-5(a)(1)).

In the Small Business Job Protection Act of 1996, Congress expanded IRC Sec. 672(f) so that subpart E now generally applies only when its effect is to designate as owner of part or all of a trust a U.S. citizen, resident or domestic corporation (IRC Sec. 672(f)(1), a “controlled foreign corporation”, defined in IRC Sec. 957 is treated as a domestic corporation. IRC Sec. 672(f)(3)(A).

IRC Sec. 672(f) reverses prior law under which subpart E designated non-resident aliens as owners of trusts, thereby allowing U.S. beneficiaries to receive the income from such trusts tax-free.

Grantor Trust: Co-ownership and Reversionary Interest

IRC Sec. 673(a) now treats the grantor who retains any reversionary interest as owner of the entire trust (Treas. Reg. 1.671-3(b)(3)); Priv. Ltr. Rul. 9519029 (Feb. 10, 1995). IRC Sec. 672(e) treats the grantor as owner of any interest their spouse owns. Unless the value of the reversionary interest at inception is less than 5% of the value of the property transferred. (IRC Sec. 673(b) excepts from the general rule any reversionary interest that follows the death before attaining age 21 of a lineal descendant of a grantor.)

A grantor who has retained a reversionary interest in the corpus of a trust is treated as owner of the corpus portion of that trust (Treas. Reg. Sec. 1.673(a)-1(a), 1.677(a)-1(g) Ex. (2).

IRC Sec. 674: Powers over Beneficial Enjoyment

IRC Sec. 674(a) treat any grantor as owner of any portion of any trust “in respect of which the beneficial enjoyment of the corpus or income is subject to a power of disposition, exercisable by a grantor or non-adverse party, or both, without the approval or consent of any adverse party.”

IRC Sec. 674, 677: Power to Apply Income to Support of a Dependent

A grantor is not subject to tax under neither IRC Sec. 677(b) nor Sec. 674(a) merely because in the discretion of another person, the trustee or the grantor (or the grantor’s spouse, IRC Sec. 672(e)), acting as trustee, income 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. Under IRC Sec. 677(a), the grantor is treated as the owner of the income portion, to the extent of the grantor’s obligation of support.

Grantor Trust - Power to Distribute Corpus

IRC Sec. 674(b)(5) provides two exceptions (to IRC Sec. 674) for powers to distribute corpus:

1. Power to distribute corpus to or for one or more beneficiaries if the power is limited by a reasonably definite standard in the trust instructions (IRC Sec. 673(b)(5)(A), i.e. a “clearly measurable standard under which the holder of a power is legally accountable (Treas. Reg. Sec. 1.674(b)-1(b)(5)(i)). Examples of reasonably definite standards are standards relating to a beneficiary’s “education, support, maintenance or health”, “reasonable support or comfort”, to enable a beneficiary to maintain an “accustomed standard of living”, to allow a beneficiary to “meet an emergency”, or to pay a beneficiary’s “medical expenses” (Treas. Reg. Sec. 1.674(b)-1(b)(5)(iii), Ex. (1)).

2. Power to distribute corpus to or for any “current income beneficiary”, whether subject to a standard or not, if the distribution must be chargeable against the proportionate share of corpus held in trust for payment of income to the beneficiary “as if the corpus constituted a separate trust” (IRC Sec. 674(b)(5)(B).

Grantor Trust - Exception: (Independent Trustee)

Exceptions to the general rule of IRC Sec. 674(a) are contained in IRC Sec. 674(c), which provides exceptions if the powerholder is an “independent trustee”; i.e. not the grantor, grantor’s spouse, no more than half of whom are related or subordinate parties who are subservient to the grantor’s wishes.

The exceptions:

1. The power of a trustee to distribute, apportion or accumulate income to or for one or more beneficiaries (IRC Sec. 674(c)(1).

2. The power of a trustee to sprinkle corpus to or among one or more beneficiaries, regardless of whether they are income beneficiaries (IRC Sec. 674(c)(2).

Grantor Trust/Exception: (Powerholder is a Trustee, other than the Grantor or the Grantor’s Spouse)

IRC Sec. 674(d) protects a power to distribute, apportion or accumulate income to or for the beneficiaries if the power is limited by a “reasonably definite external standard” (Treas. Reg. 1.674(d)(1), 1.674(b)-1(b)(5) which “defines a reasonably definite standard”). The “standard” must be set forth in the trust instrument.

Grantor Trust - Power to Remove Trustee

Under Treas. Reg. Sec. 1.674(d)-2(a), W. Clarke Swanson, Jr. 1950 Trust, 33 TCM 296, 302 (1974), aff’d 518 F.2d 59 (8th Cir. 1975), if the grantor or the grantor’s spouse has the power to remove the trustee and make either of them the trustee, neither the exception under IRC Sec. 674(c) or IRC Sec. 674(d) applies.

Grantor Trust - Power to Add Beneficiaries

A power to add beneficiaries does not qualify under IRC Sec. 674 exceptions if any person has the power to add to the group of beneficiaries, other than providing for after-born or after-adopted children. A power in a non-adverse party to add charitable beneficiaries or trigger IRC Sec. 674 (See: *Madorin v. Commr.*, 84 TC 667 (1985). Priv. Ltr. Rul. 9838017 (6/19/98), Priv. Ltr. Rul. 9710006 (11/8/96), Priv. Ltr. 97090001 (11/8/96)).

IRC Sec. 675 - Grantor Administrative Powers

IRC Sec. 675 contains provisions designed to prevent a grantor from maintaining dominion and control over a trust through certain types of administrative powers vested in either the grantor or others.

1. Power to Deal with Trust Property for Less Than Adequate and Full Consideration.

IRC Sec. 675(1) describes a power exercisable by the grantor or any non-adverse party to enable the grantor or any person to “purchase, exchange or otherwise deal with or dispose of the corpus or the income there from for less than an adequate consideration in money or money’s worth.”

2. Grantor Borrowing. IRC Sec. 675(2) relates to a power enabling a grantor to borrow without adequate interest or security. IRC Sec. 675(3) relates to actual borrowing.

Power to Borrow without Adequate Interest or Security

IRC Sec. 675(2) describes a power exercisable by the grantor or any non-adverse party to enable the grantor to borrow either principal or income “directly or indirectly, without adequate interest or adequate security”. If so, grantor is treated as the owner of some portion of the trust. If the trustee (who is not the grantor or the grantee’s spouse) has the power to lend on such terms to anyone, the power is disregarded for purposes of IRC Sec. 675(2). In addition, there are no other restrictions on the trustee’s identity; even a related or subordinate party may serve as trustee.

Actual Borrowing

IRC Sec. 675(3) states that actual borrowing by the grantor causes grantor trust status, if 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.” IRC Sec. 675(3) does not apply to a loan to a grantor that provides for adequate interest and adequate security if made by a trustee “other than the grantor and other than a related or subordinate trustee subservient to the grantor”. If a loan to a grantor provides for adequate interest and adequate security, and is made by a non-captive trustee, there are no grantor trust consequences.

In *Zand v. Commr.*, 71 TCM 1758 (1996), 143 F.3d 1393 (11th Cir. 1998), the court held that certain loans qualified under the exception of IRC Sec. 675(3) because they provided for adequate interest and security and a majority of the trustees who made them were neither related nor subordinate to the grantor under IRC Sec. 672(c), despite the fact these two trustees were also the grantor's lawyers.

General Powers of Administration

IRC Sec. 675(4) describes three powers of administration and treats the grantor as owner of a portion of the trust if any of these powers is exercisable in a "non-fiduciary capacity" by any person without the approval or consent of any person in a fiduciary capacity. Treas. Reg. Sec. 1.675-1(b)(4) limits the applicability of the provision to powers held by a "non-adverse party". If a power is exercisable by a trustee, it is presumed to be exercisable in a fiduciary capacity.

The three powers:

1. The power to vote or direct the voting of stock or securities of a corporation in which the holdings of the grantor and the trust are "significant from the viewpoint of voting control."
2. The power to control the investment of the trust funds either by directing investments or by retaining proposed investments "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".
3. The power to reacquire trust property by substituting other property of an equivalent value.

Revocable Trusts

If a trust is wholly revocable by the grantors, IRC Sec. 676 treats the grantor as owner of the entire trust because the grantor has the power to revest in himself all of the trust property.

IRC Sec. 677

Income for Benefit of Grantor or Grantor's Spouse

1. Income Distributable to the Grantor or Grantor's Spouse.

If a grantor retains a mandatory income interest, or creates a mandatory income interest in the grantor's spouse, IRC Sec. 677 treats the grantor as owner of the income portion of the trust, under IRC Sec. 677(a)(1), the "income is distributed to the grantor or the grantor's spouse." IRC Sec. 677(a) requires that the income be distributed "without the approval or consent of any adverse party."

2. Income Accumulated for the Grantor or Grantor's Spouse

IRC Sec. 677(a)(2) applies if income may be accumulated without the consent of an adverse party for future distribution to the grantor or the grantor's spouse.

3. Income Applicable to Payment of Life Insurance Premiums

IRC Sec. 677(a)(3) applies if income is or may be applied without the consent of an adverse party to the payment of premiums on policies of insurance on the life of the grantor or the grantor's spouse. The grantor is treated as the owner of some portion of any trust required or permitted to pay premiums on policies of life insurance on the life of either the grantor or the grantor's spouse. The courts have limited the amount of income on which a grantor is subject to taxation to that which the trustee actually uses to pay premiums on specified policies (Joseph Weil, 3 TC 579 (1944)).

4. Income Applicable to Discharge of Indebtedness

IRC Sec. 677(a) treats the grantor as owner of a portion of a trust if its income can be used to pay off debts of the grantor such as rent, household expenses or mortgage debt (See: Treas. Reg. Sec. 1.677(b)-1(d); Jack Wiles, 59 TC 289 (1972), *Jenn v. U.S.* 70-1 USTC Para. 9264 (S.D. Ind. 1970).

5. Income Applicable to Discharge of Support Obligations IRC Sec. 677(b) is an exception to the general rule of IRC Sec. 677(a). According to IRC Sec. 677(b), IRC Sec. 677(a) does not apply if trust income 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".

Under Treas. Reg. Sec. 1.677(b)-1(f), if income must be applied in discharge of a support obligation of the grantor, IRC Sec. 677(b) does not apply; instead IRC Sec. 677(a) applies. For IRC Sec. 677(b) to apply, the power to use trust income to discharge the grantor's support obligations must be that of "another person, the trustee, or the grantor acting as trustee or co-trustee". Under Treas. Reg. Sec. 1.677(b)-1(e), if the power is that of the grantor acting in a non-fiduciary capacity, the grantor is treated as owner of the trust's income, to the extent of his or her dischargeable obligations, regardless of whether the trust discharges them.

Under IRC Sec. 677(b), for trust distributions in discharge of a grantor's support obligations:

- If a distribution comes out of current income, the grantor is treated as owner of the trust, but only to the extent of the obligation discharged (*Brooke v. U.S.*, 300 F.Supp. 465 (D. Mont. 1969), *aff'd* 468 F.2d 1155 (9th Cir. 1972).
- If the distribution comes out of either principal or accumulated income, IRC Sec. 677(b) treats the amount distributed as deductible by the trust under IRC Sec. 661(a)(2) and taxable to the grantor under IRC Sec. 662, (Rev. Rul. 74-94, 1974-1 C.B. 26); Treas. Reg. Sec. 1.677(b)-1(c).

IRC Sec. 678 - Non-Grantors Treated as Grantors

Under IRC Sec. 678, one other than the grantor is treated as owner of any portion of a trust that he can by exercise of a power exercisable by himself, vest in himself a portion of a trust.

Released or Modified Power

IRC Sec. 678(a)(2), applies if a person other than the grantor has “previously partially released or otherwise modified” a power described in IRC Sec. 678(a)(1), and “retains such control as would subject a grantor of a trust to treatment as the owner thereof”, IRC Sec. 678(a)(2) treats anyone who has released or modified an IRC Sec. 678 power as though he created a continuing trust.

Obligations of Support

IRC Sec. 678(a), if a powerholder can direct a trust to expend either its income or its principal to discharge a legal obligation, he is treated as the powerholder, if principal or accumulated income is used to discharge the powerholder’s support obligation, the powerholder is treated as a beneficiary who receives a taxable distribution under IRC Sec. 661 and 662.

IRC Sec. 679 - Foreign Trusts with U.S. Beneficiaries (“Outbound Trusts”)

If a U.S. person transfers property to a foreign trust that has one or more U.S. beneficiaries, IRC Sec. 679 treats the transferor as owner of the portion of the trust attributable to the property transferred (IRC Sec. 679(a)(1)). There are exceptions:

A transfer by reason of the death of the transferor (IRC Sec. 679 (a)(2)(A));

A transfer “in exchange for consideration of at least the fair market value of the transferred property” (IRC Sec. 679(a)(2)(B)).

If a foreign trust accumulates income during a year in which it has no U.S. beneficiary, if the trust acquires a U.S. beneficiary in a later year, a U.S. transferor (who would have been treated as owner of a portion of the trust during the prior year, but for the fact that it had no U.S. beneficiary) is taxable in the first year IRC Sec. 679 applies, on additional income equal to the trust’s undistributed net income for all prior taxable years (to the extent such undistributed net income remains in the trust at the end of the taxable year immediately prior to applicability of IRC Sec. 679) attributable to the portion to which IRC Sec. 679 applies (IRC Sec. 679(b)).

Direct/Indirect Transfers

Under the IRC Sec. 679(a)(1) a U.S. person’s transfer to a foreign trust includes both indirect and direct transfers, either of which classifies the U.S. person as the owner of the trust attributable to the property transferred if the foreign trust has one or more U.S. beneficiaries.

Indirect transfers include:

1. A transfer by either a foreign or domestic entity in which a U.S. person has an interest “may be regarded as an indirect transfer to the foreign trust by the U.S. person if the entity merely serves as a conduit for the transfer by the U.S. person or if the U.S. person has sufficient control

over the entity to direct the transfer by the entity rather than himself.” (S. Rep. 938, 94th Cong., 2d Sess. 219 (1976)).

2. If a foreign trust borrows money or property and a U.S. person guarantees the loan, the U.S. person is making an indirect transfer to the trust.

3. An intermediate transfer to either another person or an entity that makes the actual transfer to the foreign trust is to be disregarded “unless it can be shown that the ultimate transfer of property to the trust was unrelated to the intermediate transfer. In such a case, the person making the intermediate transfer would be treated as having made the ultimate transfer directly.” See: *Haeri v. Commr.*, 56 TCM 1061 (1989) (transfer by agent). Treas. Reg. Sec. 1.679-3 provides elaborate guidance with respect to indirect transfers.

IRC Sec. 679: U.S. Persons

IRC Sec. 679 applies only to a “U.S. person” which IRC Sec. 7701 (a) (30) defines as “a citizen or resident of the U.S.”, including a resident alien (See: Treas. Reg. Sec. 1.679-1(d); *Haeri v. Commr.*, 56 TCM 1061 (1989); Rev. Rul. 90-106, 1990-2 (B162)). A “U.S. person” includes: a U.S. partnership or corporation, any estate other than a foreign estate (defined in IRC Sec. 7701(a)(31)(A). A U.S. person includes a “U.S. Trust” (i.e. a domestic trust) which is a trust if “a court within the U.S. is able to exercise primary supervision over the administration of the trust”, and “one or more U.S. persons have the authority to control all substantial decisions of the trust”. (Treas. Reg. Sec. 301.7701-7(a)(1).

IRC Sec. 679 only applies to transfer to a “foreign trust” (i.e. not a domestic trust) only if a trust has a U.S. beneficiary. (IRC Sec. 7701(a) (31)(B) defines a foreign trust as any trust that does not qualify as a U.S. person.

U.S. Beneficiary

Under IRC Sec. 679(c), a foreign trust always has a U.S. beneficiary unless “under the terms of the trust, no part of the income or corpus of the trust may be paid or accumulated during the taxable year to or for the benefit of a U.S. person (IRC Sec. 679(c)(1)(A). Under Treas. Reg. Sec. 1.679-2(a)(2)(i), this determination is independent of whether there is an actual distribution of income or corpus to a U.S. person during the year. If the trust authorizes accumulations for possible distributions to any U.S. person in the future, the trust has a U.S. beneficiary throughout the intervening period. Treas. Reg. Sec. 1.679-2(a)(2)(iii), (Ex 2). Even if the only interest a U.S. person has a right to receive is corpus upon termination, the trust has a U.S. beneficiary. Treas. Reg. 1.679-2 (a)(2)(iii), Ex (3).

In addition, a foreign trust always has a U.S. beneficiary if “no part of the income or corpus” of the trust could be paid to or for the benefit of a U.S. person “if the trust were terminated at any time during the taxable year”. (IRC Sec. 679(c)(1)(B).

If any person has the authority to distribute trust income or corpus to unnamed persons generally or to any class of persons which include “U.S. persons”, the trust has U.S. beneficiaries (Treas. Reg. 1.679-2(a)(2)(i), this determination is independent of whether a U.S. person’s trust interest is contingent).

If any person has a power of appointment pursuant to which income or corpus may pass to a U.S. person, the trust has U.S. beneficiaries (Treas. Reg. Sec. 1.679-2(a)(2)(iii), (Ex 11).

If any person has the power to amend the trust so as to include U.S. persons as beneficiaries, the trust has U.S. beneficiaries (S. Rep 938, 94th Cong., 2d Sess. 219 (1976)).

Under Treas. Reg. 1.679-2(a)(4), the determination of whether income or corpus may be paid to or for the benefit of a U.S. person, the IRC consults “writings, oral agreements between the trustee and persons transferring property to the trust, local law, and the trust instrument”.

IRC Sec. 679(c)(2) provides attribution rules that can cause income paid to or accumulated for a foreign corporation, partnership, trust or estate to be treated as though it were paid to or accumulated for the benefit of a U.S. beneficiary: these attribution rules apply if a corporation is a controlled foreign corporation, as defined in IRC Sec. 957(a) (See: IRC Sec. 679(c) (2)(A).

If a U.S. person is a partner of a foreign partnership (IRC Sec. 679(c) (2) (B), or if a U.S. person is a beneficiary of a foreign estate or trust (IRC Sec. 679(c)(2)(C). See: Treas. Reg. Sec. 1.679-2(b)(2) and (3), (Ex. 4 & 5).

A foreign trust has U.S. beneficiaries the day after the trust beneficiaries move to the U.S. (Treas. Reg. Sec. 1.679-2(a)(3)(ii), (Ex 1). Under IRC Sec. 679(c)(3), a beneficiary who first becomes a U.S. person more than 5 years after the date of a transfer to a foreign trust is not a U.S. person with respect to that transfer (See: Treas. Reg. Sec. 1.675-2(d)(3)(ii), (Ex 2). The determination whether a trust has a U.S. beneficiary for purposes of IRC Sec. 679 occurs on an annual basis (Treas. Reg. 1.679-2(a)(1).

If a foreign beneficiary becomes a U.S. person, IRC Sec. 679 begins to apply with the transferor’s first taxable year in which the foreign beneficiary is a U.S. person. The U.S. transferor has “additional income” pursuant to IRC Sec. 679(b) in the taxable year in which the trust acquires a U.S. beneficiary. Treas. Reg. 1.679-2(c)(1)(3), (Ex 1).

When a trust ceases to have any U.S. beneficiaries, the U.S. transferor continues to be treated as owner until the beginning of the following taxable year (Treas. Reg. Sec. 1.679-2(c)(2)(3), (Ex 2).

Under IRC Sec. 679, with respect to a foreign trust, to which no U.S. resident has ever transferred anything, if a non-resident alien becomes a U.S. resident within 5 years of an actual transfer (Treas. Reg. 1.679-5), it is a U.S. grantor trust.

If a non-resident alien transfers property to a foreign trust and during the succeeding 5 years becomes a U.S. resident, IRC Sec. 679 applies as though the transferor had, on that later date, transferred “an amount equal to the portion of such trust attributable to the property actually transferred”. (IRC Sec. 679(a)(4)(A), which includes undistributed net income of the trust for periods before the transferor became a U.S. resident (IRC Sec. 679(a)(4)(B)).

If a U.S. trust becomes a foreign trust, under IRC Sec. 679 the trust becomes a foreign grantor trust (Treas. Reg. 1.679-6) and IRC Sec. 679 applies as though the grantor had on that date transferred “an amount equal to the portion of such trust attributable to the property previously transferred (IRC Sec. 679(a)(5), including undistributed net income of the trust for periods before the trust became a foreign trust.” (IRC Sec. 679(a)(5)).

