

STONE TURNING TO SAND: GRANTOR TRUSTS HAVE A SHAKY LEGAL FOUNDATION

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I. INTRODUCTION

A. “Patriotism” Avoidance in Estate Planning

Faithful morning talk-show watchers, especially those more affluent viewers, were likely shocked on the morning of September 18, 2008 when they discovered that they had not been patriotic when it comes to financing the national government. During the most recent presidential campaign, then vice-presidential candidate Joe Biden appeared on ABC’s “Good Morning America” and informed those well-off Americans that an increase in taxes is a patriotic duty.¹

Other than the relatively few exceptional cases, people have a general desire to accumulate wealth. There are many different reasons why people have this desire. Among other reasons one can presume that people want money for security, access to health care, ability to make purchases, ability to support hobbies, ability to support addictions, greed, and to provide for their current and future family—the last being most in line with this paper.

Vice President Joe Biden would have himself a friend in Justice Oliver Wendell Homes, Jr. in regard to giving money to the United States. In *Compania General De Tabacos De Filipinas vs. Collector of Internal Revenue*, Holmes, in his dissenting opinion, wrote “Taxes are what we pay for a civilized society.”² In keeping with his belief that on the whole taxes are a good thing, Holmes left a will with perhaps the most famous of all residuary clauses:

All the rest, residue and remainder of my property of whatsoever nature, wheresoever situate, of which I may die seized and possessed, or in which I may have any interest at the time of my death, I give, devise and bequeath to the UNITED STATES OF AMERICA.”³

It is probably a safe assumption that no reader of this paper has had or will have a client who wants to make a final act of “patriotism” and leave anything from their estate to the federal government. Rather, most, if not all clients will approach an estate planner with the hope that they will receive sound guidance on tax avoidance rather than tax payment.

Joe Biden finds himself in a very small minority when it comes to the belief that paying taxes is a patriotic duty. Other than Justice Holmes, there are very few who hold a similar sentiment. In fact, a close contemporary and friend of Justice Holmes, who himself is one of the most well respected judges of American jurisprudence, was at odds with Justice Holmes on this issue. Judge Learned Hand wrote:

Over and over again courts have said that there is nothing sinister in so arranging one's affairs as to keep taxes as low as possible. Everybody does so, rich or poor; and all do right, for nobody owes any public duty to pay more than the law demands: taxes are enforced exactions, not voluntary contributions. To demand more in the name of morals is mere cant.⁴

To which all estate planners proclaim: "Amen!"

To arrange clients' affairs to keep taxes as low as possible, professional estate planners have for years sought out the "loopholes" in the Internal Revenue Code—the areas where, for one reason or another, the federal government has not closed the door on tax avoidance. One such loophole is created by the fact that the income tax, transfer tax, and estate tax code sections do not align on all issues—allowing for tax avoidance.⁵

One set of tax statutes that do not align throughout the Internal Revenue Code are the grantor trust rules.⁶ When a trust contains a provision that triggers the grantor trust rules, the Internal Revenue Code will ignore the existence of the trust for purposes of income taxes, and the grantor rather than the trust or its beneficiaries is the taxpayer.⁷ Yet, for estate tax and gift tax purposes, the Code recognizes the existence of the same trust and the trust property will not be part of the grantor's estate.⁸ Further, the Code will usually consider it to be a taxable gift when the trust is created; thus sheltering appreciation in the trust property from transfer taxes.

The use of grantor trusts for tax avoidance in estate planning has been a significant tool in recent decades and has gained more appeal recently as the applicable federal rate has plunged

with the economic crisis of 2008.⁹ And that brings us to the real point of this paper—do grantor trusts remain a viable form of estate planning, or is there a legitimate concern that they are in reality just houses built upon sand rather than stone?

B. *Overview*

The purpose of this paper is to explain where the grantor trust rules came from and explore their fate in the current tax system. It will provide a background in the tax system in which the rules were born and analyze the ability of the rules to survive in a new tax system. In particular, the goal is to show that the Supreme Court’s broad view of “income” in the context of assessing trust income tax to the grantor is no longer needed in the current tax structure. Therefore there is an argument that the grantor trust rules themselves, despite their longevity, have lost their place in the federal tax scheme, and are a risky planning tool.

II. GRANTOR TRUSTS: A HISTORY

“The Congress shall have power to lay and collect taxes on incomes . . .”¹⁰

A. *The Decline of the Progressive Tax Structure*

Not all that long ago, there was a legitimate reason for the grantor trust rules—they increased revenue for the United States. The Sixteenth Amendment to the Constitution of the United States of America was passed in 1913, giving Congress the right to collect income taxes.¹¹ The income tax rate structure around the time that the grantor trust rules were originally adopted was very progressive with the marginal tax rate reaching as high as 94 percent for income above \$200,000 under the Individual Income Tax Act of 1944.¹² But over the years Congress has passed many “revenue acts” in which it has adjusted the tax rate structure,

including most notably the Tax Reform Act of 1986, which transformed the formerly very progressive tax structure and sent tax rates spiraling downward.¹³ Since the Tax Reform Act of 1986, there have been, at most, six tax brackets always capped from around 30 to 40 percent for the wealthiest Americans.¹⁴ Comparing this to the 24 brackets in 1944, or the 32 brackets in 1941, or the 55 brackets in 1932, which reached upward of 90 percent for the top brackets, there has been a virtual elimination of the progressive tax structure.¹⁵ For 2010, there are only six tax brackets with the maximum marginal tax rate at 35 percent for those having a gross income of more than \$373,650.¹⁶

B. *The Need for Grantor Trust Rules Before the Decline of the Progressive Tax Structure*

1. *The Treasury's Best Friend: The Court*¹⁷

Prior to the progressive tax structure succumbing to President Ronald Reagan when he signed the Tax Reform Act of 1986 into law, the grantor trust rules served an important purpose. They were the repair that cemented over the hole in the dam that was hemorrhaging revenue that the treasury wanted and needed.¹⁸ Those individuals who were in the higher tax brackets sought to avoid taxes and did so by deflecting their income to other taxpayers who were in lower income tax brackets.

For instance, in *Lucas v. Earl*,¹⁹ a husband and wife entered into a contract under which all of their income, along with all other property received by either during their marriage, would be held as joint tenants with a right of survivorship. Earl, an attorney, had argued that he and his wife should each be taxed separately for half of the income earned.²⁰ If they could divide their taxes between the two of them, then the marginal tax rate would be significantly lowered because they would be taxed in a lower bracket.

In a very short opinion, Justice Holmes determined that no matter how skillfully drafted a contract may be, the income earned by a husband vests instantly and all of the taxes due on that income are to be paid by him, the income earner.²¹ The Earls' contract, executed in 1901, significantly predated the Sixteenth Amendment, so it likely was not tax motivated, but that did not stop the Court from halting income assignment in its tracks.²² The Court was not about to let taxpayers so easily thwart the progressive tax structure that Congress had created under the powers that it had been newly furnished by the Sixteenth Amendment.²³

The Court remained a friend to the Treasury in several more landmark cases where it prevented the avoidance of the extremely high marginal rates of the time. In *Helvering v. Horst* the Court extended its decision in *Lucas v. Earl* to situations where a gift of income was made without a transfer of the income producing property to the assignee.²⁴ Justice Stone reasoned:

[I]ncome is 'realized' by the assignor because he, who owns or controls the source of the income, also controls the disposition of that which he could have received himself and diverts the payment from himself to others as the means of procuring the satisfaction of his wants. The taxpayer has equally enjoyed the fruits of his labor or investment and obtained the satisfaction of his desires whether he collects and uses the income to procure those satisfactions, or whether he disposes of his right to collect it as the means of procuring them.²⁵

In short, the Court said, "if you, Mr. Taxpayer, would like to take advantage the tax savings that are produced by gifting income earning property to another who pays taxes at a much lower marginal rate, then you actually have to gift the property to that person, but if you prefer to maintain control of that property, then too bad, you must pay the taxes."²⁶ If taxpayers were allowed to make incomplete gifts to lower bracket taxpayers then the progressive tax structure would fail because taxpayers are able to maintain dominion and control over their property without having to pay the income taxes on income producing property.

In a case heard and decided by the United States Supreme Court not long after *Lucas v. Earl*, Justice Holmes again wrote an opinion defending the progressive tax structure.²⁷ The taxpayer in *Corliss v. Bowers* had created a trust giving the income for life to his wife, and a remainder to their children, but instead of making it a complete gift, the taxpayer retained the “power to modify or alter in any manner, or revoke in whole or in part” the provisions and interests created by the trust document.²⁸

In an opinion just as short as *Lucas v. Earl*, Justice Holmes swiftly proclaimed that the grantor of the trust would not be avoiding the taxes. Title in the property was transferred to the trustee, but his wife was the true beneficiary of the income. The income earned by the trust property was distinguishable from the income assigned in *Lucas v. Earl* because it could not be called “vested” in the grantor because the income was never, even for an instant, his. Instead of relying on when and in whom income is vested for the justification of taxing the grantor, Justice Holmes instead declared “taxation is not so much concerned with the refinements of title as it is with the *actual command* over the property taxed—the actual benefit for which the tax is paid.”²⁹

In *Corliss v. Bowers*, the Court was not really making a common law grantor trust rule, but rather was validating the constitutionality of section 219(g) of the Revenue Act of 1924, which was the predecessor to the current Internal Revenue Code § 676, the grantor trust rule treating the grantor as the owner of trust property where the trust is revocable.³⁰ Likewise, three years later, in *Burnet v. Wells*³¹, the Court again did not really do anything to add to the grantor trust rules, but instead validated the constitutionality of another already then-existing grantor trust rule, although at that time not referred to by that name.³²

In *Burnet v. Wells* the taxpayer had set up several irrevocable trusts holding insurance policies on the grantor, and the trustee of the trusts was directed to use income generated by the

trusts to make the insurance premium payments.³³ By making the trusts irrevocable the grantor had avoided the problem that befell the taxpayer in *Corliss v. Bowers*, but he was not home free. In writing the opinion, another of the most famous Justices had the opportunity to add his input on the matter of maintaining the progressive tax structure. In his opinion, Justice Cardozo fell in line with the reasoning Justice Holmes had used in *Corliss v. Bowers*—title is not what matters when it comes to taxation of trusts, what really matters is where the benefit attaches.³⁴ Justice Cardozo relied in part on the legislative history of the Revenue Act of 1924 in making his decision, and that legislative history expressed the need to prevent loopholes bypassing the progressive tax structure. Justice Cardozo wrote:

The purpose of the law is disclosed by its legislative history, and indeed is clear upon the surface. When the bill which became the Revenue Act of 1924 was introduced in the House of Representatives, the report of the Committee on Ways and Means made an explanatory statement. Referring to section 219(h) it said: ‘Trusts have been used to evade taxes by means of provisions allowing the distribution of the income to the grantor or its use for his benefit. The purpose of this subdivision of the bill is to stop this evasion.’ House Report, No. 179, 68th Congress, 1st Session, p. 21. There is a like statement in the report of the Senate Committee on Finance. . . . *By the creation of trusts, incomes had 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. Like methods of evasion, or, to speak more accurately, of avoidance . . . had been used to diminish the transfer or succession taxes payable at death. One can read in the revisions of the Revenue Acts the record of the government’s endeavor to keep pace with the fertility of invention whereby taxpayers had contrived to keep the larger benefits of ownership and be relieved of the attendant burdens.*³⁵

In section 219(g) and 219(h) of the Revenue Act of 1924, Congress had addressed part of the grantor trust problem by enacting what had essentially the same effect as current Internal Revenue Code sections 676 and 677.³⁶ The Supreme Court, in *Helvering v. Clifford*³⁷, opened up the proverbial floodgates when it determined that a trust, which was not subject to either of those sections³⁸, was still taxable to the grantor based on the broad scope of the then-current version of today’s Internal Revenue Code § 61.³⁹ The extraordinary powers held by the grantor

in this case called for the Court to step in to protect the progressive tax structure yet again. The *Clifford* decision afforded a great deal of power and discretion to the government to assess taxes to the grantor where the grantor retains certain rights.⁴⁰

Previously the Court had stated that where a trust's beneficial interest is assignable, and there is not a reservation held by the assignor, then the assignee becomes the taxpayer for income earned by the trust property.⁴¹ But, in *Clifford*, there was a second-thought about what powers may make the income taxable to the grantor. The Court was not only concerned with powers of revocation and payments of life insurance⁴², the court decided the issue was much broader than that, and that the real question was whether the grantor had retained any "dominion or control" over the trust property.⁴³ Justice Douglas wrote, "The bundle of rights which [the grantor] retained was so substantial that [he] cannot be heard to complain that he is the victim of despotic power when for the purpose of taxation he is treated as owner altogether."⁴⁴ In *Burnet v. Wells* and *Corliss v. Bowers*, the Court had used "control" as the basis for finding the statutes in those cases constitutional, but in *Clifford* the Court had gone much further and made "dominion or control" over the trust property the actual test for determining if the grantor should pay the income taxes for the trust property.

There was one immense problem created by the Court. The *Clifford* decision did not explicitly state which trust provisions would constitute "dominion or control" of trust property. It had only presented the provisions of one particular trust that, together, definitely gave the grantor control over the property.⁴⁵ But what about trusts with provisions creating less control than the trust in *Clifford*? Where should the line be drawn? A Note in the Columbia Law Review adequately expressed the problem created by *Clifford* saying, "The available literature on the subject has corresponded in quantity with the litigation. [There is so much that] [o]nly a

sampling can be presented.”⁴⁶ Now that the Court had proclaimed this broader power for the Treasury, the Treasury itself stepped in to define its power.

2. *T.D. 5488: The Treasury Defines its “Clifford Rules”*

In the wake of the landmark decision in *Clifford* there was a scramble to figure out what the decision meant. Allowing the courts to sort it out was leading to pure chaos, with the rule being continually refined and confused through litigation.⁴⁷ The Treasury Department needed to step in and provide some regulations for the tax collectors and the taxpayers alike, because the lack of clear guidelines would have led to continued litigation due to the vagueness of the *Clifford* opinion.⁴⁸

The *Clifford* decision was lacking as adequate guidance because it did not explicitly state which provisions, by themselves, would cause the trust income to be treated as the grantor’s income for purposes of income tax.⁴⁹ The Court stated that the particular trust provision in the trust before the court created tax liability for the grantor under the broad scope of section 22(a)’s definition of income.⁵⁰ Relying on a definitional statute to determine what should be taxable to a grantor was strange, considering the income was already taxable to the trust. Nevertheless the court relied on the definition of income as the reason to tax the grantor, and the court left it open to future court decisions or other actions to narrow the scope of the decision.⁵¹ The Treasury Department basically took that trust provision and broke it down into pieces; making determinations as to what would qualify as being “dominion and control” of the trust property or income under the broader *Clifford* rule.

In specifically listing what trust provisions would cause the trust income to be taxed to the grantor, the Treasury took away some of the elasticity of the rule in *Clifford*, but at the same time its specifics covered a wide range of retained grantor rights. Without the context of the goal

in mind—to prevent income splitting—the definition of “dominion and control” that the Treasury created with these provisions is surprising today because they seem extremely broad, especially when considering that each power in and of itself causes the trust to be a grantor trust. Indeed, that was the point—the Treasury created regulations that closed a form of income splitting, and increased tax revenues. In its preamble and first provisions the regulations themselves cite Clifford and its reasoning:

In order to conform [the][r]egulations . . . to the principles set forth in the decision of the Supreme Court in the case of *Helvering v. Clifford* . . . , such regulations are amended as follows: . . . Income of a trust is taxable to the grantor under section 22(a) although not payable to the grantor himself and not to be applied in satisfaction of his legal obligations if he has retained a control of the trust so complete that he is still in practical effect the owner of its income. (*Helvering v. Clifford*, 309 U. S., 331.)⁵²

The Treasury Department promulgated regulations identifying which trust provisions, in and of themselves, created a “retained control . . . so complete that [the grantor] is still in practical effect the owner of its income.”⁵³

3. *Congress Codifies the Clifford Treasury Regulations*

Almost a decade after the treasury promulgated its *Clifford* regulations, Congress decided the regulations had become well-established rules that should become part of the Code, and did so when it gave the tax code a facelift with the Internal Revenue Code of 1954. The legislative history shows that Congress agreed with the reasoning used by the courts. This is displayed in the committee reports which use the same language as *Clifford* and its progeny. The purpose of the “*Clifford* type trust” rules, as they are called in the House Report, is to provide rules for determining when a grantor has substantial “dominion and control” of trust property or income so it should be taxed to the grantor.⁵⁴

It is significant that Congress has relied on “dominion and control” in codifying the regulations and the *Clifford* decision, and it is revealing that Congress also used *Clifford*’s broad interpretation of “income” as rationale for setting the grantor trust rules in stone.⁵⁵ The fact that these statutes are so heavenly dependent on and attached to the *Clifford* decision and the resulting regulations necessarily ties it to the reasoning for the necessity of the *Clifford* decision and the subsequent regulations—the progressive income tax structure of that time period.

The rules that Congress codified in the Internal Revenue Code of 1954 remain in the current Code, largely unchanged. Sections 673 to 677 and 679 of the Internal Revenue Code identify those powers which create “control” of the trust property for purposes of income tax.⁵⁶ Following is a brief overview of each of the powers which creates grantor trust status⁵⁷:

a. *Reversionary interests.* A grantor is treated as the owner of the trust property over which the grantor retains a reversionary interest exceeding five percent of the value of that portion of the trust property when the trust is created.⁵⁸ When this grantor trust rule is triggered, the grantor actually has a future interest in the trust property for which the income taxes must be paid.

b. *Power to control beneficial enjoyment.* Subject to several exceptions, a grantor is treated as the owner of trust property when the grantor or a nonadverse party holds a power of disposition of the trust corpus or income.⁵⁹

c. *Administrative powers.* There are several administrative powers which create grantor trust status.⁶⁰ The administrative powers which trigger grantor trust status are the power to purchase, exchange, or otherwise deal with the trust corpus or income without adequate and full consideration; the power to borrow from the trust without adequate interest or security;

actual borrowing from the trust and not repaying before the taxable year begins; and other general administrative powers.⁶¹

These administrative powers are some of the more popular provisions used to create grantor trust status in estate planning, especially the section 675(4)(c) power to substitute assets of a equal value, and the section 675(2) power to borrow from the trust without adequate security or interest.⁶² Their popularity stems from the ability to use these provisions without creating a situation where the trust property is included in the estate for estate tax purposes even though it has trust status. These are the powers that offer the grantor the least “dominion and control”

d. *Power to revoke.* The power to revoke is the same power that was analyzed in *Corliss v. Bowers*.⁶³ It was already part of the Internal Revenue Code before *Clifford*.⁶⁴ Under this section the grantor is treated as the owner of any trust property where the grantor has the power to revest title in the grantor.⁶⁵

e. *Income for benefit of grantor.* This section also existed prior to *Clifford*. Its constitutionality was analyzed by the Supreme Court in *Burnet v. Wells*.⁶⁶ Perhaps the most obvious of the grantor trust rules, the grantor has to pay income taxes on income earning trust property when the income is distributable to the grantor or his or her spouse.⁶⁷

f. *Foreign trusts having one or more United States beneficiaries.* Foreign trusts are grantor trusts if the person who transfers property to the foreign trust is a United States “person”, and there is a United States person who is a beneficiary of the trust.⁶⁸

III. OOPS!: THE GRANTOR TRUST SOLUTION BECOMES THE GRANTOR TRUST PROBLEM

A. *A New Planning Strategy is Born*

From the case law, the treasury regulations, and the legislative history upon which the grantor trust rules are founded, it is obvious that they were created with the intention to fix the problem of taxpayers finding new ways to split income and avoid the top-bracket tax rates. For the Treasury, the rules *were* the fix; but they have become the problem.⁶⁹

At one time, grantor trust status was something to avoid; now it is often the goal in estate planning.⁷⁰ Estate planners regularly refer to grantor trusts as “intentionally defective” grantor trusts. The advantages of these trusts have led practitioners to drop the “intentionally defective” from the term because it is only a reflection of a prior time when these were actually something to avoid.⁷¹ A recent Tax Court opinion, recognizing that grantor trusts are no longer a bad thing for taxpayers, stated: “Although specialists call them ‘defective’, these types of trusts are widely used by sophisticated estate planners for honest purposes.”⁷² Of course “honest purposes” is to be read: “avoiding taxes.”

The gaps between the estate, gift and generation-skipping transfer tax, and income tax systems allow for significant planning opportunities.⁷³ The misalignment of the grantor trust rules among the different portions of the tax code make it possible to create trusts that allow the grantor to be the owner for income tax purposes and at the same time transfer property as a completed gift, allowing the trust property to avoid inclusion in the grantor’s estate.⁷⁴ The result of a trust fashioned in this manner is that the trust may grow free from income tax (it is paid by the grantor).⁷⁵ Income tax payments made by the grantor are an additional tax free gift to the trust because for income tax purposes the grantor and the trust are the same person, making the grantor, rather than the trust, responsible for the tax payment.⁷⁶ The government may be receiving the same income tax payment that it would have received whether the trust or the grantor paid the tax, but it is missing out on transfer taxes and estate taxes.

B. Not So Fast! Grantor Trust Powers Cause Estate Tax Consequences

The “gaps” that create the planning opportunities are narrow. If the grantor uses a trust provision that causes the trust property to be included in the grantor’s gross estate then the planning mechanism backfires and causes additional taxes upon the grantor’s death. For instance, if a trust includes a power to revoke, then under section 676 the trust property is treated as the grantor’s property to income tax purposes; however, the trust is also ignored for estate tax purposes and the trust property will be includible in the gross estate under section 2036 and 2038. Inclusion in the gross estate of the grantor defeats the purpose of intentionally creating a grantor trust. Therefore estate planners need to carefully choose which grantor trust rule to “violate.” Many, if not most, of the grantor trust rules not only create grantor trust status, but also pull the trust assets into the grantor’s estate under Code sections 2036, 2038 and others.⁷⁷ Trust property being included in a grantor’s gross estate will negate the benefit provided through the use of the grantor trust in the first place.

A section 673 reversionary interest is includible in the grantor’s estate under section 2033, which includes in the gross estate “the value of all property to the extent of the interest therein of the decedent at the time of his death.”⁷⁸ Therefore section 673 is not a viable option for grantor trust estate planning mechanism. Likewise, sections 2036 and 2038 create a gross estate inclusion minefield for the planner who tries to use the section 674 power to control beneficial enjoyment to create grantor trust status.⁷⁹

Most of the administrative powers under section 675 also risk estate tax inclusion. The power to deal with trust assets for less than full and adequate consideration likely make the trust containing it includible in the grantor's estate under sections 2036 and 2038; or 2041 if the power is given to anyone other than the grantor.⁸⁰ The section 675(2) power to borrow trust assets without adequate security also likely causes estate tax problems under section 2036 and 2038, unless there is adequate consideration in the transaction.⁸¹ Adequate consideration will require that there is interest paid for the loan, because without the interest on the loan it would likely be construed as a retained right under section 2036.⁸² The overlapping of sections 675(2) and 675(3) make the same concerns applicable to 675(3). The section 675(4)(A) and (B) administrative powers over closely held stock are also limited in their viability because under section 2036(b) the retention of voting rights in a controlled corporation is considered a retained life estate in the interest, causing it to be included in the gross estate of the grantor.⁸³

Section 675(4)(C)'s power to reacquire trust property by substituting equal value property is generally considered the safest power to use in creating grantor trust status while avoiding inclusion in the grantor's estate.⁸⁴ The power of substitution has stood up to Internal Revenue Service scrutiny. In a 2006 Private Letter Ruling, the Service said that a grantor's power to reacquire trust property by substituting property of equivalent value will not result in estate inclusion under sections 2033, 2036(a), 2036(b), 2038, or 2039 when the power is exercised in a fiduciary capacity.⁸⁵ This letter ruling was in line with the often cited case *Estate of Jordahl v. Comm'r*, which held that the power to substitute corpus of equal value does not constitute a power to alter, amend, or revoke a trust within the meaning of section 2038.⁸⁶ Further, in 2008 a Revenue Ruling specifically stated that a grantor's power of substitution under section 675(4)(C) exercisable in a nonfiduciary capacity⁸⁷ will not, by itself, cause the value of

the trust corpus to be included in the grantor's estate under sections 2036 or 2038, as long as (1) the trustee has a fiduciary obligation, under local law or the trust instrument, to ensure that the properties substituted are in fact of equivalent value and (2) the exercise of the power of substitution will not shift benefits among the beneficiaries.⁸⁸ There was some concern that the power to substitute assets in a nonfiduciary capacity would cause estate inclusion under 2036 or 2038, but the 2008 Revenue Ruling remedied that concern.⁸⁹ This right has become the most viable of the grantor trust rules for ensuring grantor trust status, but estate tax avoidance.

The section 676 power to revoke will very obviously cause estate tax inclusion under section 2036 and 2038. It uses language describing the very type of transaction that is included under those sections, and especially section 2038, which pulls "revocable transfers" into the estate.⁹⁰ Further, even an attempt give the power to the grantor's spouse will not avoid inclusion in the grantors gross estate because it is a power of appointment under section 2041.⁹¹

The right to income under section 677 is also going to cause inclusion in the estate under 2038 and 2038, unless the grantor's spouse is made a discretionary beneficiary without a general power of appointment.⁹² In sum, section 677 also has its estate tax concerns.⁹³

This section of the paper is very limited as far as providing actual analysis of the estate tax consequences of the grantor trust sections.⁹⁴ However, the purpose of this section was not to analyze how or why many of the grantor trust triggers also create estate tax inclusion, rather it is to show that there are relatively few viable options for creating grantor trusts without being subject to these consequences. The next section proceeds to analyze further the most viable option identified—the power to substitute property of equal value.

IV. STONE TO SAND: DO YOU FEEL THE TREMORS?

A. *Section 675(4)(C): Savior or Trap?*

The estate tax provisions which pull grantor trust property into the gross estate have whittled down the potential grantor trust creation options down to basically one—section 675(4)(C).⁹⁵ With the other sections mostly nullified as grantor trust planning opportunities because of estate taxes, this section has become “old reliable” for many estate planners who use the grantor trust planning strategy. But, for how much longer will old reliable survive?

To say that the power to substitute property of equal value to reacquire trust property is “dominion and control” is arguably the biggest stretch of *Clifford*. *Clifford* itself was a very broad ruling, construing section 22 (now section 61) to include much more than previously as far as individual income goes.⁹⁶ An indication of the lack of dominion and control is the fact that of all the grantor trust statutes created in the wake of *Clifford*, this is essentially the only grantor power that has not been pulled into the gross estate definitional statutes.⁹⁷ That is a testament of what a stretch it is to consider the power to reacquire for substitution of equal value as “dominion and control” over the trust property for tax purposes.

In the grantor trust powers listed in sections 673, 674, 676 and 677 the grantor has a real right to use, direct the use, or receive the income from the trust property. The powers of these sections are clearly dominion or control over the trust property because there is an actual right or benefit available to the grantor. No matter how you define “dominion or control,” the administrative powers of section 675 provide less dominion or control over the trust property than the other sections. The first three administrative powers provide the grantor the ability to borrow or deal the trust property, so it is less dominion or control than the other four sections, but it is still benefit available to the grantor, and therefore it is justified that the grantor pays the income taxes on the trust property. Likewise the first two of the powers listed in section 675(4)

are literally powers of “control.” The power to exercise the voting rights of stock or other securities which consist of a significant amount of voting control, and the power to direct investments or reinvestments of trust funds are the types of control over property that falls literally within any common definition of dominion or control over property.

However, the last of the administrative powers, the power to reacquire the trust corpus by substituting other property of equivalent value, does not rise the same level of control. The trustee of the trust will have a fiduciary responsibility to ensure that the substituted property actually is of equivalent value. In exchanging equal valued property, the grantor is not receiving any measurable benefit. The lack of effect that the grantor has on the property and the value of the property to be received by the trust beneficiaries is indicative of the lack of “dominion and control” over the trust property. While there is undeniably some control within this power, it is the least amount of control afforded by any of the other grantor trust rules.

If the Internal Revenue Service or Congress should decide to act to prevent a further loss of revenue, section 675(4)(C) would be the first to go because it provides the least control to the grantor. It is concerning that there are so many estate plans essentially betting on this particular section remaining when it is undoubtedly the weakest of the indicators of “dominion and control” that were codified in the grantor trust rules. Aside from the vulnerability of section 675(4)(C), the entire grantor trust rule structure could be at risk.

B. The Grantor Trust Rules Are Laws Without a Reason

The statutory grantor trust rules are an extension of the rule laid down by Justice Holmes in *Lucas v. Earl*, as was *Clifford*.⁹⁸ Fruits are to be taxed to the tree from which they grew.⁹⁹ The fruit-and-tree analogy has been aptly summarized by one commentator: “Salary and wages (fruit) are taxed to the person (tree) who earns them, and that investment income (fruit) is taxed to the person who owns the property (tree) that generates it, regardless of who is the owner of the fruit.”¹⁰⁰

The first part of the fruit-and-tree analogy makes sense. When a person works and receives a paycheck for her efforts, it is expected that the person who performs the work will receive the income for the services and will pay tax on the income received. Even in the case where a person tries to assign the income for the work she has performed, as was the case in *Lucas v. Earl*, there is a common sense attachment between the person who performed the work and the income. The *Lucas v. Earl* Court said that there was an immediate “vesting” of the income.¹⁰¹

Earl, in *Lucas v. Earl*, was the tree! It is impossible for the tree to be assigned to another person for the purpose of income for work performed. So there is very much a distinction to be made between the general rule of *Lucas v. Earl* prohibiting the assignment of income and the cases like *Clifford* where income earning property changes ownership. Without a doubt, it is appropriate to tax an individual who actually earns the income in the wage earning case, if for no other reason than the administrative mess that would be created by the spider web of assignments of income among individuals to minimize tax liability.

In the *Lucas v. Earl* type case, the tree cannot change ownership, but in the *Clifford* type case, ownership of the tree may change hands. The fruit-and-tree analogy becomes dicey when applied to trust property. Title to the property is transferred over to the trustee, but trust

provisions may allow the grantor to include certain trust provisions which give them some rights in trust property.¹⁰² The question then is what really should constitute ownership of the trust for income tax purposes? This is the same question that Clifford, the Treasury, and then Congress attempted to answer, and have answered with current grantor trust code sections. But, that was then, and when the same question is asked today is the answer still the same?

In 1954, when Congress codified the grantor trust rules, there were twenty-four tax rate brackets with an initial, low-end, rate of 20 percent increasing gradually to 91 percent for the highest bracket.¹⁰³ There was a real incentive to transfer income earning property to trusts in an effort to skirt the high tax rate for those in the upper brackets. To prevent this, and to protect the progressive tax rate, decisions like *Clifford* began identifying the types of trusts which were avoiding paying taxes.¹⁰⁴

The progressive tax structure that needed protection no longer exists. The Tax Reform Act of 1986 changed the tax structure significantly, and with it, the way grantor trusts are used.¹⁰⁵ At the time the grantor trust rules were created there was a money saving advantage because of the low income tax rate of trusts, but with the 1986 tax reform, that reasoning was eliminated when the trust essentially became the higher bracket taxpayer.¹⁰⁶

Individuals and trusts both pay income taxes, and it makes sense that in order to pay the least taxes, a taxpayer would want to use a trust to avoid paying taxes if the tax rate that applies to the trust is lower than the rate paid by the individual.¹⁰⁷ In 2010 the taxes on trust income reach 39.6 percent for all taxable income over \$7,500.¹⁰⁸ That is the same rate as the highest tax rate for individuals.¹⁰⁹ Without the incentive for individuals to deflect their personal income to trusts since 1986, the purpose of the grantor trust rules is defeated.

The *Clifford* Court stretched for a reason to tax the grantor of a trust which had not explicitly violated any of the then current grantor trust rules.¹¹⁰ It, and other courts, clung to the need to protect the progressive tax structure—the protection of revenue for the federal government.¹¹¹ In doing so it created a version of “dominion and control” which stretches beyond even what the estate tax provisions are willing to include in the gross estate. The “dominion and control” doctrine of *Clifford*, which in today’s context is unnecessarily inclusive of many trust powers, is easily extinguished now that its broad ruling is no longer needed to protect the tax structure of that time period. Now that the grantor trust rules are intentionally “violated” in an effort to avoid paying taxes, the government has an interest in rewriting the grantor trust rules in a way that eliminates the loss of revenue.¹¹²

V. CONCLUSION

The decisions which gave rise to the grantor trust rules were couched in protecting tax revenue. *Clifford*’s broad construction of the definition of “income” was necessary in 1940 to provide this protection, but there have been many changes to the tax code since. The most significant change came in the Tax Reform Act of 1986, which broadened the tax base, and greatly reduced the progressive structure of the tax code. With the reason for their creation largely eliminated, the grantor trust rules have gone from being the fix to creating a loophole. Therefore, estate planners should beware that this planning strategy may not be here to stay. Just as *Clifford* closed a loophole that allowed for tax avoidance, another court or the legislature may close the current loophole created by *Clifford*.

¹ Associated Press, *Biden Calls Paying Higher Taxes a Patriotic Act* (Sept. 18, 2008), available at, <http://www.msnbc.msn.com/id/26771716>.

² *Compania General De Tabacos De Filipinas v. Collector of Internal Revenue*, 275 U.S. 87, 100 (1927) (J. Holmes, dissenting).

³ Last Will and Testament of Oliver Wendell Holmes, Jr., quoted in *Holmes Left Half of Fortune to U.S.*, N.Y. TIMES, Mar. 10, 1935, § 1 at 1. In 1935, when Holmes died he had accumulated approximately \$568,000 in real and personal property. *Id.* In present day that fortune is worth anywhere from \$8,880,000 to \$110,000,000 depending on the measure used. *See*, Samuel H. Williamson, *Seven Ways to Compute the Relative Value of a U.S. Dollar Amount, 1790 to Present*, MeasuringWorth, 2010, <http://www.measuringworth.com/uscompare/> (last visited April 24, 2010) (measuring worth using the consumer price index, GDP deflator, unskilled worker wages, production worker compensation, nominal GDP per capita, and relative share of GDP).

⁴ *Comm'r v. Newman*, 159 F.2d 848, 850–51 (2d Cir. 1947). Judge Hand also wrote:

[A] transaction, otherwise within an exception of the tax law, does not lose its immunity, because it is actuated by a desire to avoid, or, if one choose, to evade, taxation. Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; *there is not even a patriotic duty to increase one's taxes.*"

Helvering v. Gregory, 69 F.2d 809 (2d Cir. 1934) (emphasis added).

⁵ *See infra*, III.A.

⁶ 26 U.S.C. §§ 671–679 (2006).

⁷ *Id.* § 671.

⁸ *See id.* §§ 2036–2038.

⁹ *See* Mike Spector & Anne Tergesen, *Unusual Trusts Gain Appeal in Unusual Time*, THE WALL STREET J., at B9 (April 7, 2009).

¹⁰ U.S. CONST. AMEND. XVI

¹¹ *Id.*

¹² Individual Income Tax Act of 1944, 53 Stat. 231 (May 29, 1944)

¹³ Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (October 22, 1986) (broadening the tax base while eliminating many tax shelters, and lowering the top marginal rate from 50 percent to 28 percent while raising the bottom rate from 11 percent to 15 percent; *see also* Tax Foundation, *Federal Individual Income Tax Rates History: Income Years 1913-2010*, available at http://www.taxfoundation.org/files/fed_individual_rate_history-20091231.pdf (showing the income tax rates since they were created—a glance at the rates during the time period in which the grantor trust rules were formed provides a visual justification for the rules during that time period, while showing the lack of need for those same rules in current years).

¹⁴ *See* Tax Foundation, *supra* note 13.

¹⁵ *See id.*

¹⁶ *See id.*

¹⁷ *See* Assaf Likhovski, *The Duke and the Lady: Helvering v. Gregory and the History of Tax Avoidance Adjudication*, 25 CARDOZO L. REV. 953, 955 (2004) (“Courts in most legal systems play a major role in fighting tax avoidance. They interpret and apply anti-avoidance provisions found in the tax code and sometimes also create judicially-made anti-avoidance doctrines of their own”).

¹⁸ The United States Supreme Court has been characterized as generally being anti-taxpayer when it comes to tax avoidance cases, and the protection of the progressive income tax structure falls in line with that characterization. *See id.* at 957–58.

¹⁹ *Lucas v. Earl*, 281 U.S. 111, 113–14 (1930).

²⁰ *Id.* at 114. At that time there was only one tax structure under which all persons were taxed as individuals; there were no married filing jointly, married filing separately, or head of household tax brackets.

²¹ *Lucas v. Earl*, 281 U.S. at 114–15.

²² *See id.* at 114; *see also* Harry J. Rudick, *The Problem of Personal Income Tax Avoidance*, 7 L. & CONTEMP. PROBS. 243, 249 (1940) (explaining *Lucas v. Earl* was not really a tax avoidance case because the contract was created long before the Sixteenth Amendment).

²³ *See* Jay A. Soled, *Reforming the Grantor Trust Rules*, 76 NOTRE DAME L. REV. 375 (2001) (stating the purpose of the grantor trust rules is to protect the progressive income tax rate structure).

²⁴ *Helvering v. Horst*, 311 U.S. 112 (1940)

²⁵ *Id.* at 116–17.

²⁶ Taxes on income earned by gifted property is paid by the gift’s recipient. 26 U.S.C. § 102(b) (2006).

²⁷ *Corliss v. Bowers*, 281 U.S. 376 (1930).

²⁸ *Id.* at 377.

²⁹ *Id.* at 378 (emphasis added).

³⁰ Revenue Act of 1924, Pub. L. No. 68-176, ch. 234 § 219(g), 43 Stat. 253, 277.

Where the grantor of a trust has, at any time during the taxable year, either alone or in conjunction with any person not a beneficiary of the trust, 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.*

Compare with:

The grantor shall be treated as the owner of any portion of a trust . . . where at any time the power to revest in the grantor title to such portion is exercisable by the grantor or a non-adverse party, or both. 26 U.S.C. § 676(a) (2006).

³¹ *Burnet v. Wells*, 289 U.S. 670 (1933).

³² Revenue Act of 1924, Pub. L. No. 68-176, ch. 234, § 219(h), 43 Stat. 253, 277.

Where any part of the income of a trust may, in the discretion of the grantor of the trust, either alone or in conjunction with any person not a beneficiary of the trust, be distributed to the grantor or be held or accumulated for future distribution to him, or 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. *Id.*

Compare with:

The grantor shall be treated as the owner of any portion of a trust . . . whose income without the approval or consent of any adverse party is, or in the discretion of the grantor or a nonadverse party, or both, may be—(1) distributed to the grantor or the grantor’s spouse; (2) held or accumulated for future

distribution to the grantor or the grantor's spouse; or (3) applied to the payment of premiums on policies of insurance on the life of the grantor or grantor's spouse 26 U.S.C. § 677 (2006).

³³ *Burnet v. Wells*, 289 U.S. at 673.

³⁴ *Id.* at 681 (discussing that a father who pays the premiums of a life insurance policy for his dependents surely benefits from a trust which maintains the payment of those premiums).

³⁵ *Id.* at 675–76 (emphasis added) (internal citations omitted).

³⁶ *See supra*, notes 27 & 31.

³⁷ *Helvering v. Clifford*, 309 U.S. 331 (1940).

³⁸ While not subject to the provisions of the Revenue Act of 1924, the trust still gave the grantor, as trustee, an extraordinary amount of power to control the trust property:

[During the trust] period he had full power (a) to exercise all voting powers incident to the trustees shares of stock; (b) to 'sell, exchange, mortgage, or pledge' any of the securities under the declaration of trust 'whether as part of the corpus or principal thereof or as investments or proceeds and any income therefrom, upon such terms and for such consideration' as respondent in his 'absolute discretion may deem fitting'; (c) to invest 'any cash or money in the trust estate or any income therefrom' by loans, secured or unsecured, by deposits in banks, or by purchase of securities or other personal property 'without restriction' because of their 'speculative character' or 'rate of return' or any 'laws pertaining to the investment of trust funds'; (d) to collect all income; (e) to compromise, etc., any claims held by him as trustee; (f) to hold any property in the trust estate in the names of 'other persons or in my own name as an individual' except as otherwise provided.

Id. at 332–33.

³⁹ *Clifford*, 309 U.S. at 337–38.

⁴⁰ *Id.* at 334–35.

⁴¹ *Blair v. Comm'r*, 300 U.S. 5, 12–13 (1937).

⁴² *See Corliss v. Bowers & Burnet v. Wells, supra*, notes 27 & 31 and accompanying text.

⁴³ *Clifford*, 309 U.S. at 335–36.

⁴⁴ *Id.* at 337.

⁴⁵ *See supra*, note 38 (stating the particular trust provision in question in *Clifford*).

⁴⁶ Note, *T.D. 5488: The Treasury Interpretation of the Clifford Rule*, 46 COL. L. REV. 601 (1946).

⁴⁷ *See, e.g., United States v. Morss*, 159 F.2d 142 (1st Cir. 1947).

Since, in the application of the Clifford doctrine, 'no one fact is normally decisive' it is not surprising that that case has given rise to a considerable volume of litigation. Courts have felt their way from case to case, drawing distinctions and invoking analogies, in an effort to give concreteness to the general proposition that a grantor of a trust remains taxable on the trust income under Sec. 22(a) [now § 61] where the benefits directly or indirectly retained by him blend imperceptibly 'with the normal concepts of full ownership.'

Id. at 142 (citations omitted); *see also Kohnstamm v. Pedrick*, 153 F.2d 506, 510 (2d Cir. 1945).

⁴⁸ *But see, Edmund W. Pavenstedt, The Broadened Scope of Section 22(a)*, 51 YALE L.J. 213, 219 (1941) (arguing that the flexibility of the *Clifford* rule is what makes it a great rule).

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- ⁴⁹ T.D. 5488, 1946-1 C.B. 19.
- ⁵⁰ *Helvering v. Clifford*, 309 U.S. 331, 334 (1940); *see supra*, note 38.
- ⁵¹ *White v. Higgins*, 116 F.2d 312, 320 (1st Cir. 1940).
- ⁵² T.D. 5488, 1946-1 C.B. 19.
- ⁵³ *See id.*
- ⁵⁴ H.R. Rep. No. 83-1337 (1954), reprinted in 1954 U.S.C.C.A.N. 4017, at 4089.
- ⁵⁵ *Id.*
- ⁵⁶ 26 U.S.C. §§ 673–677, 679 (2006 & Supp. 2009). The Code sections themselves are more in depth and contain numerous exceptions and contingencies that affect whether the trust has grantor trust status.
- ⁵⁷ For a more extensive review of creating grantor trust status *see* Stephen R. Akers, Jonathan G. Blattmachr & F. Ladson Boyle, *Creating Intentional Grantor Trusts*, 44 REAL PROP., TR., & EST. L. J. 208, 263–67 (2009).
- ⁵⁸ *Id.* § 673.
- ⁵⁹ *Id.* § 674. A “nonadverse party,” in regard to the grantor trust rules, is a person that does not have a substantial beneficial interest that is adversely affected by the exercise or nonexercise of a power respecting the trust. *Id.* § 672(b).
- ⁶⁰ *Id.* § 675.
- ⁶¹ *Id.*
- ⁶² Robert S. Keebler, *Tax Planning for the Very Large Estate—IDGT Sales*, FAM. TAX. PLAN. FORUM 5, 6 (April 2006).
- ⁶³ *Corliss v. Bowers*, 281 U.S. 376 (1930).
- ⁶⁴ Revenue Act of 1924, Pub. L. No. 68-176, ch. 234, § 219(g), 43 Stat. 253.
- ⁶⁵ 26 U.S.C. § 676.
- ⁶⁶ *Burnet v. Wells*, 289 U.S. 670 (1933); *see supra*, note 32.
- ⁶⁷ 26 U.S.C. § 677. It is questionable whether only the income portion or both income and corpus will be treated as owned by the grantor. It likely depends on the type of grantor trust that is used by the grantor. *See Akers, et al., supra*, note 57 (discussing whether the income, corpus, or both should be included for the grantor trust rule purposes).
- ⁶⁸ 26 U.S.C. § 679.
- ⁶⁹ The goal of the grantor trust rules was to increase revenue, thus the broad interpretation of income upon which the whole grantor trust system is based was created; yet the present use of grantor trusts decreases revenue by allowing people to avoid estate tax and sheltering appreciation on the trust property from transfer taxes.
- ⁷⁰ Alan Halperin & Andrea Levine Sanft, *2004-64 Sparks Applause But Leaves Questions*, EST. PLAN. & TAX. 22, 22 (Sept. 2004).
- ⁷¹ *Id.* at n.1
- ⁷² *Petter v. Comm’r*, T.C. Memo. 2009-280, 2009 WL 4598137 (U.S. Tax Ct.).
- ⁷³ *Id.* at 22.
- ⁷⁴ *Id.*
- ⁷⁵ *Id.*
- ⁷⁶ Rev. Rul. 2004-64; *see also* 26 U.S.C. § 671 (grantor trusts have no income tax liability).
- ⁷⁷ Robert S. Keebler, *Tax Planning for the Very Large Estate—IDGT Sales*, FAM. TAX. PLAN. FORUM 5, 6 (April 2006).
- ⁷⁸ *Id.* at § 2033.

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- ⁷⁹ See *id.* §§ 674, 2036, 2038; see also Akers, et al., *supra*, note 57 (2009) (discussing many circumstances that may create estate tax consequences for the grantor trust).
- ⁸⁰ Akers, et. al., at 238 & n. 161.
- ⁸¹ *Id.* at 239. The overlapping of sections 675(2) and 675(3) make the same concerns applicable to 675(3).
- ⁸² Michael D. Mulligan, *Fifteen Years of Sales to IDITS—Where Are We Now?* 35 ACTEC J. 227, 232 (2009).
- ⁸³ *Id.*
- ⁸⁴ Robert S. Keebler, *Tax Planning for the Very Large Estate—IDGT Sales*, FAM. TAX. PLAN. FORUM 5, 6 (April 2006).
- ⁸⁵ Priv. Ltr. Rul. 200603040 (Jan. 20, 2006).
- ⁸⁶ Estate of Jordahl v. Comm’r, 65 T.C. 92 (1975).
- ⁸⁷ The previous letter rulings and *Jordahl* dealt only with the power in a fiduciary capacity.
- ⁸⁸ Rev. Rul. 2008-22 (April 17, 2008).
- ⁸⁹ *Mulligan*, *supra* note 82 at 233.
- ⁹⁰ 26 U.S.C. § 2038 (2006 & Supp. 2009).
- ⁹¹ Akers, et al., *supra* note 64, at 262–63.
- ⁹² *Id.* at 267.
- ⁹³ *Id.* at 263–67.
- ⁹⁴ For a much more in-depth discussion of estate tax consequences see Akers, et al., *supra*, note 57.
- ⁹⁵ See *supra*, III.B.
- ⁹⁶ Helvering v. Clifford, 309 U.S. 331, 337–38 (1940).
- ⁹⁷ See *supra*, III.B.
- ⁹⁸ Lucas v. Earl, 281 U.S. 111 (1930).
- ⁹⁹ *Id.* at 115.
- ¹⁰⁰ Mark L. Ascher, *When to Ignore Grantor Trusts: Precedents, a Proposal, and a Prediction*, 41 TAX L. REV. 253, 280 (1986).
- ¹⁰¹ *Earl*, 281 U.S. at 115.
- ¹⁰² See e.g. 26 U.S.C. §§ 673–678.
- ¹⁰³ Internal Revenue Code of 1954, 68A Stat. 1.
- ¹⁰⁴ See *supra*, II.B.1.
- ¹⁰⁵ See John B. Huffaker & Edward Kessel, *How the Disconnect Between the Income and Estate Tax Rules Created Planning for Grantor Trusts*, 100 J. TAX’N 206, 206 (2004).
- ¹⁰⁶ *Id.*
- ¹⁰⁷ 26 U.S.C. §§ 1, 641 (2006 & Supp. 2009).
- ¹⁰⁸ *Id.* § 1(e).
- ¹⁰⁹ *Id.* § 1 (Individuals pay 39.6 percent of the excess over \$250,000).
- ¹¹⁰ Helvering v. Clifford, 309 U.S. 331, 337–38 (1940).
- ¹¹¹ See *supra*, II.B.
- ¹¹² See Richard L. Doernberg, *A Workable Flat Rate Consumption Tax*, 70 IOWA L. REV. 425, 428–29 (1985) (noting that Congress generally makes amendments to the tax code to close the loopholes used by the wealthy to avoid paying the full amount of income taxes that the law seeks from them).