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ARTICLES

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INTRODUCTION

Few things in the Internal Revenue Code (Code) are as enduring as the grantor trust rules. Housed in Subpart E of Subchapter J of the Code,¹ they are essentially the same rules that were instituted by the so-called Clifford trust regulations promulgated over a half-century ago.² In instances where the grantor trust rules apply, the Code ignores the separate existence of a trust.³ Items of income, deductions, *

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2 Sections 29.22(a)-21 and 29.22(a)-22 were added to Section 29.22(a) of Treasury Regulation 111 by T.D. 5488, 1946-1 C.B. 19, promulgated December 29, 1945. When these regulations were issued, some commentators viewed them with disdain, see, e.g., Edmund W. Pavenstedt, The Treasury Legislates: The Distortion of the Clifford Rule, 2 Tax L. Rev. 7 (1946), while others held them in high esteem, see, e.g., Louis Eisenstein, The Clifford Regulations and the Heavenly City of Legislative Intention, 2 Tax L. Rev. 327 (1947).
3 The Internal Revenue Service (Service) and most courts equate a grantor and a grantor trust as being one and the same taxpayer. See, e.g., Rev. Rul. 66-159, 1966-1 C.B. 162 (holding that a grantor trust is the alter ego of the taxpayer and, that being the case, the trustee of a grantor trust that owned and sold the grantor's principal residence was entitled to use the tax-free roll-over provisions of former Code § 1034). There are instances, however, where courts have not equated a grantor and a grantor trust as the same taxpayer. See, e.g., Rothstein v. United States, 735 F.2d 704, 709 (2d Cir. 1984) (holding, for purposes of analyzing a sales transaction, that a grantor trust was to be a separate entity). For detailed discussions regarding the issue of whether and when a grantor trust should be ignored or respected as a separate entity, see generally Mark L. Ascher, When to Ignore Grantor Trusts: The Precedents, a Proposal, and a Prediction, 41 Tax L. Rev. 253 (1986), and Thomas W. Henning, Note, Treatment of the Grantor Trust as a Separate Entity, 32 Tax L. Rev. 409 (1977).

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and credits against tax are instead attributed to the grantor.\textsuperscript{4} Grantors are thus unable to deflect income away from themselves to others (such as a trust or a trust beneficiary) whose income is taxed at a lower marginal rate.\textsuperscript{5} The purpose of the grantor trust rules then, and their purpose now, is to safeguard the progressive rate structure of the income tax.\textsuperscript{6}

Among the many well-known tax maxims is one that states a "good tax is an old tax."\textsuperscript{7} In practice, however, maxims may not always prove true, and the grantor trust rules represent such a case. In the intervening decades since the introduction of the grantor trust rules, the Code has undergone significant changes. Insofar as grantor trust status is concerned, the most significant changes are those related to the progressive rate structure of the income tax and its application. More specifically, the steeply progressive tax bracket rate structure of the past has been eliminated.\textsuperscript{8} In addition, trust income is essentially taxed at a flat tax rate equal to the highest individual tax rate;\textsuperscript{9} married couples can file joint tax returns and thus have no incentive to

\textsuperscript{4} I.R.C. § 671 (1994).

\textsuperscript{5} To illustrate, consider the situation of a taxpayer whose income is subject to the highest tax bracket and who establishes a revocable trust. Suppose this trust generates $100 of interest income. In the absence of the grantor trust rules, this income would be taxable to the trust and bear no tax due to the personal exemption afforded trusts under id. § 642(b). As a grantor trust, however, the trust entity is ignored and the $100 of interest income is instead reported on the grantor's income tax return and is taxed at the grantor's income tax rate. \textit{id}. §§ 671, 676(a).

\textsuperscript{6} Committee reports that accompanied passage of the grantor trust rules indicate that Congress wanted to institute "rules to determine when a trust's income is to be taxed to the grantor because of the grantor's substantial dominion and control over the trust property or income." H.R. Rep. No. 83-1337, at 4089 (1954), \textit{reprinted in} 1954 U.S.C.C.A.N. 4017, at 4089.


\textsuperscript{8} The Internal Revenue Code of 1954, for example, had twenty-four different rate brackets for individual taxpayers, with an initial tax rate bracket of 20% that climbed gradually to 91%. Act of Aug. 16, 1954, ch. 73651, 68A Stat. 1 (redesignated as Internal Revenue Code of 1986, Pub. L. No. 99-514, § 2, 100 Stat. 2095). In contrast, the Code today has only five rate brackets for individual taxpayers, with an initial tax rate bracket of 15% that climbs gradually to 39.6%. I.R.C. § 1 (West Supp. 2000).

\textsuperscript{9} I.R.C. § 1(e) (1994).
divide their income; and beyond a certain minimum threshold, the unearned income of children under the age of fourteen is taxed at their parents' highest marginal tax rate. Independent of the grantor trust rules, these changes significantly diminish taxpayers' incentive and ability to shift income to those whose incomes are subject to lower tax rates.

The rules regarding grantor trust status have become rules in search of a purpose and, one might think, relegated to a relic of a bygone era. But where classification as a grantor trust was once to be avoided at all costs (hence their common classification by practitioners and commentators alike as "defective trusts"), taxpayers may now deliberately establish grantor trusts as a way to minimize their income and transfer tax burdens. In short, taxpayers use as a shield what was once a sword of the Internal Revenue Service (Service). This thwarts congressional intent and leads to significant revenue losses.

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10 See id. § 6013(a); Boris I. Bittker & Martin J. McMahon, Jr., Federal Income Taxation of Individuals ¶ 44.2(2), at 44-14 (2d ed. 1995) ("[M]arried couples have no incentive to engage in income-splitting devices to shift income from one spouse to the other; the joint return itself is an efficient income-splitting device, which produces the same tax result as an actual equal division of their taxable income between the two spouses."). For an historical look at the legislation that introduced joint returns, see Stanley Surrey, Federal Taxation of the Family—The Revenue Act of 1948, 61 Harv. L. Rev. 1097, 1103–16 (1948). See also Boris I. Bittker, Federal Income Taxation and the Family, 27 Stan. L. Rev. 1389, 1412–14 (1975) (discussing Congress's passage of optional joint return legislation).

11 See I.R.C. § 1(g) (West Supp. 2000).

12 E.g., George Brode, Jr., Tax Shelter Problem Areas—Potential Depreciation Recapture on Death of a Partner, Phantom Gain, and the Defective Trust Gambit, 54 Taxes 306 (1976); Burton W. Kanter, Supplementary Comment on the "Defective Trust Gambit," 54 Taxes 656 (1976).


14 The Code exacerbates this problem by defining grantor trust status in a way that permits taxpayers to choose virtually at will (and often with very little consequence) whether grantor trust status will apply. For a discussion of how taxpayers can manipulate trust terms to elect in and out of grantor trust status, see infra Part III.B.
Some fifty years ago, the progressive rate structure of the income tax system required that grantor trust status be defined broadly. To-day, however, in light of how the Code has evolved, just the opposite is true. The time has come, therefore, for Congress to narrow the scope and applicability of grantor trust status to the few remaining situations where its classification is still appropriate.

This Article is divided into several Parts. Part I outlines the factors that led to the introduction of grantor trust rules and suggests that these rules were generally well-crafted and effective in accomplishing the venerable goal of protecting the progressive rate structure of the income tax. Part II summarizes the grantor trust rules and their implications and examines why many taxpayers, over a half-century since the introduction of these rules, now utilize them to their advantage. Part III discusses the common methods that grantors employ to transform non-grantor trusts into grantor trusts. Part IV sets forth a proposal to change the grantor trust rules in order to halt the abusive use of grantor trust status. The final Part concludes that reforming the grantor trust rules would put these rules in better alignment with the rest of the Code and catapult them out of their anachronistic state.

I. BACKGROUND

Trusts have long been recognized as separate taxpayers under the Code, with their own tax bracket structure. Under state law, a trust may be established orally or with a few strokes of a pen or clicks of a word processor. In an age of computers, laser printers, and copy machines, trust formation has never been easier. Not all trusts, however, warrant recognition as separate taxpayers. The grantor trust

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15 See supra note 8.
16 See id.
18 See 1 AUSTIN WAKEMAN SCOTT & WILLIAM FRANKLIN FRATCHER, THE LAW OF TRUSTS § 52 (4th ed. 1987 & Supp. 2000 (Mark L. Ascher, auth.)) (stating that state law generally permits trusts which do not convey real property to be created orally). But see N.Y. EST. POWERS & TRUSTS LAW § 7-17(a) (McKinney Supp. 2000) (requiring that a trust be in writing and executed and acknowledged by the initial grantor).
19 See, e.g., I.R.C. § 643(f) (1994) (treating multiple trusts as one trust if "such trusts have substantially the same grantor or grantors and substantially the same primary beneficiary or beneficiaries" and noting that a principal purpose behind the establishment of such trusts is the avoidance of tax); Boyce v. United States, 190 F. Supp. 950, 950 (W.D. La. 1961) (involving a taxpayer who established ninety trusts for the same beneficiary to exploit the use of a $100 per trust credit available under prior law), aff'd per curiam, 296 F.2d 731 (5th Cir. 1961).
rules were a response to tax avoidance; their purpose was to stem the onslaught of innovative taxpayers who sought to minimize their tax burdens through trust establishment.20

The grantor trust rules attempt to determine when a trust should be respected for tax purposes and when it should be ignored. More specifically, the grantor trust rules recognize the separate existence of a trust when a grantor has parted with dominion and control over the contributed trust property, but ignore the separate existence of a trust when the grantor has retained dominion and control over trust assets. Left unchecked, respect under the Code for all trusts would prove a boon to grantors and a bust to the government.21

The following Subsections examine (A) the circumstances that led taxpayers to establish trusts where they retained dominion and control over trust property, (B) the judiciary's and Treasury Department's reactions to such trust establishment, and (C) the Congressional introduction of the grantor trust rules and the initial effectiveness of these rules.

A. Circumstances that Led to the Expansion of Trust Formation

In general, a family unit can save taxes by shifting income from one family member whose income is subject to a high marginal tax rate to another family member whose income is subject to a lower


21 To illustrate, suppose there was a 10% tax rate on all income up to $50,000 and a 50% tax rate on income in excess of $50,000. Suppose further that a taxpayer annually earns $50,000 interest on each of two identical corporate bonds she owns. Under this set of assumptions, the taxpayer normally bears an annual tax of $30,000 ((.10 x $50,000) + (.50 x $50,000)) on the interest income she receives.

Instead, suppose the taxpayer establishes a trust. Suppose further that the taxpayer designates her spouse as trustee and she transfers title to one of the two corporate bonds she owns to the trustee. The terms of the trust state that the trust is being established for the benefit of the taxpayer's daughter. Notwithstanding this declaration, the terms of the trust also provide the trustee with the right to apply the trust income and principal for the use or benefit of the taxpayer. From the taxpayer's perspective, the establishment and funding of this trust is a non-event. The taxpayer's spouse is likely to acquiesce to the taxpayer's demands, and the assets of the trust may be expended for the taxpayer's benefit. Despite the absence of any sacrifice on the taxpayer's part, were the Code to respect this arrangement, the taxpayer and her family would be economically much better off. More specifically, the taxpayer and the trustee of the trust would each bear a tax of $5000 (.10 x $50,000) or a total tax of $10,000 on the interest income they each earned. The $20,000 difference of overall tax burden between not establishing a trust ($30,000) and establishing a trust ($10,000) would all come at the government's expense.
marginal tax rate. For example, if a taxpayer whose income is subject to a 70% marginal tax rate owns a share of corporate stock that pays an annual dividend of $100, the taxpayer may gift that stock to his adult daughter whose income is subject to a 20% marginal tax rate. By gifting the corporate stock, the taxpayer's family unit will achieve an overall tax reduction of $50. This is the difference between the amount of tax on the dividend if no gift had been made (.7 x $100 = $70) and the tax that will now be paid on the dividend (.2 x $100 = $20). Both the courts and the Code respect the validity of this transfer and sanction this outcome.\(^2\)

Despite the tax benefits associated with outright gifts of income-producing property, taxpayers are often reluctant to make such transfers due to loss of economic security and control. Taxpayers would much prefer an arrangement that minimizes their (and their families') tax burdens yet poses no meaningful sacrifices on their part. Prior to the advent of grantor trust rules, the use of trusts seemed to supply the perfect solution to these dual, yet conflicting, goals.\(^3\) Trusts were subject to their own progressive tax rates, and careful trust drafting could position taxpayers with dominion and control over trust property. These features proved to be a powerful, attractive force for many taxpayers.\(^4\)

The assignment of income doctrine was probably another reason for the popularity of trust establishment. This doctrine dates back to 1930 when Justice Holmes declared in *Lucas v. Earl*\(^5\) that "the fruits" of a taxpayer's labor could not be "attributed to a different tree from that on which they grew" insofar as service income was concerned.\(^6\) Some years after the assignment of income doctrine became part of tax common law,\(^7\) its application was extended to situations in which

\(^2\) See I.R.C. § 102(b) (1994); Williams v. Comm'tr, 36 T.C. 195, 201 (1961) (holding that income earned on gifted property is taxable to the recipient).


\(^4\) *Id.*

\(^5\) 281 U.S. 111 (1930).

\(^6\) *Id.* at 115.

\(^7\) Some commentators contend that the assignment of income doctrine originated as a means to preserve the progressive rate structure of the income tax. See BITTNER & McMANNON, supra note 10, ¶ 34.1, at 34-3 ("[T]he courts recognized at the outset that transfers within the family, if honored by federal tax law, could seriously undermine the progressive rate schedule."); Ralph S. Rice, *Judicial Trends in Gratuitous Assignments to Avoid Federal Income Taxes*, 64 YALE L.J. 991, 991 (1955) (recognizing that "[t]axpayers in the higher income brackets often seek to redirect their income to objects of their bounty in order to minimize the progressive features of the tax"); Lloyd George Soll, *Intra-Family Assignments: Attribution and Realization of Income*, 6 TAX
taxpayers made gifts of income but did not transfer the underlying income-producing property (for example, a gift of bond interest coupons, but not the bond itself). The Court stated that "[t]he power to dispose of income is the equivalent of ownership of it" and that such income should remain taxable to the owner of such property. The extension of the assignment of income doctrine to the gifting arena hampered taxpayers' efforts to minimize their taxes. Thus, taxpayers searched for alternatives. Trust establishment appeared to be one such alternative, drawing the attention of many taxpayers.

B. Intervention by the Judiciary

Taxpayers often crafted trust instruments offering themselves the promise of dominion and control over trust property without its attendant tax burdens. The Supreme Court, however, made sure that this promise could not easily be kept. This Section analyzes three Supreme Court decisions that established firm precedents against abusive trust use.

L. Rev. 435, 435 (1951) ("The problem of the gratuitous intra-family assignment is a creature of the progressive surtax."). At least one commentator believes that the assignment of income doctrine originated as a matter of "convenience and fairness." Alan Gunn, Tax Avoidance, 76 Mich. L. Rev. 733, 762 (1978).

29 Id. at 118.
30 Id.
31 Another probable allure of trust formation at that time was the then rate differential between the gift and estate taxes. The transfer tax rate levied on gifts used to be significantly lower than that levied on one's estate. See James Casner, American Law Institute Federal Estate and Gift Project, 22 Tax L. Rev. 515, 516 (1967); Theodore S. Sims, Timing Under a Unified Wealth Transfer Tax, 51 U. Chi. L. Rev. 34, 34-35 n.3 (1984). To capture this rate differential, it was advantageous for taxpayers to make inter vivos transfers rather than testamentary bequests. Thus, beyond the potential income tax savings offered by trusts, their establishment offered another mechanism for taxpayers and their families to minimize their overall tax burden.

32 The importance of protecting the Code's progressive rate structure is captured by Justice Cardozo's description of the damage unchecked trust establishment might render: "By the creation of trusts, incomes have been so divided and subdivided as to withdraw from the Government the benefit of the graduated taxes and surtaxes applicable to income when concentrated in a single ownership." Burnet v. Wells, 289 U.S. 670, 675 (1933). Consider, too, Justice Douglas's comment that "[w]e granted certiorari in [Clifford] because of the importance to the revenue of the use of such short term trusts in the reduction of surtaxes." Helvering v. Clifford, 309 U.S. 331, 334 (1940).

33 While this trilogy of Supreme Court decisions likely played a decisive role in limiting abusive trust arrangements, it did not entirely eliminate them. Something more was clearly needed, and that something more was supplied by the Treasury De-
In *Corliss v. Bowers,* the Court held that the benchmark of taxability is not necessarily title ownership to property, but rather its control. The facts in *Bowers* are straightforward: the taxpayer established a trust providing income for his wife for life with the remainder to their children. In addition, the taxpayer reserved a discretionary right to revoke or amend the trust in whole or in part. The issue before the Court was the constitutionality of section 219(g) of the Revenue Act of 1924, which stated that the grantor, rather than the trust, was the appropriate taxpayer when the grantor established a revocable trust.

In a pithy analysis that has an acerbic ring, Justice Holmes frowned upon the taxpayer’s position that section 219(g) was unconstitutional and that the trust was the appropriate taxpayer. Holmes compared the taxpayer’s situation to that of a man who had directed his bank to pay over income to a servant or friend until further instructions were given. Holmes pointed out that the only difference between this hypothetical case and the case before the Court was that the taxpayer in *Bowers* had relinquished property title. But taxation, Holmes declared, “is not so concerned with the refinements of title as it is with actual command over the property taxed—the actual benefit for which the tax is paid.” Because the taxpayer held command over the property (although not its title), Holmes saw no fault in a statute that deemed the taxpayer taxable on income earned by the trust.

In *Burnet v. Wells,* Justice Cardozo echoed Justice Holmes’s sentiments regarding a taxing authority’s prerogative to ignore the vagaries of title and to adroitly focus upon the “right or privilege that is a

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34 281 U.S. 376 (1930).
35 Id. at 378.
36 Id. at 377.
37 Id.
39 “Where the grantor of a trust has, at any time during the taxable year, . . . the power to revest in himself title to any part of the corpus of the trust, then the income of such part of the trust for such taxable year shall be included in computing the net income of the grantor.” Id. § 219(g), 43 Stat. at 277.
40 See *Bowers,* 281 U.S. at 378.
41 Id.
42 Id.
43 Id.
44 See id.
45 289 U.S. 670 (1933).
constituent of ownership."\textsuperscript{46} The taxpayer in \textit{Wells} had established several irrevocable trusts funded with insurance policies on the life of the taxpayer.\textsuperscript{47} The trustee of these trusts was supposed to use the income generated by the trusts to maintain these insurance policies.\textsuperscript{48} Relying upon section 219(h) of the Revenue Act of 1924,\textsuperscript{49} the government argued that the taxpayer should be taxed on the income each trust generated that was used to meet insurance premium payments.\textsuperscript{50} The taxpayer, however, challenged the constitutionality of this statute and steadfastly maintained that the trusts should bear the tax burden on the income earned.\textsuperscript{51}

In his analysis, Justice Cardozo first emphasized the important role life insurance played in the lives of most people.\textsuperscript{52} Many people, he argued, conceived of maintaining "life insurance as a pressing social duty. Even if not a duty, it is a common item in the family budget, kept up very often at the cost of painful sacrifice, and abandoned only under dire compulsion."\textsuperscript{53} Whether or not a trust owned the insurance policies, the taxpayer was duty bound to maintain them—just as he was duty bound to maintain the economic well-being of his own family.\textsuperscript{54} It should have come as no surprise to the taxpayer, Justice Cardozo insisted, that income used to satisfy an inherent personal obligation of the taxpayer should remain taxable to him.\textsuperscript{55}

Prior to the promulgation of Treasury regulations and the emergence of the grantor trust rules, the final Supreme Court word on trust establishment as a source of tax refuge came from Justice Douglas. In \textit{Helvering} v. \textit{Clifford},\textsuperscript{56} the Court was asked to decide whether the grantor or a trust he had established should report the income that the trust had earned.\textsuperscript{57} In \textit{Clifford}, the taxpayer had established a five-year trust for the benefit of his wife; the income was to be distrib-

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\textsuperscript{46} \textit{Id.} at 678.
\textsuperscript{47} \textit{Id.} at 673.
\textsuperscript{48} \textit{Id.}
\textsuperscript{49} "Where any part of the income of a trust is or may be applied to the payment of premiums upon policies of insurance on the life of the grantor . . . , such part of the income of the trust shall be included in computing the net income of the grantor." Revenue Act of 1924, Pub. L. No. 68-176, ch. 234, § 219(h), 43 Stat. 253, 277, \textit{repealed by} Revenue Act of 1926, ch. 27, 44 Stat. 9, 125–26.
\textsuperscript{50} 289 U.S. at 674.
\textsuperscript{51} \textit{Id.}
\textsuperscript{52} \textit{See} \textit{id.} at 681.
\textsuperscript{53} \textit{Id.}
\textsuperscript{54} \textit{See} \textit{id.}
\textsuperscript{55} \textit{Id.} at 681–82.
\textsuperscript{56} 309 U.S. 331 (1940).
\textsuperscript{57} \textit{Id.} at 334.
\end{flushleft}
uted or accumulated for her benefit with a reversion of the trust corpus to the taxpayer.\(^58\) The taxpayer designated himself trustee and, as trustee, vested himself with an extraordinarily broad range of fiduciary powers.\(^59\)

In both \textit{Bowers} and \textit{Wells}, the Commissioner of Internal Revenue had direct statutory authority (section 219(g) and (h) of the Revenue Act of 1924) to tax the taxpayer on the income the trust earned rather than the trust he had established.\(^60\) In \textit{Clifford}, the Commissioner had no such authority.\(^61\) Justice Douglas (and four other justices) instead relied on the broad scope of § 22(a) of the Code (the predecessor to Code § 61)\(^62\) to declare that the trust’s income was taxable to the taxpayer.\(^63\) Subject to judicial refinement,\(^64\) this section of the Code essentially proclaimed that all accretions to wealth were taxable.\(^65\) The terms of the trust, said Justice Douglas, did little to dilute the taxpayer’s dominion and control over the trust property:

Since the income remains in the family and since the husband retains control over the investment, he has rather complete assurance that the trust will not effect any substantial change in his economic position. It is hard to imagine that respondent felt himself the poorer after this trust had been executed or, if he did, that it had any rational foundation in fact. For as a result of the terms of the

\(^{58}\) \textit{Id.} at 332.

\(^{59}\) These powers included the power to manage trust property, including the right (a) to vote trusted shares and to sell, exchange, mortgage, or pledge trust securities constituting corpus or accumulated income on any terms or for any consideration; (b) to invest cash constituting corpus or accumulated income by making unsecured loans, by deposits in banks, or by buying securities regardless of their speculative character, rate of return, or legality for trust funds, and to compromise any claims held as trustee; and (c) to hold trust property in any name, including his own, as an individual. \textit{Id.} at 332-33.


\(^{61}\) \textit{See} 309 U.S. at 338.


\(^{63}\) \textit{See} 309 U.S. at 338.

\(^{64}\) \textit{See, e.g.}, \textit{Helvering v. Indep. Life Ins. Co.}, 292 U.S. 371, 381 (1934) (holding that imputed income was not taxable).


\textit{[G]ross income includes [all] gains, profits, and income derived . . . from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever.}

\textit{Id.}
trust and the intimacy of the familial relationship respondent retained the substance of full enjoyment of all the rights which previously he had in the property. 66

The Court was once again unwilling to follow the paper trail of property title. Instead, Justice Douglas, like Justices Holmes and Cardozo before him, emphasized the importance of practical control over the transferred trust property rather than "[t]echnical considerations, niceties of the law of trusts or conveyances, or the legal paraphernalia which inventive genius may construct . . . ." 67 These other things, Justice Douglas declared, only obscure the real issue at hand, namely, whether a taxpayer may still be held liable under the broad taxing authority of § 22(a) for income earned by a trust. 68 In his opinion, the specifics of the trust's establishment (the length of the trust's term, the identities of the trustee and the trust beneficiaries, and the matter of control) amounted to the taxpayer holding dominion and control over the trust property. 69 He felt, therefore, that the taxpayer should have to bear the trust's attendant tax burdens. 70

Clifford was not the last word on the matter of trust taxation. It was followed by a swelter of commentary—some favorable 71 and some not 72—and numerous inquiries as to its scope. 73 In addition, the very vagueness of the decision opened the floodgates of litigation as both the government and taxpayers explored Clifford's application. 74

66 309 U.S. at 335–36.
67 Id. at 334.
68 Id.
69 Id. at 335.
70 Id. at 336.
71 E.g., Edmund W. Pavenstedt, The Broadened Scope of Section 22(a): The Evolution of the Clifford Doctrine, 51 Yale L. J. 213 (1941); see also Roswell Magill, The Supreme Court on Federal Taxation, 1939–40, 8 U. Chi. L. Rev. 1, 5 (1940) (describing the Clifford decision as a "desirable" "extension of the income tax statute by the Court").
74 From the time of the Clifford decision (1940) to the time of the Treasury Department regulations (1945), one of the most litigated issues in the Code was whether the independent existence of a trust should be respected for tax purposes. See Roswell Magill, What Shall Be Done with the Clifford Case?, 45 Colum. L. Rev. 111, 111 (1944) ("Since 1940, there has been a flood of litigation, . . . and the end is not at all in sight."). Learned Hand's comment in Kohnstamm v. Pedrich, 153 F.2d 506, 510 (2d Cir. 1945), penetrates the nature of the problem:

The test [under Clifford] is impalpable enough at best; but if it is to be continually refined by successive distinctions, each trifling in itself, shall end
C. Response of the Treasury Department

The flood of Clifford trust litigation, coupled with the taxpayers' cries of frustration, stirred the Treasury Department. It promulgated a set of regulations that are the basis for the present-day grantor trust rules.

The Clifford trust regulations were precise and pragmatic. If a particular identifying factor (described below) was present, the trust was deemed a grantor trust and the taxpayer, not the trust, was taxed on the trust income. Conversely, if no identifying factor was present, the trust was deemed a non-grantor trust and thus recognized as a separate entity for tax purposes.

The newly-issued Clifford trust regulations classified a trust as a grantor trust if any of the following identifying factors were present: (1) the corpus or income would or might return to the grantor "after a relatively short term of years"; (2) "beneficial enjoyment" of the corpus or income was "subject to a power of disposition" in the grantor or another person lacking a substantial adverse interest in the disposition; or (3) the corpus or income was "subject to administrative control, exercisable primarily" for the grantor's "benefit." 75 In its preambles, the Clifford trust regulations declared that the presence of an identifying factor would "demonstrate the retention by the grantor of

in a morass from which there will be no escape; and the spate of decisions already poured upon us will be the earnest of eventual utter confusion.

75 Treas. Reg. 111, § 29.22(a)-21(b) (as amended in 1947). For a detailed analysis of what these regulations said and how they applied, see Maurice Alexandre, A Case Method Restatement of the New Clifford Regulations, 3 Tax L. Rev. 189 (1947).

The obvious source of these categories of circumstances derive from the Clifford decision and its progeny. For examples where courts found the length of the term decisive, see Commissioner v. Berolzheimer, 116 F.2d 628, 630 (2d Cir. 1940) (extending the Clifford "rule" to a ten-year trust), and Fahnestock v. Commissioner, 43 B.T.A. 569, 571 (1941) (holding that the income from a ten-year trust is taxable to the grantor). For examples where courts held the grantor's retained beneficial enjoyment decisive, see Brown v. Commissioner, 131 F.2d 640, 641 (3d Cir. 1942) ("We think that a settlor who is a person of means and who can control the spending of a fund, which she has set up, in every respect except spending it for herself is sufficiently the 'owner' of the fund to make its income taxable to her under § 22(a)."'), and Morgan v. Commissioner, 2 T.C. 510, 515 (1943) ("To a person of ample means the right to say who shall receive property and income may be a more important attribute of ownership than the right to use them for his own well-being."). Finally, for examples where courts held the grantor's administrative control decisive, see Hall v. Commissioner, 150 F.2d 304, 308 (10th Cir. 1945) ("It may be conceded that the power to invest trust funds for the trustee's personal advantage and benefit is equivalent to the taxable enjoyment of the trust income . . . ."), and Marshall v. Commissioner, 1 T.C. 442, 448-49 (1943) (holding that where the donor retained certain administrative powers, the Clifford doctrine applies).
such complete control of the trust that he is taxable on the income therefrom under § 22(a).”76 Aside from delineating the identifying factors, the Clifford trust regulations offered several examples of how this classification process operated.77

The Clifford trust regulations did not look at the whole picture surrounding a trust's establishment or its administration. Instead, the presence of a single identifying factor was deemed sufficient for the Code to ignore a trust's separate identity for tax purposes. While this Procrustean approach did not always produce the right result, it did have the tremendously appealing virtue of offering taxpayers certainty where little or none had existed under Clifford and its progeny.

D. Congressional Endorsement of the Clifford Trust Regulations and Issuance of the Grantor Trust Rules

In general, the Clifford trust regulations were well-received by taxpayers, their advisers, and the courts.78 They seemed to have struck the right balance between protecting legitimate trust arrangements and inhibiting tax subterfuge. But in the minds of many commentators, these regulations did not eradicate the myriad of tax controversies that stemmed from trust establishment.79

In order to “eliminate . . . issues of administrative authority and statutory interpretation,” Congress needed to codify the Clifford trust regulations.80 In addition, the grantor trust rules had two homes: (1) under the heading “Supplement E—Estates and Trusts,” two Code sections declared a grantor taxable on trust income under certain cir-

76 Treas. Reg. 111, § 29.22(a)-21 (as amended in 1947).
77 Id.
78 See H. Brian Holland et al., A Proposed Revision of the Federal Income Tax Treatment of Trusts and Estates—American Law Institute Draft, 53 COLUM. L. REV. 316, 360 (1953) (“These Regulations were the result of an extensive exploration of the possible solutions, and involved considerable discussion with legal and trust company representatives. The consensus which experience under the Regulations in the intervening years has produced is that the task of classification was well executed.”).

But, as previously stated, not all commentators viewed the Clifford trust regulations so favorably. See Pavenstedt, supra note 2 (arguing that in promulgating the Clifford regulations, the Treasury Department overstepped its regulatory powers). Indeed, soon after the regulations were issued, even the Tax Court found fault with the Treasury Department's efforts to clarify the scope of the Clifford decision. Estate of Stockstrom v. Comm'r, 7 T.C. 251, 254 (1946) (“However, the mere change in respondent's administrative construction of the revenue acts of Congress will not result, as petitioner seems to assume, in the overruling of a line of decisions of this Court which, to the present time, have the approval of the higher courts.”).
79 E.g., Holland et al., supra note 78, at 361.
80 Id.
cumstances, and (2) the Clifford trust regulations under § 22(a) similarly declared a grantor taxable on trust income under certain other circumstances. The statutory and regulatory laws were so similar in nature that sound logic dictated that Congress should integrate them.

In 1954, Congress conducted a massive overhaul of the 1939 Code. Congress used this opportunity to consolidate the rules relating to trust taxation and, in so doing, gave the Clifford trust regulations its imprimatur by using them as the substantive basis for what are now commonly known as the grantor trust rules.

In transforming the Clifford trust regulations into statutory law, Congress greatly improved trust taxation certainty. First, Congress made the grantor trust rules the exclusive mechanism to evaluate the independent existence of a trust; no longer would the Service be able to use the broad scope of other tax statutes to challenge whether a trust was the responsible taxpayer. Second, Congress integrated the grantor trust rules under Subpart E of Subchapter J of the Code; no longer would these rules have to be gleaned from different places in the Code or Treasury regulations. Finally, Congress offered elaborate detail regarding the tax consequences that would result from grantor trust classification; no longer would the focus of grantor trust classification be strictly upon trust income—their breadth would extend to deductions and credits against tax as well.

These new grantor trust rules required little conceptual explanation. The separate existence of a trust was to be ignored when "the grantor or another person has retained substantial dominion or control" over trust property. The concept and need for grantor trust status was easily understood, but the challenge was how to define dominion and control in the context of a trust arrangement. The next Part of this Article explores the congressional response to this challenge.

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81 See I.R.C. §§ 166 (taxing income generated by a revocable trust to the grantor), 167 (taxing income generated by a trust for the grantor's benefit to the grantor) (1939) (current version at I.R.C. §§ 676–677 (1994)).
82 See supra notes 75–77 and accompanying text.
85 See id. § 671 (1994) (last sentence).
87 See id. § 671 (1994) (first sentence).
II. THE GRANTOR TRUST RULES AND THEIR PAST AND PRESENT EFFECTIVENESS

This Part first summarizes the grantor trust rules and how and when they apply, and submits that they were generally effective in yielding their intended goal, namely safeguarding the progressive rate structure of the income tax.\(^8\) Next, this Part shows why many taxpayers now favor grantor trust status, and why, from a tax policy perspective, this is an unsettling phenomenon.

A. The Grantor Trust Rules and Their Past Effectiveness

The Code sets forth the grantor trust rules in the following manner: (1) Code § 671 describes the tax repercussions that stem from grantor trust status,\(^9\) (2) Code § 672 defines certain terms of art that are integral to the grantor trust rules,\(^10\) and (3) Code §§ 673–679 identify those trust characteristics that cause a taxpayer to hold dominion and control of all or a portion of a trust.\(^11\)

1. Code § 671: Tax Repercussions Associated with Grantor Trust Status

Code § 671 makes a trust instrument function like a spaghetti colander. All income, deductions, and credits against tax of a trust are poured in. If a taxpayer is treated as having dominion and control over all or a portion of a trust, then items of income, deductions, and credits against tax attributable to such ownership remain in the spaghetti colander and the taxpayer must take them into account in computing the taxpayer's taxes.\(^12\) The balance of income, deductions, and credits against tax drain through the spaghetti colander and are taxed to the trust or trust beneficiaries in accordance with the non-

\(^8\) This Article discusses the salient features of the grantor trust rules, highlighting their encompassing nature. For a detailed exposition of specific grantor trust rules, see M. CARR FERGUSON ET AL., FEDERAL INCOME TAXATION OF ESTATES, TRUSTS, & BENEFICIARIES 10-1 to 10-122 (3d ed. 1998).


\(^11\) See id. §§ 673–679. Sometimes a person other than the grantor is treated as owner of all or a portion of a trust. See id. § 678(a) (1994). These beneficiary-controlled trusts are often known as Mallinckrodt trusts, named after the first case in which someone other than the trust's grantor was treated as having dominion and control over the assets of the trust, Mallinckrodt v. Numan, 146 F.2d 1 (8th Cir. 1945). For further details regarding beneficiary-controlled trusts, see infra notes 125–27 and accompanying text.

\(^12\) See I.R.C. § 671 (1994). For a discussion of the less obvious tax ramifications that stem from grantor trust status, see generally Ascher, supra note 3.
grantor trust taxation rules established under Subchapter J, exclusive of Subpart E. 94

Despite the emphasis the grantor trust rules place on the term "portion," nowhere is this term defined in Subpart E. Treasury regulations, however, offer guidance—albeit incomplete—as to its meaning. 95 In certain instances, the taxpayer is deemed to own a "vertical portion" of the trust (for example, the income or corpus portions of the trust). 96 In other instances, the taxpayer is deemed to own a "horizontal portion" of the trust (for example, a fraction or pecuniary portion of the trust, or sometimes even a specific trust asset). 97

There are various tax reporting requirements that apply once the presence of grantor trust status has been determined and all or a portion of trust ownership is attributed to the grantor. In general, these reporting requirements instruct that the "spaghetti" be removed from the colander and, if this metaphor can be carried one step further, that it be "served" on the grantor's tax return. 98

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94 See I.R.C. § 671. For an exhaustive discussion of how trusts that are not subject to Subpart E are taxed, see John L. Peschel & Edward D. Spurgeon, Federal Taxation of Trusts, Grantors and Beneficiaries 3-1 to 3-68 (3d ed. 1997). For a nice summary of how these rules operate, see Jeffrey G. Sherman, All You Really Need to Know About Subchapter J You Learned from This Article, 63 Mo. L. Rev. 1, 12-14 (1998).

95 For the most thorough analysis of the meaning of the term "portion" and the tax implications associated with this concept, see Leo L. Schmolka, Selected Aspects of the Grantor Trust Rules, 9 Inst. on Est. Plan. ¶ 1400 (1975).

96 See Treas. Reg. § 1.671-3(b) (as amended in 1969). For example, suppose a taxpayer establishes an irrevocable trust. The terms of the trust instruct the trustee to pay the taxpayer income for life and to distribute the remainder to the taxpayer's son. Under the regulations, the taxpayer would be deemed to own only the income portion of the trust. See id. § 1.671-3(b)(1).

97 See id. § 1.671-3(a)(3). For example, suppose a taxpayer establishes an irrevocable trust. The terms of the trust instruct the trustee to pay current income to the taxpayer's children and, in the year 2010, to distribute the remainder in equal shares to the taxpayer's children. The taxpayer, however, reserves the discretionary right to reacquire one-quarter of the trust assets. Under the regulations, the taxpayer would be deemed to own one-quarter of the trust's income and corpus. Id. § 1.671-3(a)(2).


Note that in instances where the grantor is considered the owner of all the trust property (for example, where the trust is revocable), the trust is ignored entirely for income-tax reporting purposes. More specifically, the trustee may elect to furnish the name and taxpayer identification number of the grantor and the address of the trust to all payers during the taxable year. Treas. Reg. § 1.671-3(b) (1)–(2) (1996). Under this reporting election, the trust is completely transparent, leaving the trustee with no independent reporting obligations to the Service.
2. Code § 672: Defined Terms of Art

In formulating the grantor trust rules, Congress realized that taxpayers might attempt to camouflage their continued stake in the contributed trust property. For example, a taxpayer may have a family member serve as a trustee who has decision-making authority with respect to the trust property. Congress instituted Code § 672 in an attempt to determine the degree of allegiance a party will have to the grantor. In theory, the closer the degree of allegiance, the more likely a party will conform to the grantor's demands.

On one end of the allegiance spectrum there is what is known as an “adverse party.” An “adverse party” is “any person having a substantial beneficial interest in the trust which would be adversely affected by the exercise or nonexercise of the power which he possesses respecting the trust.” Essentially, an adverse party and the grantor have conflicting interests. To illustrate, suppose Father establishes a trust for the benefit of Daughter and suppose further that Father retains the right to revoke the trust, but only with Daughter's consent. Because Daughter has an economic stake in maintaining rather than permitting its revocation, the Code classifies Daughter as an adverse party. This remains true even though Daughter might be willing to accede to Father's demands.

The Code considers the grantor's spouse, on the other hand, to be a nonadverse party. Code § 672 makes the categorical assumption that a grantor and the grantor's spouse have interests that coincide. Therefore, when analyzing a grantor's beneficial interest in a trust, the Code assumes that the grantor has any power or interest held by the grantor's spouse.

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99 See, e.g., Barker v. Comm'r, 25 T.C. 1230, 1234 (1956) (holding that parents who served as trustees for a trust established for the benefit of their son and who held a remote contingency interest in the trust assets did not hold a substantial adverse interest).

100 See S. REP. No. 72-665, at 34-35 (1932) (stating that a so-called “adverse party” must be more than a mere beneficiary “having a very minor interest”).

101 I.R.C. § 672(a) (1994).

102 This fact pattern illustrates a case when a party holds an adverse interest as to the entire trust. There are cases when a party holds an adverse interest as to only a portion of a trust: Suppose Father had three other children and suppose further that Father could only revoke Daughter's one-quarter trust interest with her approval. Under these assumed facts, Daughter would be deemed to have a one-quarter adverse interest as to the whole trust. See Treas. Reg. § 1.672(a)-1(b) (1960).

103 See id. § 1.672(a)-1(a).

Parties who are not the grantor’s spouse and who have no economic stake in the trust are also considered nonadverse parties. More specifically, nonadverse parties who are not the grantor’s spouse are presumed to have interests that coincide with the grantor, if they are “related” (for example, a parent of the grantor) or “subordinate” to the grantor (for example, a bank that is wholly owned by the grantor). Depending upon the circumstances, these parties may be treated as acting for, or on behalf of, the grantor. If, however, the nonadverse parties are not related or subordinate to the grantor, such parties are deemed to have the trust beneficiaries’ interests, rather than the grantor’s interests, at heart, and the grantor trust rules thus treat these nonadverse parties as independent.

In sum, the terms “adverse,” “nonadverse,” and “independent” help identify those persons or entities that would be beholden to the grantor and prone to act as the grantor’s surrogate.


In formulating the grantor trust rules, Congress attempted to distinguish between those taxpayers who established trusts as a device to minimize their income taxes from those who established trusts as a means of providing legitimate asset management. But in making this distinction, Congress long ago recognized the obvious: “The conclusion is inescapable that irrevocable inter vivos trusts usually are created primarily to save taxes and in forms dictated by tax considerations. They are part of a nationwide adventure in tax avoidance.”

With the intent of curbing the use of trusts as a tax minimization device, Congress sought to make grantor trust status the norm for inter vivos trusts rather than the exception, thereby eliminating a tax-

105 See id. § 672(b) (1994).
106 There is a rebuttable presumption (that can only be overcome by a preponderance of evidence) that certain “related or subordinate parties” are subservient to the grantor. Id. § 672(c) (1994 & Supp. IV 1998). In addition to the grantor’s spouse, the term “related or subordinate parties” includes “[t]he grantor’s father, mother, issue, brother or sister; an employee of the grantor; a corporation or any employee of a corporation in which the stock holdings of the grantor and the trust are significant from the viewpoint of voting control; a subordinate employee of a corporation in which the grantor is an executive.” Id. § 672(c)(2).
107 Treas. Reg. § 1.674(c)-1 (1960).
payer's ability to shift income to another taxpayer whose income was subject to a lower marginal tax rate. A section-by-section analysis of the grantor trust rules reveals this strategic approach.

Code § 673 represents the codification (with some refinement) of the Clifford decision.110 It classifies as a grantor trust any trust (or portion thereof) in which a grantor directly or indirectly holds a reversionary interest.111 There are only two instances when this rule will not apply: (1) if the value of the reversionary interest does not exceed five percent of the value of the property interest which ultimately reverts to the grantor,112 and (2) if the interest reverts to the grantor upon the death, prior to age twenty-one, of a minor lineal descendent who is a beneficiary of such trust.113

Code § 674 classifies as a grantor trust any trust (or portion thereof) over which a grantor or nonadverse party can dictate beneficial enjoyment, unless the terms of the trust require the approval or consent of an adverse party.114 On its surface, this rule would make virtually every trust a grantor trust, because rarely would a grantor vest an adverse party with any powers. There are, however, three important exceptions to this grantor trust rule that curb its potentially expansive application.115

111 I.R.C. § 673(a). To illustrate, suppose a grantor establishes a trust. The terms of the trust provide income to the grantor's son for a period of five years, and Friendly National Bank is named as trustee. At the end of the five-year term, trust principal reverts to the grantor. The Code would classify this trust as a grantor trust, because the value of the reversionary interest exceeds five percent of the value of the property contributed to the trust. See id.
112 Id.
113 Id. § 673(b).
114 Id. § 674(a). To illustrate, suppose a grantor establishes a trust. The terms of the trust provide income to the grantor's three minor children until they all reach majority age, at which time trust principal will be divided equally among the grantor's children. Assume that the grantor also reserves the right to sprinkle income and principal between and among his children. Under these circumstances, the Code would classify this trust as a grantor trust, because the grantor retains the power to control beneficial enjoyment. See id. For a detailed exposition of this rule, see James B. Lewis, Powers Retained by the Settlor of a Trust: Their Income, Estate and Gift Tax Treatment, 5 REAL PROP. PROB. & TR. J. 1, 5–12 (1970); Edward W. Turley, Jr., Section 674: Mr. Clifford's Enigmatic Progeny, 9 Hous. L. Rev. 928, 929–30 (1972); Westfall, supra note 109, at 330–32.
115 The first exception provides that certain restrictive forms of beneficial control can be held by anyone, including the grantor, without the Code classifying such trust as a grantor trust. I.R.C. § 674(b) (1994 & Supp. IV 1998). These forms of beneficial control include the following: the power to apply income to support a dependent, id. § 674(b)(1) (1994), a postponed power affecting beneficial enjoyment, id.
Code § 675 deems the grantor to be the owner of all or the portion of a trust in which the grantor holds certain administrative powers\textsuperscript{116} including: (1) administrative powers held by the grantor or nonadverse party that potentially threaten a trust beneficiary's economic stake in the trust\textsuperscript{117} and (2) administrative powers held by any person in a nonfiduciary capacity that reflect the grantor's continuing dominion and control over trust property.\textsuperscript{118}

\textsection{674(b)(2)}, a power exercisable only by will (other than a power in the grantor to appoint by will the income of the trust where the income is accumulated by such disposition by the grantor or may be so accumulated in the discretion of the grantor or a nonadverse party, or both, without the approval or consent of any adverse party), \textit{id.} \textsection{674(b)(3)}, a power to allocate among charitable beneficiaries, \textit{id.} \textsection{674(b)(4)} (Supp. IV 1998), a power to distribute corpus (a) to or for one or more beneficiaries, provided that the power is limited by a reasonably definite standard which is set forth in the trust instrument, or (b) to or for any current income beneficiary, provided that the distribution of corpus must be chargeable against the proportionate share of corpus held in trust for the payment of income to the beneficiary as if the corpus constituted a separate trust enjoyment, \textit{id.} \textsection{674(b)(5)} (1994), a power to withhold income temporarily, \textit{id.} \textsection{674(b)(6)}, a power to withhold income during disability of a beneficiary, \textit{id.} \textsection{674(b)(7)}, and a power to allocate between corpus and income, \textit{id.} \textsection{674(b)(8)}.

The second exception provides that anyone other than the grantor or the grantor's spouse can hold the power to allocate income, if limited by an ascertainable standard. \textit{id.} \textsection{674(d)}.

The third exception provides that so-called independent trustees can hold virtually any power over trust income or corpus, including the right, in their complete discretion, to sprinkle income and principal as they deem appropriate. \textit{id.} \textsection{674(c)}.

A single trustee is independent if the trustee is not a related or subordinate party who is subservient to the wishes of the grantor; multiple trustees are independent if no more than half of them are related or subservient to the wishes of the grantor. \textit{id.} \textsection{675}. To illustrate, suppose a grantor establishes a trust for the benefit of his daughter, but reserves the right to borrow trust funds free of interest. The Code would classify this trust as a grantor trust, because the grantor had retained administrative control of the trust assets. \textit{id.} \textsection{675(2)}.

\textsection{675(1)}, (ii) a power to borrow without adequate interest or security, \textit{id.} \textsection{675(2)}, and (iii) the actual borrowing of trust funds (except where an independent party serves as trustee), \textit{id.} \textsection{675(3)}.

Administrative powers that are exercisable in a nonfiduciary capacity include the following: (i) 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, \textit{id.} \textsection{675(4)(A)}, (ii) 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, \textit{id.} \textsection{675(4)(B)}, and (iii) a power to reacquire the trust corpus by substituting other property of equivalent value, \textit{id.} \textsection{675(4)(C)}.
Code § 676 accords grantor trust status over all or a portion of a trust where the grantor, a nonadverse party, or both can vest title to trust property back in the grantor.\textsuperscript{119} The origin of Code § 676 pre-dates the issuance of the Clifford trust regulations.\textsuperscript{120} Long ago, Congress determined that a grantor held dominion and control over trust property, if the grantor, directly or indirectly, held a trust revocation right.\textsuperscript{121}

Code § 677 categorizes the grantor as having dominion and control over any portion of a trust when the trust's income is or 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 life insurance premiums for the grantor or the grantor's spouse (except those policies irrevocably payable to charities).\textsuperscript{122} In addition, the grantor will also be treated as owner of the income used to pay the grantor's support obligations.\textsuperscript{123} Like Code § 676, the origins of Code § 677 predate the grantor trust rules. It, too, is based upon congressional recognition that trusts that function like personal bank accounts should be taxed as such.\textsuperscript{124}

Code § 678 is an extension of the grantor trust rules. It provides that a person other than a grantor will be treated as having dominion and control over any portion of a trust, if he alone can vest the corpus or the income of any portion of a testamentary or inter vivos trust in himself.\textsuperscript{125} This rule does not apply if (a) the grantor is taxable on the income the trust generates\textsuperscript{126} or (b) the only right such person

\begin{itemize}
\item \textsuperscript{119} Id. § 676(a). To illustrate, suppose a grantor establishes a trust. The terms of the trust provide income and corpus distributions for the benefit of the grantor's daughter. In addition, the grantor reserves the right, in his discretion, to revoke the trust. The Code would classify this trust as a grantor trust, because the grantor holds a trust revocation power. \textit{See id.}
\item \textsuperscript{120} \textit{See supra} notes 38–39.
\item \textsuperscript{121} \textit{See id.}
\item \textsuperscript{122} I.R.C. § 677(a) (1994). To illustrate, suppose a grantor establishes a trust. The terms of the trust permit the trustee to make discretionary distributions of income and corpus to the grantor, during his lifetime, and, upon his death, the principal of the trust passes to the grantor's son. The Code would classify this trust as a grantor trust because the income and corpus of this trust could be expended to or for the grantor's benefit. \textit{See id.}
\item \textsuperscript{123} Id. § 677(b).
\item \textsuperscript{124} \textit{See supra} note 49.
\item \textsuperscript{125} I.R.C. § 678(a) (1994). To illustrate, suppose a grantor establishes a trust. The terms of the trust provide the grantor's daughter with the annual right to withdraw all the income and principal of the trust. The Code would classify this trust as a grantor trust, and the daughter would be taxed on the income of the trust. \textit{See id.}
\item \textsuperscript{126} Id. § 678(b).
\end{itemize}
has is to apply trust income to discharge a support obligation, but such person does not exercise this right.\textsuperscript{127}

Code § 679 is a late addition to the grantor trust rules.\textsuperscript{128} Instead of attempting to identify characteristics of dominion and control for grantor trust analysis purposes, it classifies as a grantor trust any portion of a foreign trust established by a United States person to the extent that there is a United States beneficiary of any portion of such trust.\textsuperscript{129}

As codified, the grantor trust rules were designed as a bulwark in the defense of the Code's progressive rate structure.\textsuperscript{130} And for the next thirty or so years after their introduction, the grantor trust rules served this role and served it well.\textsuperscript{131} Grantors who attempted to use trusts as a device to shift income would, if audited, have to overcome the grantor trust rules. In the vast majority of cases, the Service frustrated taxpayers' income-shifting attempts.\textsuperscript{132} Even in those rare instances when grantors tried to use grantor trust status to their own advantage, their efforts were rebuffed by the courts and the Service\textsuperscript{133}

\textsuperscript{127} \textit{Id.} § 678(c).


\textsuperscript{130} See Ascher, \textit{supra} note 3, at 281.

\textsuperscript{131} See Howard M. Zaritsky, \textit{The Hollow Crown? What's Left of Grantor Trust}, 21 INST. ON EST. PLAN. ¶ 1500 (1987) ("Estate planners have grown to think of the grantor trust rules . . . as a series of traps and obstacles which one must traverse in order to create a trust that is a separate taxable entity.").

\textsuperscript{132} \textit{E.g.}, Carson v. Comm'r, 92 T.C. 1134, 1137 (1989) (holding that grantor trust status applied when the grantor retained spray power over trust income); Wysong v. Comm'r, 57 T.C.M. (P-H) 1725, 1727 (1988) (treating a grantor as owner of a trust by virtue of his demand right to trust corpus and his complete control over the beneficial enjoyment of trust corpus); Braun v. Comm'r, 53 T.C.M. (P-H) 1116, 1119 (1984) (taxing a grantor on all trust income used to meet the educational costs of the grantor's minor and adult children).

\textsuperscript{133} Prior to the significant changes made by the Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (codified as amended in scattered sections of 26 U.S.C.), to the Code's progressive rate structure and its application, several commentators promoted the virtues of using grantor trusts in conjunction with tax shelters. They thought that grantor trusts, rather than individual investors, were the appropriate parties to invest in tax shelters. When the tax shelter did not produce any losses, the grantor would then release the power(s) that led the trust to being classified as a grantor trust. If all went according to plan, the tax burdens associated with the disposition of tax shelter interests would befall the trust, as a non-grantor trust, rather than the grantor. See generally George Brode, Jr., \textit{Tax Shelter Problem Areas—Potential Depreciation Recapture on Death of a Partner, Phantom Gain, and the Defective Trust Gambit}, 54 TAXES 306 (1976) (advocating the possible use of these trusts as a mechanism to minimize income tax); Martin B. Cowan, \textit{Use of Grantor Trusts to Escape a Tax Shelter Without
and foiled by legislative initiatives.\textsuperscript{134}

\textbf{B. Grantor Trust Rules and Their Present Effectiveness}

A review of judicial controversies over the last ten years might lead one to conclude that the grantor trust rules continue to enjoy unprecedented success. Indeed, there is not a single case involving a post-1991 fact pattern in which the Service has invoked the grantor trust rules. This absence of judicial activity might signify that the grantor trust rules cast such a harsh shadow on the use of trusts as a tax minimization device that they are no longer employed as such.

But drawing such an optimistic conclusion would be foolhardy. Although tax advisors were at one time careful to avoid the “trap” of grantor trust status, today the opposite is true. In a major role reversal, many tax advisors are using the same care on behalf of some of their clients, but this time to ensure that the trusts their clients establish are “defective” for tax purposes.

The Tax Reform Act of 1986\textsuperscript{135} made vast changes to the progressive rate structure of the income tax and its application.\textsuperscript{136} As a result of these changes, grantor trust status no longer carries the same burdens it once did; to the contrary, grantor trust status now often offers taxpayers a refuge, making its invocation by the Service almost always pointless.


\textsuperscript{136} See supra notes 8–11 and accompanying text.
A simple example illustrates this point. Consider a trust that holds title to a million dollars worth of bonds that generate $100,000 of interest. If the Code recognizes this trust as a non-grantor trust, the tax liability on the interest in 2000 would be $38,622 (assuming no distribution deduction). If, instead, the Code classifies the trust as a grantor trust, the tax liability on the interest in 2000 would be $22,300 (assuming the grantor had no other sources of income and files a joint income tax return). The difference in outcomes is due to the fact that trust income earned by a non-grantor trust is taxed under a highly compressed rate structure. In contrast, income earned by a grantor trust is subject to the grantor's more graduated rate structure. The difference between the two rate structures almost always leaves taxpayers and their families financially better off, if they establish grantor trusts.

In addition to the newfound tax rate advantage associated with the use of grantor trusts, other tax minimization opportunities are available: (1) the use of grantor trust status to minimize a grantor's gift, estate, and generation-skipping transfer tax burdens (collectively hereinafter referred to as "transfer taxes") and (2) the use of grantor trust status to minimize a grantor's (or a grantor's heirs') income tax burdens.

1. Grantor Trust Use to Minimize Transfer Taxes

The courts have concluded that "income tax provisions are not to be construed as though they were in pari materia" with transfer tax statutes. What this means is that the rules and definitions for one tax system will not dictate the rules and definitions of the other tax system and vice versa. Each system of taxation, for example, has

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137 I.R.C. § 1(e) (West Supp. 2000).
138 Id. § 1(a).
139 Id. § 1(e).
140 Id. § 1(a).
141 Farid-Es-Sultaneh v. Comm'r, 160 F.2d 812, 814 (2d Cir. 1947); see also Lockard v. Comm'r, 166 F.2d 409, 412 (1st Cir. 1948) ("[F]or the most part any correlation that may exist between the three [income, estate, and gift] taxes is 'purely coincidental'.").
142 Despite commentators' pleas that Congress harmonize the income and transfer systems of taxation, their recommendations have largely been ignored. See, e.g., Erwin N. Griswold, A Plan for the Coordination of the Income, Estate, and Gift Tax Provisions with Respect to Trusts and Other Transfers, 56 Harv. L. Rev. 337, 342-52 (1942). This absence of coordination continues to draw attack from commentators. See, e.g., John L. Peschel, The Impact of Fiduciary Standards on Federal Taxation of Grantor Trusts: Illusion and Inconsistency, 1979 Duke L.J. 709, 709 ("When applied to inter vivos trusts,
developed a different concept of the term "control."\textsuperscript{143} Consider, for example, the tax consequences to a taxpayer who makes a property contribution to a trust. For transfer tax purposes, this contribution may constitute a completed gift that is excluded from the taxpayer's gross estate; conversely, for income tax purposes, the taxpayer may maintain enough indicia of dominion and control over the trust property to remain liable for the income such trust property generates.\textsuperscript{144}

Tax advisers have seized upon the inconsistencies between these two tax systems as mechanisms to alleviate their clients' transfer tax burdens. They have had their clients establish wealth maximization trusts,\textsuperscript{145} institute special forms of installment sales,\textsuperscript{146} and engage in federal income, estate and gift tax rules often produce uncoordinated—at times unpredictable—tax consequences.")


\textsuperscript{144} \textit{See infra} Part III.A.

\textsuperscript{145} Wealth maximization trusts involve a simple strategy: a grantor establishes a trust for the benefit of his intended beneficiaries that qualifies for grantor trust status, but the terms of this trust do not cause the trust-held property to be includible in the grantor's gross estate. The grantor trust status of the trust makes the grantor liable for tax on any income the trust generates. This produces significant transfer tax savings to the grantor and the grantor's intended beneficiaries, because the trust accumulates income without diminishment related to taxes. \textit{See} Roth, \textit{supra} note 13, ¶ 406.1 (showing in present value terms that this technique offers taxpayers significant transfer tax savings).

To illustrate, suppose a grantor funds an irrevocable trust with cash of $100,000 that yields a 10% annual return. Suppose further that the effective individual income tax rate is 30% and the effective trust income tax rate is 40%. If the trust is a grantor trust, the grantor will pay $3000 of tax, leaving $110,000 in trust ($100,000 initial contribution plus $10,000 return). If the trust is a non-grantor trust, the trust will bear a $4000 tax burden, leaving only $106,000 in trust ($100,000 plus $10,000 return less $4000 tax). In addition to the income tax savings of $1000 ($4000 – $3000), the transfer tax savings from employing this technique are even more dramatic. In just the first year, $4000 of additional wealth remains in trust. Were the estate tax rate 55%, this would save $2200 in transfer taxes ($4000 x .55) in one year versus a trust that does not qualify for grantor trust status. Over time, the tax savings and the additional wealth that can pass to the grantor's heirs can be extraordinary.

\textsuperscript{146} Tax advisors now exploit grantor trust status in the context of installment sales to circumvent the special valuation rules provided under Chapter 14 of the Code. \textit{See}, \textit{e.g.}, Burton W. Kanter & Michael J. Legamaro, \textit{The Grantor Trust: Handmaiden to the IRS and Servant to the Taxpayer}, 75 Taxes 706, 755–59 (1997); Mulligan, \textit{supra} note 13, ¶ 1510.

By way of background, Chapter 14's Code § 2702 generally provides that, with respect to any transfer into trust, the value of any retained interest held by the grantor in such trust will be zero, unless the interest retained is "qualified." I.R.C. § 2702(a) (1994 & Supp. IV 1998). A qualified interest includes the right to a fixed annual amount or a fixed annual percentage of trust-held property. \textit{Id.} § 2702(b). While
this special valuation rule has not eliminated grantors making trust contributions with retained interests, see, e.g., Lawrence P. Katzenstein, *Running the Numbers: An Economic Analysis of GRATS and QPRTS*, 32 INST. ON EST. PLAN. ¶¶ 1400, 1402 (1998); Carlyn S. McCaffrey & Pam H. Schneider, *Trimming Transfer Taxes with Split-interest Transfers: GRATS and QPRTS*, in *VALUATION, TAXATION AND PLANNING TECHNIQUES FOR SOPHISTI-
CATED ESTATES* 101 (Practicing Law Inst. 1999), grantors are less inclined to do so. The reason for this reluctance is twofold. First, the value of the grantor's retained interest in the trust is determined under Code § 7520. This rate is equal to 120% of the federal midterm rate in effect under Code § 1274(d)(1) on the date of the gift. I.R.C. § 7520(a)(2) (1994). Unless the trust-held property produces a net return in excess of the rate posited under Code § 7520 (which may be very difficult to achieve), a transfer under Code § 2702 will not meet its intended tax result. Second, should the grantor die during the period in which the grantor has a retained interest, some or possibly all of the trust-held property is includible in the grantor's estate. I.R.S. Field Service Advisory 2000-36-012 (May 25, 2000) (concluding that the entire corpus of a GRAT is includible in the grantor's estate under Code § 2039(b) where the grantor had died during the GRAT's term); see also I.R.C. § 2036(a) (1994); Rev. Rul. 82-
105, 1982-1 C.B. 133 (addressing the amount includible in the estate of a grantor-annuitant under a charitable remainder trust; holding that the includible amount is that portion of the trust principal necessary to produce the annuity amount using the applicable discount rate (now the Code § 7520 rate) for the month of the grantor's death).

Rather than transfer property into a trust and subject the property to the special valuation rules under Chapter 14 of the Code, creative tax advisors have devised a new planning technique. Under this technique, a grantor establishes a grantor trust that is effective to avoid estate tax inclusion. The trust is funded with a small initial cash contribution. The grantor then sells property to the trustee of the trust. The trustee of the trust pays for the property by making a small cash down payment and issuing a promissory note equal to the balance due. Interest on the note is paid on a current basis and a balloon payment of principal is due at the end of an agreed-upon term. The interest rate set on the note is usually equal to the current federal rate established under Code § 1274. (This rate will vary depending on the term length of the promissory note.)

If all goes according to plan, this technique offers several benefits. First, the grantor status of the trust permits the sale itself to be ignored. See Rev. Rul. 85-13, 1985-1 C.B. 184. Thus, the grantor does not have to recognize the gain, if any, associated with the sale of the property. Second, any interest payments made by the trust to the grantor can likewise be ignored and need not be included in income, because under the grantor trust rules, a grantor cannot loan money to herself. Priv. Ltr. Rul. 95-35-026 (May 31, 1995). Third, the interest rate chargeable under the terms of the installment arrangement is that which is required under Code § 1274 (the Code section that controls in the context of a sale). This rate is generally less than that which would be imposed were Code § 7520 applicable (the Code section that controls for purposes of computing the grantor's retained interest under Code § 2702). See Frazee v. Comm'r, 98 T.C. 554, 587-90 (1992) (holding that the value of a promissory note given in exchange for the sale of property was to be determined under Code § 7872, which incorporates through Code § 7872(f)(2) the interest rate under Code § 1274). Fourth, should the grantor die while the promissory note is outstanding, the amount included in the deceased grantor's estate would not be the fair market value
trust loans, all in an effort to exploit the grantor trust rules. The effectiveness of these techniques depends upon two factors: (1) the income tax savings or costs associated with grantor trust status and (2) the transfer tax savings that inure to the trust beneficiaries by the grantor’s payment of tax on trust income. Because non-grantor trust income is taxed under the compressed rate structure of Code § 1(e), and the grantor’s income tax payments are not subject to gift tax, it is a rare occasion when it does not make sense to secure grantor trust status.

of the trust-held property, but rather would be limited to the fair market value of the unpaid balance of the promissory note. See Rev. Rul. 77-193, 1977-1 C.B. 273 (ruling that the value of property sold for the promissory note is not includible in the decedent’s estate under Code § 2036(a)(1)).

At least one commentator contends that the installment sale technique does not work, see Brendan P. Smith, A Sale to an Entity Trust Will Have Better Results Than a Sale to an Intentionally Defective Grantor Trust or a Transfer to a GRAT, 23 TAX MGMT. EST. GIFTS & TR. J. 86 (1998) (arguing that the sale constitutes a non-event because the transfer does not constitute a gift for transfer tax purposes and is ignored for income tax purposes), but the vast majority of other commentators think otherwise. See, e.g., Mulligan, supra note 13, ¶ 1500 n.1 (citing Kanter & Legamaro, supra, at 755-59; H. Allan Shore & Craig T. McClung, Beyond the Basic SUPERFREEZE—An Update and Additional Planning Opportunities, 75 TAXES 41 (1997)).

147 Normally, the extension of credit by a grantor to a trust does not make economic sense. This is because the grantor must pay income tax on the interest income earned and the trust may be disallowed a corresponding interest deduction or lack sufficient trust income to absorb its use. See generally I.R.C. § 163 (1994).

When a trust qualifies for grantor status, however, an extension of credit by the grantor to the trust may prove attractive. For income tax purposes the loan is entirely ignored: no deduction or income inclusion is required. Priv. Ltr. Rul. 95-35-026 (Sept. 1, 1995). Therefore, as long as the trust is able to command a return (for example, 10%) on the loan proceeds that is greater than its interest obligation under the loan (for example, 6%), wealth can inure transfer-tax free to the beneficiaries of the trust. See generally Jay Soled, Simon Levin & Lionel Etra, Market Interest Rate Loans: A Simple and Effective Potential Estate Planning Technique, 77 TAXES 37 (1999) (discussing the transfer tax-saving opportunities that intra-family loans offer).


149 If state and local tax burdens on a grantor are onerous and the trust's situs can easily be moved to another state, the benefits of using a grantor trust may not be as great as intended. See Carlyn S. McCaffrey, Collateral Consequences of Grantor Trust Status; The Sword of the Service Becomes the Estate Planner’s Plowshare 7–8 (Nov. 10, 1998) (unpublished manuscript presented at the New York Upstate Meeting of the American College of Trust and Estate Counsel, on file with the Notre Dame Law Review). For example, no New York State personal income tax may be imposed on a
The Service has not welcomed taxpayers' blissful change of attitudes towards grantor trust status. It has attacked the use of grantor trust status as a tax minimization tool. One mode of attack has been to argue that the grantor's payment of income tax constitutes an additional trust contribution, making it subject to gift tax.\(^{150}\) The theory underlying this line of attack by the Service is that the grantor has a right under local law to reimbursement from the trustee for the grantor's income tax payment.\(^{151}\) Should the grantor not exercise this right of reimbursement, the grantor arguably has made a de facto trust contribution that constitutes a taxable gift. The problem with this line of attack, however, is that local law does not support the Service's position; to the contrary, virtually all local laws seem to indicate that the grantor has no right to reimbursement.\(^{152}\) (Despite numerous criticisms from tax commentators,\(^{153}\) the Service has explicitly refused to abandon this position.\(^{154}\))

A second line of attack has been to argue that the establishment of a grantor trust constitutes a taxable gift at the date of trust inception. The Service has informally suggested that when a taxpayer deliberately establishes a grantor trust, the taxpayer has bound herself to undertake the tax obligations of another.\(^{155}\) The Service posits that this voluntary undertaking constitutes a gift.\(^{156}\) The Code and case

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\(^{150}\) See infra note 154.


\(^{152}\) One commentator conducted an informal survey of the laws of the fifty states and did not find a single state that provided the grantor with a right to reimbursement. See Coleman, supra note 13, ¶ 806.

\(^{153}\) See Danforth, supra note 148, at 573–601; Huffaker et al., supra note 148; Kasner, supra note 148.

\(^{154}\) At one time, the Service would not issue a favorable ruling with respect to a grantor-retained annuity trust unless the governing instrument contained a provision directing the trustee to reimburse the grantor for income taxes paid by her on trust income not distributed to her. See Priv. Ltr. Rul. 94-44-033 (Aug. 5, 1994) (“If there were no reimbursement provision, an additional gift to a remainderperson would occur when the grantor paid tax [on] any income that would otherwise be payable from the corpus of the trust.”). The Service, however, subsequently withdrew this ruling and replaced it with another ruling that did not contain the quoted text. See Priv. Ltr. Rul. 95-43-049 (Aug. 3, 1995).

\(^{155}\) See McCaffrey, supra note 149, at 15–17.

\(^{156}\) Id.
law, however, do not support the Service's position. When a grantor bears the trust's tax liabilities, those are indeed her own liabilities; she is not undertaking the tax obligations of another. In addition, determining the value of the taxpayer's gift on the date of trust establishment would make this line of attack extremely difficult to pursue.

The bottom line is that the plain language of the grantor trust rules, combined with the Service's own position, seems to suggest that taxpayers have the upper hand, if these techniques are ever judicially challenged.

2. Grantor Trust Use to Minimize Income Tax

The benefits associated with grantor trust status do not end at transfer tax minimization. They extend to the income tax arena as well. Taxpayers use grantor trust status as a way to lessen their beneficiaries' income tax burdens, to facilitate trust use, and to avoid

157 See I.R.C. § 671 (1994); Rosenthal v. Comm'r, 205 F.2d 505, 508-10 (2d Cir. 1953); Comm'r v. Copley's Estate, 194 F.2d 364 (7th Cir. 1952); Harris v. Comm'r, 178 F.2d 861, 865 (2d Cir. 1949), rev'd on other grounds, 340 U.S. 106 (1950).

158 See McCaffrey, supra note 149, at 16-17.

159 One well-known sacrifice commonly associated with gifts in trust is that the tax basis of the transferred property in the hands of the trust beneficiary will usually be that of the grantor. See I.R.C. § 1015(a) (1994). When a grantor pays gift tax, the tax basis of the contributed property may be adjusted upwards. Id. § 1015(d)(6).

To illustrate, consider the tax plight of a trust beneficiary when a grantor establishes a twenty-year term trust and transfers into such trust real estate with a $10 basis. Suppose when the trustee distributes the trust property in year twenty, the fair market value of the trust property has appreciated to $1000. The trust beneficiary will receive such property with a tax basis still equal to $10. Assuming the federal and state combined tax rate is 30% and the trust beneficiary immediately sells the distributed property, the trust beneficiary would have to recognize a $990 gain ($1000 - $10) and pay $297 (.3 x $990) of tax.

To help avoid the trust beneficiary's potential income tax exposure, tax advisors now advocate that their clients establish grantor trusts. See, e.g., Roth, supra note 145, ¶ 406. This maneuver may eliminate or minimize the income tax burden to the trust beneficiaries who receive trust property. To accomplish this, the grantor purchases, towards the end of the trust term, any highly appreciated trust assets using cash or nonappreciated property. While this sale is ignored for income tax purposes, see Rev. Rul. 85-13, 1985-1 C.B. 184, the trust beneficiary will receive nonappreciated property or cash that can be sold for little, if any, gain. When the grantor ultimately dies, the step-up in basis allowed to the grantor's estate will erase the taxable gain on the once-held appreciated trust property. See I.R.C. § 1014(a) (Supp. IV 1998).

160 Grantor trust status often alleviates the income tax consequences associated with the disposition of trust property. The two most common occasions when this benefit is evident are when the grantor has, pursuant to Code § 2702, established a grantor retained annuity trust (GRAT) or a qualified personal residence trust (QPRT).
A GRAT is an arrangement where the grantor establishes a trust and retains the right to receive an annual annuity from the trust over the trust term. Grayson M.P. McCouch, *Rethinking Section 2702*, 2 Fla. Tax L. Rev. 99, 118–19 (1994). A QPRT is an arrangement where the grantor establishes a trust funded with the grantor’s personal residence or vacation home and retains the right to the use of the trust property for a fixed number of years. John A. Miller & Jeffrey A. Maine, *Fundamentals of Estate Tax Planning*, 32 Idaho L. Rev. 197, 249–50 (1996). In the case of a QPRT, the grantor often retains a reversionary right in the trust in case of death prior to termination of the trust term. *Id.*

By their terms, both GRATs and QPRTs qualify for grantor trust status. In the case of a GRAT, the grantor’s right to receive an annual annuity will make the grantor owner of the income portion of the trust under Code § 677(a)(1). See I.R.C. § 677(a)(1) (1994). In addition, the grantor will be treated as the owner of the entire trust for income tax purposes if the annuity payments can be made out of principal to the extent income is insufficient. Priv. Ltr. Rul. 94-44-033 (Aug. 5, 1994), amended by Priv. Ltr. Rul. 95-43-049 (Aug. 3, 1995).

In the case of a QPRT, the grantor’s right to annual use of the trust property will make the grantor owner of the income portion of the trust under Code § 677(a)(1). See I.R.C. § 677(a)(1) (1994). The grantor will also generally be treated as owner of the corpus under Code § 673 because of the grantor’s reversionary right to trust principal. See id. § 673.

The status of these trusts offers taxpayers tax-saving opportunities not found in non-grantor trusts. For example, suppose a grantor establishes a ten-year GRAT, contributing stock in a highly appreciated, closely-held business in which he has a zero tax basis and the stock is worth $1 million. Suppose further that the terms of the GRAT provide a $200,000 annual annuity to the grantor. If the stock did not generate any income or grow in value in the first year, the trustee of the GRAT would have to distribute $200,000 of stock with a zero basis to the grantor. Normally, the satisfaction of a debt (that is, the annuity obligation) with appreciated property (that is, the stock) would trigger a taxable gain (here $200,000). See Kenan v. Comm’r, 114 F.2d 217, 220 (2d Cir. 1940). However, due to the grantor trust status of a GRAT, this gain is not recognized. Priv. Ltr. Rul. 93-52-017 (Sept. 30, 1993) (ruling that use of appreciated property to satisfy an annuity obligation does not trigger gain); Priv. Ltr. Rul. 93-52-007 (Sept. 28, 1993) (same); Priv. Ltr. Rul. 93-51-005 (Sept. 16, 1993) (same); Priv. Ltr. Rul. 92-39-015 (June 25, 1992).

In addition to a GRAT, suppose a grantor also establishes a ten year QPRT funded with the grantor’s personal residence, worth $1 million, in which he has a $500,000 tax basis. Due to the grantor trust status of the trust, the grantor can continue to command deductions associated with home ownership (for example, mortgage interest and real estate taxes). Priv. Ltr. Rul. 1999-16-030 (Jan. 22, 1999) (ruling that mortgage interest, tax, and other deductions are allocable to income). Furthermore, the trustee of the QPRT may also sell this residence and exclude part or all of the gain from the grantor’s income under Code § 121. See Rev. Rul. 85-45, 1985-1 C.B. 183 (holding that the prior exclusion of $125,000 of gain allowed to persons age fifty-five or older would be applied to sales of principal residences held in grantor trusts as if the sale were made to the grantor); see also Priv. Ltr. Rul. 1999-12-026 (Dec. 23, 1998) (ruling that the new exclusion under Code § 121 applies to grantor trusts). This Code section permits homeowners to exclude $250,000 of gain on the sale of a
the transfer for value rule that pertains to the sale of life insurance policies.\textsuperscript{161}

The Code provides that the receipt of life insurance proceeds is excluded from income. I.R.C. § 101(a)(1) (1994). This rule is subject, however, to an exception known as the transfer for value rule. The transfer for value rule provides that, if a life insurance policy is transferred for valuable consideration, the proceeds of such policy are includible in income. \textit{Id} § 101(a)(2) (1994 & Supp. IV 1998). This exception is itself subject to an exception: the transfer for value rule does not apply if (a) the transferee's basis in such insurance policy is determined in whole or in part by reference to the transferor's basis, \textit{id} § 101(a)(2)(A), or (b) such transfer is to the insured, \textit{id} § 101(a)(2)(B).

Grantor trust status can play a pivotal role in ensuring that life insurance proceeds remain excluded from a taxpayer's income. Consider the situation in which a taxpayer owns a life insurance policy and wishes to transfer this policy to an irrevocable trust and yet avoid application of the three-year estate tax inclusion rule that applies to transfers of life insurance policies made within three years of death. See \textit{id} § 2035(a) (1994). The taxpayer could contribute cash to the trust and have the trust purchase the policy from him. The three-year estate tax inclusion rule does not apply in the context of a bona fide purchase. \textit{Id} § 2035(d). In addition, the transfer for value rule would not apply, because under the grantor trust rules (a) the trustee who purchases the policy will have the taxpayer's tax basis in the purchased policy (thus meeting the first transfer for value exception under Code § 101(a)(2)(A)) and, even if the first exception did not apply, (b) the trust and insured are treated as if they are one and the same (thus meeting the second transfer for value exception under Code § 101(a)(2)(B)). See \textit{id} § 101(a)(2)(A)-(B).

By enabling the grantor to avoid the transfer for value rules, grantor trust status also offers taxpayers tremendous flexibility in arranging their financial affairs. Consider the situation of a taxpayer who establishes an irrevocable trust that holds a recently-purchased $1 million life insurance policy on the life of the taxpayer with a current cash surrender value of $20,000. Suppose the trust is for the benefit of the taxpayer's daughter and terminates when the taxpayer's daughter attains age thirty. Suppose further that the taxpayer subsequently has reservations concerning his daughter's financial acumen and thinks that age forty would be a more appropriate age restriction limitation in the trust. The taxpayer may establish a new irrevocable trust funded with $20,000 that has an age forty restriction limitation. Assuming the trustees of the old trust and new trust agree, the trustee of the old trust may sell the life insurance policy it holds to the trustee of the new trust for the policy's fair market value. Again, because of the grantor trust status of the two irrevocable trusts, this transfer should not trigger the transfer for value rule. See \textit{Swanson v. Comm'r}, 518 F.2d 59, 63-64 (8th Cir. 1975) (equating a purchase by the grantor trust to a purchase by the grantor-insured), \textit{aff'd} 33 T.C.M. (P-H) 278 (1974); \textit{see also} Jay A. Soled, \textit{Strategies for Handling a Life Insurance Trust That No Longer Meets the Grantor's Needs}, 21 Tax Mgmt. Est. Gifts & Tr. J. 207 (1996) (discussing the advantages of utilizing grantor trusts as a tool to eliminate life insurance trusts that no longer serve a useful purpose).

\footnote{161}{The Code provides that the receipt of life insurance proceeds is excluded from income. I.R.C. § 101(a)(1) (1994). This rule is subject, however, to an exception known as the transfer for value rule. The transfer for value rule provides that, if a life insurance policy is transferred for valuable consideration, the proceeds of such policy are includible in income. \textit{Id} § 101(a)(2) (1994 & Supp. IV 1998). This exception is itself subject to an exception: the transfer for value rule does not apply if (a) the transferee's basis in such insurance policy is determined in whole or in part by reference to the transferor's basis, \textit{id} § 101(a)(2)(A), or (b) such transfer is to the insured, \textit{id} § 101(a)(2)(B).}
Grantor trust status offers taxpayers tremendous flexibility in tax reduction opportunities. Barring one exception, grantors are essentially able (assuming the trustee consents) to switch title to property in and out of trust without any negative tax consequences. This flexibility all comes, of course, at the expense of the government.

III. Securing Grantor Trust Status

Given the broad scope of the grantor trust rules, securing grantor trust status is relatively easy. But there are two additional conditions that must be met in order for grantors to achieve the tax minimization results described in the prior Section. First, violation of the grantor trust rules must not leave the grantor vulnerable to having the trust-held property includible in the grantor’s gross estate. Second, the entire trust—not just a portion thereof—must qualify for grantor trust status.

A. Similarities and Distinctions Between the Grantor Trust Rules and the Estate Tax Inclusion Rules

The estate tax inclusion rules operate on the same basic premise as the grantor trust rules. If a grantor retains certain indicia of dominion and control over trust-held property—albeit not outright ownership—such property is includible in the grantor’s gross estate. Three so-called “string sections” comprise the mainstay of these rules: trust-held property is includible in the grantor’s gross estate, if the grantor has retained (a) the right to beneficial enjoyment or control over trust property, (b) a reversionary interest in trust property (under certain and limited circumstances), or (c) the right to alter, amend, revoke, or terminate a trust.

In the vast majority of cases, the grantor trust rules and the estate tax inclusion rules function in unison. How one set of rules defines indicia of dominion and control is essentially how the other set of rules defines indicia of dominion and control and vice versa. Property

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162 The Treasury Department recently adopted regulations that require that the terms of personal residence trusts prohibit the sale or transfer of the trust-held residence directly or indirectly to the grantor. See Treas. Reg. § 25.2702-5(c)(9) (as amended in 1997). Treasury adopted this regulation because it believed that the transfer of the residence back to the grantor thwarted congressional intent. T.D. 8743, 1998-1 C.B. 543.
164 Id. § 2037(a).
165 Id. § 2038(a).
held in a grantor trust, therefore, is also likely to be included in the grantor’s gross estate.166

Two critical factors, however, distinguish the grantor trust rules from the estate tax inclusion rules. First, despite all their overlap, the grantor trust rules and the estate tax inclusion rules define indicia of dominion and control somewhat differently. The grantor trust rules take a sweeping approach, classifying any trust in which the grantor has any vestige of retained dominion and control (including, for example, the administrative right to reacquire trust property and substitute property of equivalent value) as a grantor trust.167 The estate tax inclusion rules do not have quite the same breadth. They permit the grantor to retain certain indicia of dominion and control (including, for example, the administrative right to reacquire trust property and substitute property of equivalent value) without causing inclusion of the trust-held property in the grantor’s gross estate.168

Second, the grantor trust rules require a thorough analysis of the powers and rights, if any, held or vested in others, including the grantor’s spouse and other so-called nonadverse parties.169 In contrast, the estate tax inclusion rules only scrutinize whether the grantor has a power in or right over trust property.170 If no such right or power is found, the trust-held property is not includible in the grantor’s gross estate.171 Therefore, if the grantor trust rules are violated as a result of a third-party power or right, this violation will virtually never cause the trust-held property to be included in the grantor’s gross estate.172

166 A simple example illustrates this point. Suppose a grantor establishes a revocable trust to which she transfers title to a building. Due to the grantor trust status of this trust, see id. § 676(a), during the trust term any rental income, deductions, or credits against tax associated with the operation of this building must be reported on the grantor’s individual income tax return. Id. § 671. Upon grantor’s death, due to the revocable nature of the trust, the building’s fair market value will likewise be includible in the grantor’s gross estate and must be reported on the grantor’s estate tax return. Id. § 2038(a).
167 Id. § 675(4)(C).
168 See Estate of Jordahl v. Comm’r, 65 T.C. 92, 96 (1975) (holding that a grantor’s power to substitute property did not constitute a power “to alter, amend, or revoke” the trust”), acq., 1977-1 C.B. 1.
170 Subtitle B of the Code is entitled “Estate and Gift Taxes.” References therein are to the decedent, not to any other taxpayer.
171 See, e.g., I.R.C. § 2033 (1994) (“The value of the gross estate shall include the value of all property to the extent of the interest therein of the decedent at the time of his death.”).
172 That is, of course, unless the grantor of a trust had an oral or written arrangement that another party will act as the grantor’s agent. See Estate of Skinner v. United
The incomplete harmony between these two sets of rules permits the seemingly impossible to be achieved: abracadabra, a grantor can establish a trust where he is treated as the owner of the trust-held property for income tax purposes, but not for transfer tax purposes. Given the similarities between these two systems of taxation, this achievement is not necessarily easy. But through the careful selection of trust terms and/or trustees, the grantor may accomplish this magical feat and exploit the tax minimization techniques previously enumerated. 173

B. Methods to Secure Grantor Trust Status for the Entire Trust

To achieve tax minimization, one must not only avoid estate tax inclusion, but also ensure that the entire trust qualifies as a grantor trust. If only a portion of the trust qualifies for grantor trust status, 174 the intended unity between the grantor and trust will not be met, and the grantor may forfeit some or all of the tax benefits associated with the use of grantor trust status. There are various methods that grantors can use to achieve unity between themselves and the trusts they establish. The methods are presented in order of their likely effectiveness and judicial soundness.

1. Code §675(4): The Right to Reacquire Trust Property and Substitute Other Property of Equivalent Value

The right to reacquire trust property and substitute other property of equivalent value triggers grantor trust status, if (i) the right is held by any person acting in a nonfiduciary capacity, and (ii) exercise of this right does not need the consent or approval of a person acting in a fiduciary capacity. 175 Properly placed, this seemingly benign right can transform the status of any trust into a grantor trust.

While a reacquisition right triggers grantor trust status, its use does not trigger the estate tax inclusion rules. This is because this

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173 See infra Part III.B.
174 See supra notes 95–97 and accompanying text.
175 I.R.C. §675(4) (1994). To illustrate, suppose a grantor establishes a trust that designates his sister as trustee. Suppose further that the terms of the trust provide the grantor with the right to reacquire any or all the trust property as long as he substitutes other property of equivalent value and, in exercising this right, he acts in a nonfiduciary capacity. Under this set of circumstances, Code §675 deems the grantor the owner of the entire trust. See id.
power can be held by anyone. In addition, even if the grantor directly holds this right, the estate tax inclusion rules are not triggered, because the mere right to reacquire trust property and substitute property of equivalent value does not secure any economic advantage or procure any vestige of control in the grantor.

Besides not triggering the estate tax inclusion rules, the structure of Code § 675 serves another useful role. It secures blanket grantor trust status. In its prefacing language, Code § 675 provides that the "grantor shall be treated as the owner of any portion of a trust in respect of which" the grantor or nonadverse party holds an enumerated administrative power. When the terms of the trust vest the grantor or nonadverse party with a reacquisition power over all the trust-held property, grantor trust status correspondingly attaches to the entire trust.

There is one caveat regarding the use of a reacquisition and substitution right. The Code requires that the person who possesses this right hold it in a nonfiduciary capacity. Whether a person holds this right in a nonfiduciary capacity "depends on all the terms of the trust and the circumstances surrounding its creation and administration." There is, however, no administrative or judicial guidance to help determine in what capacity a person acts.

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176 The Code uses the term "reacquire," which implies that the person who made the trust contribution must be the same party who holds this right. See id. The issue, however, of who possesses the right of reacquisition is not addressed in the regulations and the Service appears to ignore it. See e.g., Priv. Ltr. Rul. 90-37-011 (June 14, 1990) ("Provided that the circumstances surrounding the administration of the power held by [A, the trustee,] to substitute property of equal value for the trust corpus do not indicate that the power is held in a fiduciary capacity, ... [B, the grantor,] shall be treated as the owner of all of the [t]rust under section 675 ... "); see also Priv. Ltr. Rul. 96-42-039 (July 18, 1996) (ruling that the power of substituting rights with a third party could qualify the trust for grantor trust status); Priv. Ltr. Rul. 97-13-017 (Dec. 27, 1996) (same).

177 See Estate of Jordahl v. Comm'r, 65 T.C. 92, 97 (1975); Priv. Ltr. Rul. 95-48-013 (Aug. 29, 1995) ("A and B's powers with respect to his or her trust to reacquire and substitute trust corpus with property of equal value ... do not constitute a power to alter, amend, or revoke the trusts within the meaning of section 2038(a), and therefore do not require that each trust's property be included in the gross estate of its respective grantor under section 2038(a) ... ").


179 Id. § 675(4)(e).

180 Id. § 675(4).


182 Commentators suggest that one possible and recommended way of meeting this requirement is to stipulate in the trust instrument that the person vested with a
2. Code § 674: Power to Add Beneficiaries

The general rule regarding beneficial control over trust property is set forth under Code § 674(a): a grantor will be treated as the owner of any portion of a trust in respect of which the grantor has "beneficial enjoyment." 183 This general rule, however, is subject to several important exceptions. 184 None of these exceptions apply (and grantor trust classification will be bestowed) in instances where any person (other than an adverse party) has a power to add beneficiaries to receive trust income or corpus. 185 This is true unless such power "is to provide for after-born or after-adopted children." 186

Given the general rule of Code § 674(a), its exceptions, and exceptions to those exceptions, there is one way a grantor may achieve grantor trust status that will meet all the grantor's tax objectives. The grantor can give a person (for example, the trustee) the right to add beneficiaries other than after-born or after-adopted children to the trust. 187

While another person's right to add trust beneficiaries triggers grantor trust status, its presence does not trigger the estate tax inclusion rules. This right confers no economic benefit to the grantor and, absent a written or oral agreement, does not give the grantor the ability to exercise beneficial control over the trust-held assets. In sum, while the right to add beneficiaries is sufficient for income tax pur-
poses to treat the grantor as having dominion and control over the entire trust, the converse is not true for transfer tax purposes.

3. Code § 674(c): Power to Control Discretionary Distributions

Grantor trust status generally applies to any spray trust (that is, where the trustees have the discretionary right to distribute trust income and principal between and among trust beneficiaries as they determine). There is, however, an exception to this general rule (and non-grantor trust status will apply) when three conjunctive conditions are met. These conditions are as follows: (1) neither the grantor nor the grantor's spouse is trustee, (2) no more than half of the trustees are related or subordinate parties who are subservient to the wishes of the grantor, and (3) the exercise of the spray right does not require the approval or consent of any other person.

Designating the grantor's spouse as a trustee over a spray trust qualifies the trust for grantor trust status, because the exception to the general rule does not apply. From the grantor's perspective, this designation should prove painless: the grantor's spouse will likely adhere to the grantor's wishes, and this designation should not trigger the estate tax inclusion rules. This option, however, suffers from two deficiencies: the spouse may die or the grantor's marriage may falter. Should either event occur, grantor trust status would end.

Another way to achieve grantor trust status with a spray trust and avoid estate tax inclusion is to designate a person who is given veto authority over the trustees' discretionary distributions. This person can be anyone except an adverse party (for example, a loyal sibling of the grantor). Use of this option does not suffer the same deficiencies as the first option, yet it permits the grantor to fulfill the same tax minimization agenda.

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189 See I.R.C. § 674(a) (1994); Carson v. Comm'r, 92 T.C. 1134, 1137-38, 1140 (1989) (holding that a "spraying" power was retained over all of a trust's income by virtue of a discriminatory power held directly by one grantor and indirectly by a co-grantor spouse, resulting in all of the trust income being taxable to the grantors).

190 I.R.C. § 674(c) (1994).

191 See id.

192 Estate tax inclusion rules focus exclusively on powers held by a decedent, not others. See generally id. §§ 2036-2038.

193 See id. § 674(c).

194 Violation of the second condition could cause inclusion of the trust-held property in the grantor's gross estate. If the trustees are considered subservient to the grantor's wishes, they might be deemed to be the grantor's alter ego, making the assets of the trust vulnerable to estate tax inclusion. But see Priv. Ltr. Rul. 95-43-050 (Aug. 3, 1995) (holding that the trustee's subservient relationship warranted grantor

Full grantor trust status attaches to any trust when the grantor or a nonadverse party, or both, holds power to allow the grantor to borrow trust income and corpus, directly or indirectly, without adequate security.\(^\text{195}\) A strategically incorporated trust provision that specifically authorizes the trustee to lend trust income and corpus to the grantor without adequate security should, therefore, result in full grantor trust status. Furthermore, although not free from doubt,\(^\text{196}\) the grant of such a power should not trigger application of the estate tax inclusion rules, which have no provision that directly corresponds to Code § 675(2).

5. Code § 676 and Code § 677: Designation of Spouse as a Trust Beneficiary

For purposes of the grantor trust rules, the Code essentially considers the grantor and the grantor's spouse as being the same person.\(^\text{197}\) The grantor is deemed to hold any power held by the grantor's spouse.\(^\text{198}\) In contrast, the transfer tax rules do not make this same equation of identities.\(^\text{199}\) Were the terms of a trust to make the grantor's spouse a trust beneficiary,\(^\text{200}\) the trust would qualify as a grantor trust, yet its terms would not trigger the estate tax inclusion rules.\(^\text{201}\) However, because the successful utilization of this rule depends on the longevity of the spouse and the success of the marriage between the grantor and his or her spouse, few tax advisors favor its use to achieve grantor trust status.

\(^{195}\) See I.R.C. § 675(2) (1994). This Code section does not apply, however, when it is made part of a general lending power; the regulations require more specificity. Treas. Reg. § 1.675-1(b)(2) (1960).

\(^{196}\) At least one commentator suggests that providing the grantor with a power to borrow without adequate security could cause inclusion of trust property in the grantor's gross estate under Code §§ 2036 or 2038. See McCaffrey, supra note 149, at 53.

\(^{197}\) See I.R.C. § 672(e) (1994).

\(^{198}\) Id.

\(^{199}\) See supra notes 169–73 and accompanying text.


\(^{201}\) E.g., Estate of Mitchell v. Comm'r, 55 T.C. 576, 580–81 (1970) (holding that the decedent did not retain or reserve the possession or enjoyment of, or right to the income from, the property transferred into trust to be used for the spouse's benefit), acq., 1971-1 C.B. 2.
IV. Reforming the Grantor Trust Rules

Grantor trust rules, once an effective method of checking taxpayers’ abuses, are now themselves a method of abuse. To curb this abuse and to simplify the Code, there are at least two well-known and well-respected commentators who advocate outright repeal of the grantor trust rules.\textsuperscript{202} They believe that the grantor trust rules can be cast aside, if Congress would require all trust income during the grantor’s lifetime (whether accumulated or distributed) to be taxed at the grantor’s marginal tax rate.\textsuperscript{203} Under at least one of these proposals, this would be accomplished in two steps: (1) each trust would compute its own taxable income essentially as an individual and pay tax based on that income, and (2) then the taxpayer would include the trust income on the taxpayer’s return and take a credit for the tax paid by the trust.\textsuperscript{204}

While the arguments these commentators advance in favor of repealing the grantor trust rules and replacing them with a different taxing regime are appealing, they suffer from several flaws. First, the income tax treatment for outright gifts and those made in trust should be consistent: there is no theoretical justification for income on gifted property to be taxed at the recipient’s rate in the case of the former and at the grantor’s rate in the case of the latter. This creates an incentive for taxpayers to make outright gifts when trust contributions might be more appropriate. Second, repeal of the grantor trust rules and their replacement by a system that taxes grantors on trust income would, in the case of irrevocable trusts—where trust contributions most often constitute completed gifts—perpetuate inconsistencies between the income and the transfer tax systems. This is particularly troublesome since previous experience indicates that taxpayers are prone to exploit these inconsistencies. Finally, supplanting the grantor trust rules with a new set of rules that recognizes the existence of all trusts would correspondingly require the preparation and submission of tax returns on behalf of all trusts. (This would include trustees having to file a tax return on behalf of the most popular choice of trust instrument, namely those trusts that are revocable in nature, when no such burden currently exists.)\textsuperscript{205} The addition of a new ad-

\textsuperscript{203} See Dodge, supra note 202, at 150–56; Kamin, supra note 202, at 227–30.
\textsuperscript{204} See Kamin, supra note 202, at 222.
\textsuperscript{205} See supra note 98.
ministrative burden makes this new taxing regime immediately suspect.

Although repeal of the grantor trust rules is not the answer, reform is clearly in order.206 Congress should overhaul these rules to make them compatible with the rest of the Code and harmonize them with the transfer tax rules. This reform would stem the hemorrhage of tax dollars lost due to taxpayers who use grantor trust stratagems, simplify the Code, and renew public respect for these rules.

Reform should be founded upon a basic premise: when a trust contribution resembles a completed gift (that is, when a grantor parts with all dominion and control over trust property), the trust (or the trust beneficiaries) should be the responsible taxpayer; alternatively, when a trust contribution resembles an incomplete gift (that is, when a grantor does not part with all dominion and control over trust property), the contributor of such property, namely the grantor, should be the responsible taxpayer. This premise has an intuitive appeal, and it is based upon an existing and well-established body of law with respect to inter vivos gift-giving.207

Accomplishing this reform can be achieved by changing the definition of grantor trust status to narrow its scope, by eliminating trust distribution deductions under certain circumstances,208 and by amending the definition of a taxable gift, the concept of a gross estate, and several other Code provisions.209 Other than the changes proposed, the rules set forth in Subchapter J would remain intact.

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206 Reforming the grantor trust rules could be undertaken in a series of different ways. One way would be to repeal or amend those grantor rules that specifically foster taxpayer gamesmanship. In some instances, reform of this nature could be easily instituted. With little collateral repercussions to the Code, Congress could, for example, repeal Code § 675(4)(C), the so-called “reacquisition and substitution power.” See I.R.C. § 675(4)(c) (1994). But in the vast majority of instances, Congress would find tinkering with the existing grantor trust rules frustrating. This is because the encompassing nature of the grantor trust rules would remain out of sync with the Code’s current progressive rate structure and it is highly unlikely that mere tinkering with these rules would result in a coordinated set of rules between the income and transfer tax systems. See Griswold, supra note 142, at 342 (“While [i]t might then appear that further tinkering would be desirable, . . . the process could go on resulting in ever increasing statutory complexity.”).

207 See supra text accompanying note 22.


209 Many Code sections cross-reference Code § 671 or Subpart E. E.g., id. § 1361(c)(2)(A)(i) (1994 & Supp. IV 1998). Congress would have to analyze each of these Code sections to determine whether and how they would need to be changed.
A. Proposed Definition of Grantor Trust Status

During the lifetime of the grantor, grantor trust status should only apply in two situations: (1) when the terms of the trust require payments of trust property to the grantor or grantor's spouse or (2) when payments of trust property can be made currently to the grantor or the grantor's spouse under a discretionary, revocation, or amendment power exercisable by the grantor or the grantor's spouse, whether acting alone or in conjunction with any other person. This proposed definition of grantor trust status combines current Code §§ 676 and 677(a)(1), both of which were enacted before the grantor trust rules. Their enactment and retention under the proposal makes sense even today, because when the grantor or the grantor's spouse has direct access or use of trust property, the grantor should be treated as having complete dominion and control over trust property and taxed accordingly.

This proposed definition of grantor trust status implicitly presumes that a grantor would only solicit a friendly party to serve in a fiduciary capacity, erasing the degree of allegiance issue that a trustee or another party has to the grantor under Code § 672.

210 In some significant ways, this proposal resembles a proposal made by the American Law Institute over a decade and a half ago. See Am. Law Inst., Federal Income Tax Project Subchapter J: Proposals on the Taxation of Trust and Estate Income and Income in Respect of Decedents 14 (1985) [hereinafter Proposals]. Several subsequent tax acts necessitate that the American Law Institute proposal be refined and updated. In addition, elements of this proposal can also be found in the Treasury Department Report to the President. The proposal would maintain Code § 679 in its present form. 2 U.S. Treasury Dep't, Tax Reform for Fairness, Simplicity, and Economic Growth 96–109 (1984).

211 See supra notes 39, 49.

212 As a general rule, tax should be borne by the party with the liquidity to bear its burden. See Edward A. Zelinsky, For Realization: Income Taxation, Sectoral Accretionism, and the Virtue of Attainable Virtues, 19 Cardozo L. Rev. 861, 889–93 (1997) (making a case for retaining the concept of realization to determine taxable events by highlighting the importance liquidity plays in shaping tax timing issues under the Code). The further the government strays from this principle, the greater the perceived tax burden and the difficulty of tax collection may become. Magill, supra note 74, at 129.

In general, an individual should be taxed on the income he receives, and not on what he does not and cannot receive. [My proposal arises out of my] concern for settlor-fathers who were being subjected to tax upon income which they did not and could not receive, their total income taxes sometimes exceeding their actual money incomes.

213 With regard to the utility—or lack thereof—of the definitions relating to adverse and nonadverse parties, one commentator once declared that "[t]he 'independence' from grantor influence which is presumed to reside in the bosom of the
B. Special Restriction on Trust Distribution Deductions

To discourage the renewal of income-shifting opportunities that might flow from a restrictive definition of grantor trust status, the law should include a special restriction on otherwise allowable trust distribution deductions under Subchapter J.214 This restriction would apply if the grantor or grantor's spouse were to have a "reversionary interest" in a portion of a trust. Any portion of the trust in which the grantor held a reversionary interest would be taxed to the trust, unless such income was to inure to a charitable beneficiary.

Consider the situation of a grantor whose income is subject to the highest marginal tax rate and who would like to shift income temporarily to her son whose income is taxed at the lowest marginal tax rate. Following the Clifford model, the grantor could establish a short-term trust for a period of five years that paid income currently to her son and then reverted to the grantor upon the trust's termination. Under the proposal set forth, the terms of this trust would not cause it to be classified as a grantor trust and, absent the proposed changes to Subchapter J, the grantor's son would pay tax on all the trust income distributed to him. This would present the grantor with a tempting opportunity to shift income, at least on a temporary basis.

Reforming the grantor trust rules thus requires that steps be taken to restrict distribution deductions to prevent a renewal of income-shifting between grantors and the trusts they establish. Under the proposal at hand, the trust in the prior example would not be entitled to any distribution deductions with respect to income distributed to a grantor's banker, lawyer, or accountant may be more apparent than real in many cases." Marvin A. Chirelstein, Federal Income Taxation 217 (8th ed. 1997).

In addition, any rule that has proven to be a trap for the unwary or that fails to achieve its intended purpose does not warrant retention. In the past, these definitions have resulted in some taxpayers bearing tax when they did not expect the grantor trust rules to apply. E.g., Paxton v. Comm'r, 520 F.2d 923, 927 (9th Cir. 1975) (holding that a 3.84% interest of one trustee upon termination did not render him adverse as to the entire trust but only as to his share); Holt v. United States, 669 F. Supp. 751, 752 (W.D. Va. 1987) (holding that the trustee's beneficial interest was too remote to be classified as adverse), aff'd, 842 F.2d 1291 (4th Cir. 1988). Other taxpayers have deliberately violated these definitions, resulting in intentional tax relief. See, e.g., Madorin v. Comm'r, 84 T.C. 667, 668-69 (1985) (involving a taxpayer who created, with the intention of establishing trusts qualifying for grantor trust status, four trusts and gave an independent trustee power to add one or more charitable organizations as beneficiaries of each trust).

214 See generally I.R.C. §§ 651(a), 661(a) (1994) (permitting current distribution deductions for simple and complex trusts).
uted to the grantor’s son; all income would be taxable to the trust, subject to its marginal tax rate.\textsuperscript{215}

The grantor or grantor’s spouse would be deemed to hold a reversionary interest in a portion of a trust under any one of the following set of circumstances:\textsuperscript{216}

- the grantor or grantor’s spouse holds a specified administrative trust power (for example, the right to borrow trust funds without adequate security or interest);\textsuperscript{217}
- the grantor or the grantor’s spouse, alone or in conjunction with any person, has a power to determine who would receive present or future trust benefits;
- a person other than the grantor or the grantor’s spouse has a current discretionary power to make payments of a portion of the trust property to the grantor or the grantor’s spouse or to provide for future payments to either one; or
- trust income is applied or distributed by another person, the trustee, or the grantor acting as trustee or co-trustee for the support or maintenance of a beneficiary (other than the grantor’s spouse) whom the grantor is legally obligated to support and maintain.

This trust distribution deduction disallowance derives its salient features from several current grantor trust rules. The fact that the grantor or the grantor’s spouse retains a reversionary interest (and thus tacit dominion and control) in the trust property qualifies the grantor or the trust, rather than the trust beneficiary, as the appropriate taxpayer. Due to liquidity concerns and the need to coordinate the income and transfer tax systems, the trust seems the more sensible choice.

\textit{C. Coordinating the Income and Transfer Systems of Taxation}

Adopting a proposal to limit grantor trust status would also facilitate coordination of the income and transfer tax systems where trust contributions are concerned. As it stands, these rules are indepen-

\textsuperscript{215} Some commentators might argue that taxing trust income under the compressed rate schedule of Code § 1(e) under these circumstances would be punitive in nature. \textit{Dodge, supra} note 202, at 153. But because trusts are often established by economically well-to-do taxpayers whose own income is subject to the highest marginal bracket rate, trust income would not necessarily bear a higher rate of tax than under the current grantor trust rules.

\textsuperscript{216} \textit{See Proposals, supra} note 210, at 15-16.

\textsuperscript{217} These powers would be akin to those specified under current Code § 675. \textit{See} I.R.C. § 675 (1994).
dent of each other. By mere coincidence, they sometimes function in unison; other times, they do not. And in cases of the latter, not only does this lack of harmonization foment judicial frustration, it fosters artful tax dodging as well.

Coordination would start from the following two interrelated suppositions: (1) when taxpayers make incomplete gifts, the value of the property they transfer is not subject to gift tax, but taxpayers remain responsible for income and estate taxes on it; and (2) when taxpayers make completed gifts, their transfers are ordinarily subject to gift tax, but not income or estate taxes related to such property.

When grantor trust status applies, the grantor's trust contribution would be deemed incomplete and would not constitute a taxable gift (except to the extent payments under the trust instrument are made to someone other than the grantor). This outcome is instinctual: grantors who continue to be taxed on income generated by trust-held property would likely equate such property as being theirs, not expecting transfer tax repercussions until their deaths (when the value of such trust-held property would be includible in their gross estates).

When grantor trust status does not apply, a grantor's contribution to a trust would be deemed complete and would constitute a taxable gift. The trust or the trust's beneficiaries would be the responsible taxpayer, and the value of the property held in the trusts would generally not be includible in the grantor's gross estate.

D. The Proposal in Perspective

Had the Clifford case come before the Supreme Court today, there is little reason to think that Justice Douglas would have been able to assemble a majority opinion in support of his position that the grantor, rather than the trust established by the grantor, be taxed.

218 See supra notes 141–44 and accompanying text.
219 E.g., Comm'r v. Prouty, 115 F.2d 331, 337 (1st Cir. 1940) ("[T]he interrelation of [various taxes] presents many puzzling problems which deserve the attention of Congress.").
221 Griswold, supra note 142, at 342.
222 There would be one minor exception to this rule: a trust contribution would remain incomplete when the grantor retained the right to determine beneficial trust ownership. See Estate of Sanford v. Comm'r, 308 U.S. 39, 46 (1939) (holding that when a grantor retains the power to add or subtract beneficiaries, he has not yet made a completed gift).
223 If the value of the reversionary interest exceeded five percent of the value of such property, the value of such property would be includible in the grantor's gross estate. I.R.C. § 2037(a) (1994).
Reforming the Grantor Trust Rules

The evolution of the progressive rate structure combined with other changes in the Code have nullified many of the justifications intrinsic to the *Clifford* holding.

The same probably could not be said with respect to the decisions in *Bowers* (where the taxpayer established a revocable trust) and *Wells* (where the taxpayer benefited from the income of a trust he established). In instances where the taxpayer retains direct dominion and control over trust property, the taxpayer should be taxed on the income such property generates.

The proposal for reform of the grantor trust rules retains (with some refinement) the two Code sections that are central to the underpinnings of the *Bowers* and *Wells* decisions. Moreover, aside from the theoretical justification for retention of these two Code sections, there is a practical issue at stake as well, namely that the majority of established trusts are revocable in nature. Therefore, ignoring them under the Code relieves significant numbers of trustee taxpayers from the burden of having to file annual trust income tax returns and the government from having to process such returns.224

There are those in Congress and others, however, who may still have serious misgivings regarding certain elements of the proposal. More specifically, they may find fault with the provision that attempts to coordinate the income and transfer tax systems and the introduction of a special restriction on trust distribution deductions. On both counts these detractors have valid concerns, yet for different reasons.

Attempts to coordinate the transfer and income tax systems have been part of the academic landscape for several decades.225 However, each system of taxation is founded upon a different premise (that is, one on the accretion of wealth and the other on the transfer of wealth). These differing premises complicate efforts to coordinate the two tax systems. Yet, even if this section of the proposal must be tabled, its absence would not detract from the effect the rest of this proposal would have on curbing abusive trust arrangements.

The special restriction on trust distribution deductions relating to reversionary interests may also draw objections from commentators. This is because Subchapter J currently permits deductible distributions of trust income to taxpayer beneficiaries whose income may be

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224 See *supra* note 98. Professor Leo L. Schmolka proposed that Congress repeal the grantor trust rules. Leo L. Schmolka, *FLPs and GRATs: What to Do?*, 86 Tax Notes 1473, 1489-90 (2000). He recognized, however, that Congress should provide an exception for a trust wholly and currently revocable by the grantor acting alone, equating such a trust to nothing more than a custodial account. *Id.* at 1490 n.77.

225 See *supra* note 142.
subject to lower tax rates. These commentators would argue that any restriction on trust distribution deductions would unnecessarily complicate trust administrations and is redundant given the compressed income tax bracket structure of trusts and other progressive rate safeguards that are already in place. Although the proposal would ideally include the special restriction on trust distribution deductions, this element of the proposal could also be shelved until such time when the Code's progressive rate structure again becomes more graduated.

CONCLUSION

Reform of the grantor trust rules would lead to several positive changes in the Code: the grantor trust rules would be thrust into modernity, tax gamesmanship in the trust arena would be quashed, and the income and transfer systems of taxation would apply in a more uniform fashion.

This is not to say that the institution of this reform would be entirely painless or without casualty. But in light of the current state of affairs, where grantor trust status is overly inclusive and subject to frequent taxpayer abuse, such are tolerable changes. Reform always comes at some price and here that price is meager in comparison to allowing the status quo to remain unchecked.

Congress must therefore recast and modernize the grantor trust rules. Absent such reform, the black letter of the Code will continue to sanction the use of grantor trusts as a tax avoidance device. This is certainly not what Congress intended when the grantor trust rules were first instituted over half of a century ago, and it seems evident that this is not what Congress now intends.

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226 See I.R.C. §§ 651(a), 661(a) (1994).
227 See supra notes 8–11 and accompanying text.
228 Take, for example, the rules posited under Code § 2702. These rules currently permit grantors to make trust contributions that constitute completed gifts, even when grantors continue to retain a direct trust interest. See McCouch, supra note 160, at 117–21. Under the proposal, these trusts would be classified as grantor trusts. As such, for gift tax purposes, contributions made to these trusts would be treated as incomplete. Code § 2702 would therefore either fall by the wayside or have to be significantly modified were this proposal instituted.

In addition to Code § 2702 being repealed or significantly modified, several other adjustments to the Code would have to be made as well. For example, Code § 1361(c)(2)(A)(i) states that all grantor trusts qualify to be shareholders of an S corporation. Were the scope of grantor trust status to be defined more narrowly, Congress might want trusts that no longer qualify as grantor trusts under the proposal to still qualify as S corporation shareholders. I.R.C. § 1361(c)(2)(A)(i) (1994 & Supp. IV 1998).
Only for nostalgic reasons should Congress thus retain the grantor trust rules in their present form, but nostalgia is a poor basis upon which to formulate tax policy.