Accumulation Trusts After the Revenue Reconciliation Act of 1993

Table of Contents

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I. INTRODUCTION

A. Trust Taxation - Basic Principles

1. TAXATION OF TRUST INCOME

a. Income from property held in trust is taxed either to the trust, the grantor or to the beneficiaries, depending on rights of the grantor or the beneficiaries with respect to the trust income.

1) If beneficial ownership or control over the trust property is retained by the grantor, generally the trust income will be taxed to him or her under IRC Sec. 671-677.

a) The grantor trust rules are aimed at situations when the trust entity should be disregarded as a separate taxable because the trust arrangement functions primarily for tax avoidance purposes.

b) If the grantor's powers pertain only to a part of the trust, then he or she will be considered the owner of the property for only that portion.

2) If the grantor trust rules apply, then actual distributions by the fiduciary to the beneficiaries are treated, for income tax purposes, as gifts to them by the grantor, and are excluded under IRC Sec. 102(a) as property acquired by gift.

3) Beneficiaries (or other third parties who) have the power to receive income or principal from the trust without restrictions are treated as the owner of the income from the trust relating to their power, under the so-called demand trust rules of IRC Sec. 678.

b. If the grantor trust rules are inapplicable, then, in general, the income from a trust is taxed to the beneficiaries if currently distributable to them or to the trust, if the income is accumulated (retained) in the trust.

1) Income that is accumulated in the trust may be subject to another tax when it is distributed to the beneficiaries under the so-called "throw-back" rules.

2) The throwback rules generally tax trust distributions if those distributions were taxed at a lower rate in the trust than if distributed to the beneficiaries.

a) The purpose of these rules is the prevent trust accumulations at lower tax rates if that income would have been taxed at a higher rated if it were distributed directly to the beneficiaries.

b) Given the lack of divergence between the individual tax rates and the trust tax rates, the throwback rules have been rendered obsolete, but they may still have some minor application to trusts which accumulate a small amount of income and whose beneficiaries are in high income tax brackets.

c. Distributions of trust principal in excess of current and accumulated income are received tax-free by the beneficiary under IRC Sec. 102(a). Gifts or bequests of specific sums of money or particular assets are generally deemed to come from the trust principal and are generally received tax-free

1) The tax-free receipt of money or other property, according to IRC Sec. 663(a)(1), must be paid or credited all at once or in not more than three installments, and must not be paid solely from trust income.

d. The trust tax rules generally apply to estates as well as trusts.

2. THE POLICY UNDERLYING THE TRUST TAXATION RULES.

a. The trust tax rules under Subchapter J of the Internal Revenue Code embodies a compromise between two conflicting values.

1) Congress has recognized that trusts serve a legitimate family planning vehicle whereby wealth is transferred from one generation to another, without vesting control over the trust principal in the beneficiaries.

a) Control may be withheld for a variety of reasons: the beneficiary may be too young, inexperienced or irresponsible to handle the assets placed into trust, or the income derived therefrom.

b) The trust, as a legal arrangement which separates beneficial ownership from control by placing legal title to the assets in the trustee, provides a mechanism whereby the trustee can determine the timing and amount of distributions to be made to the beneficiaries.

b. The second concern involves the fact that if a trust were treated as a separate taxable entity for income tax purposes, wealthy taxpayers could lower the overall tax paid by their families by creating accumulation trusts.

1) Congress historically taxed trusts at the “married filing separately” tax rate modified to exclude the zero bracket amount since trusts did not qualify for the standard deduction.

2) In the Tax Reform Act of 1986, however, Congress prescribed an entirely separate tax rate schedule for trusts to prevent them from benefiting from progressive tax rates. According to the Joint Committee explanation, the new trust tax rates were imposed to “significantly reduce the tax benefits inherent in the prior law rules of taxing trusts and estates while still retaining the existing structure of taxing these entities.”

3) By sharply increasing the rate of taxation on accumulations by trusts, the significance of the throwback rule diminished.

A. Change in the law

1. TAX RATES FOR TRUSTS

   a. The Revenue Reconciliation Act of 1993 ("RRA") has drastically increased the rate of taxation for estates and non-grantor trusts. [Unless otherwise stated, the term "trust" means both non-grantor trusts and estates]. Trusts with incomes over $7,500 will be subject to the new income sur-tax, thereby creating a marginal tax rate of 39.6%.

      1) In contrast, an individual reaches the 39.6% bracket once taxable income exceeds $250,000.

   b. The new rates for taxable are:

Taxable Income:	**Tax Rate**
less than $1,500	15%
$1,501 to $3,500	$225 plus 28% on the amount in excess of $1,500
$5,501 to $7,500	$785 plus 31% of the amount in excess of $3,500
over $7,501	$2,115 plus 39.6% of the excess over $7,500

   c. The maximum tax rate for capital gains will remain at 28%.

   d. The alternative minimum tax provisions applies to trusts in the same manner as individuals. It is 24% for alternative minimum taxable income ("AMTI") not exceeding $175,000 and 28% for AMTI exceeding $175,000. The exemption amount for a trust has been raised from $20,000 to $22,500.

2. EFFECTIVE DATE

   a. These new rates are effective for tax years beginning after December 31, 1992. Most trusts are required to have a calendar year, however, some estates which elected a fiscal year could be taxed under the old rates.

   b. The new rates may apply to estates of decedents dying prior to December 31, 1992; however, estates with fiscal years beginning before 1993 do not blend tax rates.

   c. Changes in the alternative minimum tax are effective for tax years after 1992.

   d. Note: The 3-year relief provisions for individuals facing higher taxes caused by the retroactive nature of the RRA do not apply to trusts.

3. CONSUMER PRICE INDEX ("CPI") ADJUSTMENTS

a. The base year for CPI adjustments has been changed from 1989 to 1992. For tax year 1994, however, there will be no CPI adjustments for the 36% or 39.6% brackets.

1) These brackets will receive CPI adjustments for tax years after 1994.

2) The base year for the CPI adjustments for these brackets will be 1993.

B. The Impact on Trust Planning

1. CONGRESSIONAL INTENT

a. In its search for revenue, Congress evidently concluded that rich people are escaping the payment of tax by creating trusts that accumulate income, and chose to tax these trusts at the highest possible rate.

b. The concept of punishing trusts that accumulate is directly at odds for the very purpose of creating an accumulation trust: to avoid distributing funds to a beneficiary who, for a myriad of reasons, is currently incapable of handling the funds.

c. While a high-bracket taxpayer might consider using an accumulation trust to shift the burden of tax to a trust, which, presumably, would be in a lower tax bracket, the solution in such a situation would be to tax the trust at the grantor's highest marginal tax rate.

1) Congress chose to prevent the shifting of tax to a taxpayer's children by enacting the so-called "Kiddie Tax" whereby children under the age of 14 who received unearned income over $1,200 would pay tax on the excess at the parent's tax rate.

a) The "Kiddie-Tax" approach could have been used in the current situation, if Congress believed that accumulation trusts were being employed as a tax dodge.

b) Ironically, the impact of the RRA changes will not severely impact trusts whose grantors or beneficiaries are already in the 39.6% bracket; they will affect the smaller estates of middle and upper-middle income taxpayers, whose grantors and beneficiaries are in lower tax brackets.

2) Since the tax on accumulation trusts was set at such a high rate, Congress clearly intended to use the accumulation trust as a revenue raiser, despite its alleged concerns with tax planning.

3) As a revenue raising device, the accumulation trust is a poor candidate since trustee's usually have the discretion to distribute current income to the beneficiaries and thereby cause the trust income to be taxed at the beneficiary's income tax bracket.

2. THE PROBLEM: ACCUMULATION VERSUS DISTRIBUTION

   a. By targeting the accumulation trust as a revenue raiser, Congress has forced trustees to choose between accumulating income in the trust according to the wishes of the Grantor or distributing that income to the beneficiaries to reduce the rate of tax.

   b. In short, Congress has disrupted and entire segment of long-standing family planning: the use of an accumulation trust to provide for a grantor's beneficiary according to the grantor's desires and concerns — as expressed in the trust instrument, and in reliance of the experience and judgment of trust officers who have been administering such trusts for hundreds of years.

      1) The typical discretionary trust where the trustee may either distribute or accumulate income may reduce the overall tax burden by distributing income to the beneficiaries.

      2) The mandatory accumulation trust, however, where the grantor strongly desires that funds with accumulated to provide for the beneficiary at a later date, will be the most vulnerable to the rise in trust income tax rates. This result, as a matter of social policy, seems cruel and perverse, since it extracts a high rate of taxation for the protection of the needy and vulnerable.

3. ILLUSTRATING THE PROBLEM, THE DRAMATIC INCREASE IN TAX ON INCOME THAT IS ACCUMULATED.

   a. Prior to the RRA, trusts were taxed at the following rates:

Taxable Income:	**Tax Rate**
less than $3,750	15%
$3,501 to $11,250	$562.50 plus 28% on the amount in excess of $3,750
over $7,501	$2,662 plus 31% of the excess over $11,250

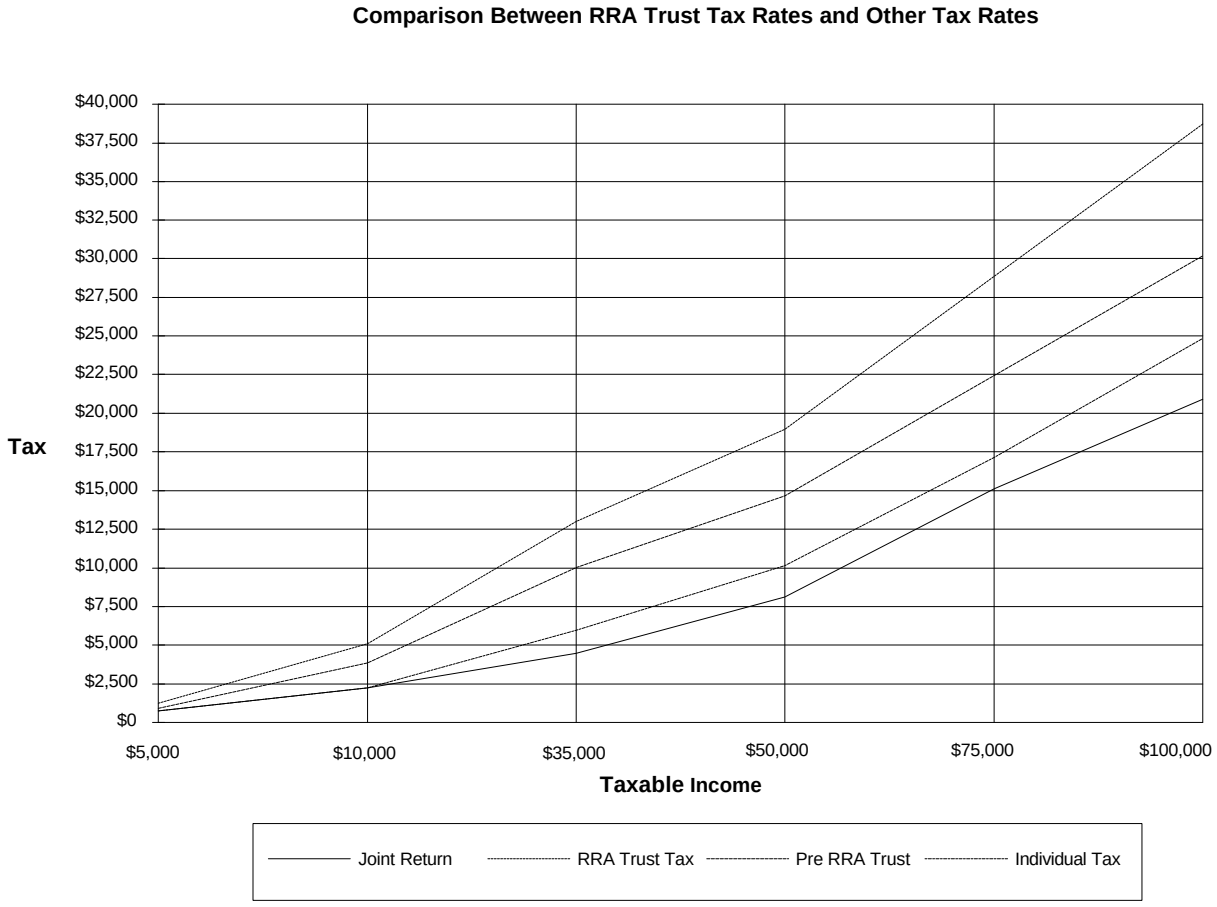
   b. Comparing the rate of taxation between the old law and the new law.

Taxable Income	Tax -- Old Law	Tax -- New Law	Percentage Change
$5,000			
$10,000			
$25,000			
$50,000			

[graph]

c. Comparing the rate of taxation between a trust and an individual taxpayer under RRA.

Taxable Income	Tax -- Trust	Tax -- Individual	Percentage Change
$5,000			
$10,000			
$25,000			
$50,000			



II. TAXING THE INCOME TO THE TRUST

A. Changing the Investment Strategy

1. CAPITAL GAINS:

   a. The rate of tax on capital gains remains at 28%; therefore, trustees could shift the investment mix from investments that produce ordinary income to those which retain their earnings and enhance the value of the investment.

   b. Growth stocks and other types of investments that will appreciate over time, rather than pay current earnings, could be the investments of choice.

   c. In the year of termination, capital gains or losses realized by the trust will be distributed to the beneficiaries as DNI and will be taxed to them as capital gains or losses.

2. TAX-FREE BONDS

   a. Interest on tax-free bonds will not be taxed to either the trust nor the beneficiaries and their income could be accumulated without imposition of the 39.6% income tax bracket.

   b. Note: The tax advantage of purchasing a "qualified United States savings bond" under IRC 135 only applies to individuals and not trusts.

3. PURCHASE OF ANNUITIES

   a. The purchase of annuities or other investments that permit a tax-free build-up may be an appropriate investment, under some circumstances.

B. Trust Deductions

1. TRUSTEE FEES

   a. If family member or beneficiary also a trustee of the trust or personal representative, then payment of personal representatives or trustees fees can create a deduction to the trust or estate.

   b. The higher rate of taxation on trusts and estates may cause more family fiduciaries to receive compensation.

2. ADMINISTRATION EXPENSES

   a. Since the disparity between estate tax rates and income tax rates has lessened, the decision of whether to take administration expenses as a deduction on the estate tax return will have to be reconsidered.

   b. Under the old rates, estates were taxed at a beginning rate of 37%, whereas the highest trust rate was 31%; therefore, it was generally advisable to deduct administration expenses on the estate tax return. With the change in the trust tax rates to 39.6%, fiduciaries may choose to deduct administration expenses against the income tax return.

1) With the rate differential so small, and with the potential tension between the income beneficiary and the remainder beneficiary, the fiduciary's duty to deduct administration expenses has become much more difficult.

2) In cases there the rate differential is insignificant, the fiduciary may choose to split the administration expenses between the income and estate tax return.

d. Administration expenses must be paid by the end of the tax year. The 65-day rule under IRC Sec. 663(b) for trust distributions does not apply to either trusts or estates for the payment of administration expenses.

3. DISTRIBUTIONS TO BENEFICIARIES

a. Under IRC Sec. 661, trusts are entitled to deductions not in excess of "distributable net income" ("DNI") in computing their taxable income for income required to be distributed to beneficiaries currently, and for any other amounts properly paid, credited, or required to be distribution to beneficiaries during the tax year.

1) Under IRC Sec. 663(b), trusts that make distributions to beneficiaries within the first 65 days following the end of the taxable year are treated as making a distribution on the last day of the taxable year.

2) Note: There is no similar rule for estates.

b. As a general rule, capital gains are not part of DNI and cannot be deducted as a distribution.

1) Such gains are therefore taxed to the trust, whether or not distributed to the beneficiaries.

2) Capital gains are taxed at 28%, rather than at the 39.6% highest marginal rate for trusts.

3) Capital gains are considered DNI if they are realized in the year the trust terminates and are taxed to the beneficiaries. Trustees may want to delay the sale of assets until the year of distribution to take advantage of this rule.

4) Also, if capital gains are considered income for fiduciary accounting purposes, under the governing instrument or under local law, they will become part of DNI. Regulation 1.643(a)-3(a)(2) provides an exception whereby capital gains may constituted DNI.

C. Determining the Income

1. WAITING FOR THE K-1 OR 1099

a. Trustees who are aiming for the 15% or 28% trust tax bracket will have to calculate the trust's income, often months prior to receiving the actual K-1 or 1099 forms. Year-end tax estimates of S corporation and partnerships will carry great weight.

1) While a trust will have 65 days to make the year-end determination, estates do not have the luxury of the 65-day rule under IRC Sec. 663(b).

2. DETERMINING INCOME FOR A PORTION OF THE YEAR.

a. When a trust becomes an independent tax-paying entity during the year, such as by the death of the grantor, the amount of income taxed to the trust will depend on the type of entity the decedent had an ownership interest.

b. If the trust owns a partnership interest, it succeeds to the entire distributive share of the decedent partner.

1) If the trust sells the partnership interest before the end of the tax year, it will receive the decedent's distributive share to the date of sale.

2) If the trust distributes the partnership interest to its beneficiaries prior to the end of the tax year, the beneficiaries will be treated as receiving the decedent's distributed share.

3) If the decedent received cash during the taxable year, the trust will be taxed on the full distributive share, but may not have the cash with which to pay the tax on this "phantom income."

c. If the decedent was the beneficiary of another trust or was an "S" corporation shareholder, then some of his distributive share will be reported on his final income tax return. The trust will be dependent on estimates of the decedent's distributable share from the date of death to the end of the entity's taxable year.

d. Also, non-cash distributions of property made to a beneficiary of an ongoing trust who dies mid-year may carry DNI to the trust which is newly created by the decedent's death, and the new trust may not have the cash necessary to pay the increase in tax.

D. Multiple Trusts

1. ONE TRUST OR SEVERAL?

a. Since a trust is taxed on accumulated income as a separate entity, it is sometimes desirable to create as many trusts as possible for purposes of accumulating income at the lower tax brackets.

b. IRC Sec. 643(f) however, requires that two or more trusts be treated as one trust for the purposes of Subchapter J if —

1) The trust have substantially the same grantor and primary beneficiaries; and

2) federal tax avoidance is a principal purpose of the trusts.

a) For purposes of determining the grantor, a husband and wife are treated as one person.

b) Trust may be substantially the same if they have nominal grantors, and contingent beneficiaries are disregarded in determining whether the beneficiaries are substantially the same.

c) If the trusts have substantially independent purposes, then tax avoidance will not be considered a principal purpose.

d) Separate trusts for each child should have separate independent purposes. See: Staff of Joint Committee on Taxation, 98th Cong. 2nd Session, General Explanation of Revenue Provisions of the Deficit Reduction Act of 1984 at 256.

c. The separate share rule of IRC Sec. 663(c) states that a trust will be considered to be two or more trusts if the beneficiaries have substantially separate and independent shares.

1) For example, if a testamentary trust provides that the decedent's three children will be have a one-third share of the income and principal of the trust, and the trustee is permitted to accumulate or distribute that beneficiary's share of income, then the separate share rule would treat the testamentary trust as three separate trusts for purposes of IRC Sec. 643(f).

2) The separate share rule does not apply to simple trust, which, by definition, cannot accumulate income, nor to estates since substantial accumulations by estates would be uncommon. Harkness v U.S., 469 F2d 310 (Ct Cl. 1972) cert. denied, 414 U.S. 820 (1973).

III. TAXING SOMEONE OTHER THAN THE TRUST

A. Taxing the Grantor

1. PRELIMINARY CONSIDERATIONS

a) For income tax purposes, a grantor will be treated as the owner of a trust and therefore will be taxed on the income of the trust, if he or she has any of the powers described in IRC Sec. 661-668, the so-called "Grantor Trust Rules."

1) Generally, a Grantor will be treated as the owner of a trust if he or she has:

(1) a reversionary interest whose value exceeds 5% of the value of the trust when the trust transfer occurs;

(2) certain powers to affect the beneficial enjoyment of the corpus or income; or

(3) specified managerial powers of a broad and unusual character.

2) In addition, if a "non-adverse" party holds the powers described above, then such powers will be treated as being held by the grantor. A non-adverse party would be a party who would answer to, or be

controlled by the grantor, such as an employee, family member, corporation in which the grantor or trust has significant voting power, or the grantor's spouse. [See IRC Sec. 672(c)].

(1) A party who has a beneficial interest in the trust that would be adversely affected by exercising a power in the grantor's favor would be considered an independent trustee and the Grantor trust rules would not apply.

(2) Independent trustees generally will include trust companies, business partners, accountants, and lawyers, even though these trustees may in fact act as the grantor's agents or instrumentalities.

(3) Under IRC Sec. 672(e), the grantor's spouse is treated as the grantor for purposes of the Grantor Trust Rules.

b) Preliminarily, to tax the trust's grantor he or she must still be alive. This option will not work once the grantor has died.

c) In addition, if the trust is a separate taxpaying entity, the grantor trust rules, by definition do not apply to the trust; therefore, a modification to the trust which gives the grantor one or more of the powers under the Grantor Trust Rules must be made.

1) Such a modification may, however, run counter to the trust agreement in which case, the trust must be modified through a court order.

a) California Probate Code Sec. 15409 provides for modification or termination of a trust in changed circumstances. The statute says that upon:

> petition by a trustee or beneficiary, the court may modify the administrative or dispositive provisions of the trust of terminate the trust if, owing to circumstances not known to the settlor and not anticipated by the settlor, the continuation of the trust under its terms would defeat or substantially impair the accomplishment of the purposes of the trust.

b) It would appear that under the trustee's duty not to waste assets, the modification to the trust agreement should be permitted to lower the trust's taxation.

d. The main problem with using the Grantor Trust Rules is if the grantor retains too much control over the trust corpus, he or she will be considered the owner of the corpus for estate tax purposes under IRC Sections 2033, 2036 and 2038.

1) As discussed below, carefully drafted administrative powers will cause the grantor to be taxed on the income of the trust, but the trust corpus will not be includable in the grantor's estate for estate tax purposes.

2) By shifting the incidence of taxation to the grantor, and then by having the grantor pay the tax from his or her separate funds, the trust, in essence, will be able to accumulate income on a tax-free basis.

a) This will permit the beneficiaries to receive a greater of the trust, since no payment of tax will be made by the trust nor the beneficiaries.

b) Also, the grantor's estate will be diminished by the amount of tax paid on the trust's income.

2. THE CLIFFORD CASE.

a. The Grantor Trust Rules evolved from the U.S. Supreme Court's decision in Helvering v. Clifford, 309 US 331 (1940), in which the Court sustained the IRS's determination that the grantor of a trust should be taxed on the trust's income.

1) In the Clifford case, the grantor retained extensive managerial powers over the trust, the trust was to terminate on the earlier of: (i) 5 years; (ii) the grantor's death; or (iii) the grantor's wife's death, and the income from the trust was payable to the grantor's spouse currently or at the termination of the trust, at the grantor's discretion.

2) The Court noted that there was merely a "temporary reallocation of income within an intimate family group," and went on to say:

> ...no one fact is normally decisive but that all considerations and circumstances of the kind we have mentioned are relevant to the question of ownership and are appropriate foundations for findings on that issue.

3) In response to the Clifford Case, the Treasury issued regulations, which later became codified as the Grantor Trust Rules contained in IRC Sec. 671-675.

3. THE GRANTOR TRUST RULES.

a. General Rule:

1) IRC Section 671 states that a grantor will not be taxed as the owner of the trust solely on the grounds of his dominion and control over the trust, unless he or she holds a power that is specifically disallowed under IRC Sec. 673-677.

a) The grantor must hold a power that violates a specific code section, rather than have general dominion and control over the trust, for the Grantor Trust Rules to apply.

b) This provision does not override other IRC code provisions that would tax the grantor on income, such as the assignment of income doctrine, since the grantor is being tax for reasons other than his or her dominion and control over the trust.

c) IRC Sec. 671 does not offer protection to trusts that are shams or lack economic reality.

b. Reversions:

1) Under IRC Sec. 673(a), a grantor is considered the owner of a trust if he or she has a reversionary interest in either income or corpus that exceeds 5% of the value of such portion when the trust was created.

2) The grantor's reversionary interest is generally the unrestricted right to receive the trust corpus and/or income on the trust's termination.

3) This statute was amended in 1986 to prevent the temporary reallocation of income within the family under the so-called "Clifford Trust" arrangement in which the grantor would transfer property to a family member, in trust, for 10 years, when would receive the property back upon the trust's termination.

c. Revocable Trusts:

1) The grantor is treated as the owner of a trust under IRC Sec. 676 if the grantor, the grantor's spouse or a non-adverse party has the power to reinvest title to trust property to the grantor.

a) This power may be expressed in the trust instrument or may arise under operation of law.

b) A power that is equivalent in nature, such as the unrestricted right to invade trust corpus, is treated as the power to revoke.

2) Corliss v Bowers, 281 U.S. 376 (1930), involved a case which challenged the constitutionality of taxing the grantor of a revocable trust. The grantor claimed that the income from the trust was never his because he never exercised the power to revoke the trust. The Supreme Court, through Justice Holmes, made the following historic statements concerning revocable trusts and the exercise of the power to revoke:

> Taxation is not so much 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...
>
> The income that is subject to a man's unfettered command and that he is free to enjoy at his own option may be taxed to him as his income, whether he sees fit to enjoy it or not.

d. Income Used for Grantor's Benefit:

1) Under IRC Sec. 677, the grantor, in general, is treated as the owner of any portion of a trust whose income is or may be distributed or accumulated for future distribution to the grantor or the grantor's spouse, without the approval of an adverse party.

2) An adverse party is defined under IRC 672 as a person having a substantial beneficial interest in the trust which would be adversely

affected by the exercise or non-exercise of a power which he possesses respecting the trust.

a) Generally, a related or subordinate party under IRC Sec. 672(c) is not an adverse party for purposes of IRC Sec. 677.

b) Therefore, if the beneficiary whose consent is necessary for the grantor's actions is a child of the grantor, IRC Sec. 677 will treat the grantor as the owner of the trust.

2) The grantor is also considered the owner of the trust whose income is or may be applied to pay life insurance premiums on the grantor's life or the grantor's spouse's life.

3) In Helvering v Stuart, 317 U.S. 154 (1942), the Supreme Court held that a trust whose income could be used to support the grantor's children was considered income that the grantor enjoyed personally. Therefore, the grantor was taxed as the owner of the trust.

4) Since the Stuart Case, Congress has broadened IRC Sec. 677 to include family support trusts and income that is used to discharge the grantor's legal obligations, as well as his spouse's legal obligations.

e. Controlling Beneficial Enjoyment:

1) IRC Sec. 675(a) treats the grantor as the owner of the trust when the grantor, the grantor's spouse or a non-adverse party has the power of disposition to effect the beneficial enjoyment of the trust, without the approval or consent of the adverse party.

2) This provision prevents the grantor from controlling who will receive the benefits of the trust, such as the addition or deletion of beneficiaries, except to add after-born or after-adopted children.

3) Although the general rule prohibiting the grantor from directing the beneficial enjoyment of the trust is quite broad, there are numerous exceptions to the general rule.

4) The following 6 powers, contained in IRC Sec. 674(b), can be vested in the grantor or anyone else, without causing the Grantor Trust Rules to apply:

a) The power to dispose of the trust corpus exercisable by will.

b) The power to allocate corpus or income among charitable beneficiaries.

c) The power to distribute corpus if limited by standard or charged against the income beneficiary's share of corpus.

1) The scope of the reasonably definite standard, as defined in Reg. 1.674(b)-1(b)(5), includes the power to distribute corpus "for the education, support, maintenance or health of the beneficiary; for his

reasonable support and comfort; or to enable him to maintain his accustomed standard of living; or to meet an emergency."

2) The regulation states that the terms "please, desire or happiness of the beneficiary" do not meet the reasonable definite standard.

3) Note: Similar standards are set forth for estate tax purposes in Reg. 20.2041-1(c)(2).

d) The power to withhold income temporarily from a beneficiary, if the accumulated income.

1) The income must be ultimately paid to: (i) the beneficiary; (ii) the beneficiary's estate; (iii) the beneficiary's appointees; or (iv) on termination of the trust or no distribution of trust corpus that is augmented by the accumulated income, to the current income beneficiaries in shares that are irrevocably stated in the trust.

e) The power to withhold income during a beneficiary's legal disability or minority (under age 21).

f) The power to allocate receipts and disbursements between corpus and income.

5) Under IRC Sec. 674(d) a trustee (other than the grantor or the grantor's spouse living with the grantor) may distribute or allocate income to or among beneficiaries, subject to a reasonably definite external standard set out in the trust instrument.

a) The grantor cannot have the unrestricted power to substitute, remove or add trustees, except to add substitute another qualified trustee.

6) Under IRC Sec. 674(c) if at least one-half the trustees are independent, the trustees may have broad discretionary power to sprinkle income and corpus among the beneficiaries and the trustee's discretion will not be limited by a standard.

f. Administrative Powers.

1) IRC Section 675 treats the grantor as the owner of the trust if he or she has certain prohibited administrative powers exercisable primarily in the grantor's interest, rather than in the interests of the beneficiaries. The prohibitive powers include:

a) The power to deal with the trust property for less than adequate consideration.

b) The power to borrow without adequate interest or security.

c) Actual loans made to the grantor which have not been completely repaid before the beginning of the taxable year.

(1) Loans made by an trustee who is not the grantor, the grantor's spouse or a related or subordinated person in which the interest rate and security are adequate, are exempt from the year end repayment rule.

d) Certain nonfiduciary administrative powers

(1) The ability to control or influence a corporation through a combination of voting stock held by the grantor and the trust. The power to control the assets of the trust, through direction or veto to the extent the trust holds stock in which the grantor and trust, combined, hold significant voting power, is also proscribed.

(2) The power to reacquire trust property by substituting other property of equivalent value is also prohibited (a continuing option in the grantor over what property will belong in the trust).

2) In Private Letter Ruling 9037011, the service ruled that an irrevocable trust in which a third party had the power, exercised in a non-fiduciary capacity, at any time to acquire trust property by substituting property of equivalent value, would cause the grantor to become the owner of all of the trust under IRC Sec. 675(4)(C).

a) More importantly, the IRS ruled that the power to substitute property held by the third party would not cause the trust corpus to be includable in the grantor's estate for estate tax purposes.

b) The trust would also be a trust eligible to hold "S" corporation stock under IRC Sec. 1361(c)(2)(A)(i).

3) Modifying an existing trust to give a third party the power to substitute property for existing trust property could be the best approach to creating a grantor trust for income tax purposes, while eliminating grantor trust status for estate tax purposes.

a) As described below, if the grantor desires to place "S" corporation stock in trust, this approach could be quite useful since the trust would not have to meet the restrictive requirements of the qualified "S" corporation trust rules under IRC Sec. 1361(d).

B. Taxing the Beneficiary

1, PRELIMINARY CONSIDERATIONS

a. The beneficiary of the trust will usually be in a lower tax bracket than the grantor and, if possible, the trust's income should be taxed to the beneficiary.

b. If the trust document permits distributions to the beneficiary, then the trustee, by distributing DNI to the beneficiary will shift the tax on the income to the beneficiary, but such an approach could be at odds with the grantor's desire to accumulate income in the trust for the beneficiary's future benefit.

c. If the trust could be amended or modified to make the beneficiary the owner of the trust's income for tax purposes through the use of a "Crummy" power to withdrawal, but without actually making a current distribution of trust income to the beneficiary, this could solve the problem of high tax rates on trust accumulations of income and could be consistent with the grantor's intentions.

1) But the beneficiary would have to consent to such a change, and such a change would have to be permitted under local trust law, such as California Probate Code Section 15409.

2) As a practical matter, the trustee would have to distribute to the beneficiary sufficient income to pay the tax on the trust's income.

3) Also, if the beneficiary is under age 14, the "kiddie tax" will cause the grantor to be taxed on the trust's income on amounts over $1,200 per year.

a) This result, however, will generally not cause the trust income to be taxed at any higher rate than it otherwise would have been taxed if the trust paid the tax, since the grantor's highest tax bracket will be 39.6% on taxable income over $250,000. The trust, in contrast, will be taxed at 39.6% on all income over $7,500.

2. DISTRIBUTIONS DIRECTLY TO THE BENEFICIARY

a. If the trust documents permits the trustee to make current distributions, the trustee could simply make direct distributions of DNI to the beneficiary and thereby cause the beneficiary to be taxed on the trust's income.

b. This approach, however, could be at odds with the grantor's purpose in setting up the accumulation trust: to accumulate income currently rather than to pay it out to the beneficiary.

c. Beneficiaries may be expected to use the new trust brackets as justification for demanding current distributions on the theory that to accumulate income at a cost of 39.6% amounts to the trustee "wasting assets."

1) The new trust tax bracket will undoubtedly exacerbate the tension between the beneficiary's desire for current income distributions and the trustee's duty to comply with the desires of the grantor.

3. AMENDING THE CURRENT TRUST

a. If the beneficiary will agree, the trust could be amended or modified to give the beneficiary a power that would cause the income of the trust to be taxed

currently to the beneficiary, under IRC Sec. 678, but that would sufficiently restricted so as to not interfere with the grantor's intent.

b. IRC Sec. 678 provides that someone other than the grantor will be considered the owner of portion of the trust, if that person can vest in himself or herself, by exercise of a power vested solely in him or her, unless another part of the Grantor Trust Rules makes the grantor the owner of that portion.

1) In Mallinckrodt vs. Nunan, 146 F2d 1 (8th Cir), cert. denied, 324 U.S. 871 (1945), the beneficiary of a trust was entitled receive so much of the income of the trust as he requested. The Court relied on the ruling in the Clifford case and concluded that:

> ... it is the possession of power over the disposition of trust income which is of significance in determining whether ... the income is taxable to the possessor of such power, and that logically it makes no difference whether the possessor is a grantor who retained the power or a beneficiary who acquired it from another.

2) IRC Sec. 678 was the codification of the result in Mallinckrodt.

3) If the power is given to a beneficiary who is a minor, the minor is considered the owner of the portion of the trust to which the power applies, even though he or she is incapable of legally exercising the power.

a) In Revenue Ruling 81-6, 1981-1 C.B. 385, the IRS ruled that it is the existence of the power rather than the capacity to exercise such power that determines whether a person other than the grantor will be treated as the owner of any part of the trust.

c. IRC Sec. 678 and using a "Crummy" power of withdrawal.

1) Under IRC Sec. 678(a)2), powers that have been released or otherwise modified may cause IRC Sec. 678 to apply.

a) Anyone who has released or modified a IRC Sec. 678 power may still be treated as though he or she created a continuing trust, if he or she retains such control as would, within the principles of IRC Sec. 671-677 cause a grantor to be treated as the owner of the trust.

b) IRC Sec. 678 describes both presently exercisable powers and powers that have been modified or released so as to create results similar to the Grantor Trust Rules.

c) One difficulty with IRC Sec. 678(a)(2) involves lapsing powers, such as the "5 and 5" power described in IRC Sec. 2041(b)(2).

(1) The 5 and 5 power allows the power holder, on an annual basis, to withdraw the greater of $5,000 or 5% of

the value of the assets out of which an exercise of the power can be satisfied.

(2) Section 678(a)(2) may not literally apply since a power that lapses does so one its own; it is not "partially released or otherwise modified" as required under IRC Sec. 678(a)(2).

(3) In Private Letter Ruling 9034004, the IRS ruled that IRC Sec. 678(a)(2) applied to lapsed rights of withdrawal, including the portion that falls within the "5 and 5" exception for estate and gift tax purposes.

(a) In fact, IRC Sec. 678 does not contain an exception for the lapse of a "5 and 5" power; however, that could be because a lapse of a power was not considered by Congress to be within IRC Sec. 678(a)(2) in the first place.

(4) In Private Letter Rulings 8142061 and 8545076, the IRS stated that an individual who permitted a Crummy power to lapse with respect to a trust was treated, for income tax purposes, as having withdrawn the assets subject to the power and recontributed those assets to the trust.

(a) Under this approach, the holder of the power was treated as the original grantor of the recontributed assets and would be taxed on the income attributable to the recontributed assets.

(b) If the goal is to tax the beneficiary on the income of the trust, then the recontribution theory expressed in Private Letter Rulings 8142061 and 8545076 would support that approach.

d. To shift the incidence of taxation onto the beneficiary would be giving the beneficiary the right to appoint the income of the trust to himself or herself, a proposition that, if exercised by the beneficiary, could possibly defeat the grantor's intent for creating the trust.

1) Nevertheless, IRC Sec. 678 provides a mechanism to lower the tax on trust income by taxing it to the beneficiary.

2) In addition, the IRS has ruled that a lapse of a power of withdrawal causes the beneficiary to be taxed on increasingly larger portions of income (including capital gains) as the owner of that portion of the trust that was originally subject to the right of withdrawal.

a) The IRS's position with respect to lapsing powers of withdrawal will assist the trust in its effort to shift the income tax burden to the beneficiary.

4. CREATING A NEW PARALLEL TRUST

   a. If amending the current trust is not possible or desirable, the trustee could consider creating a new trust with distribution provisions identical to the present trust, but giving the beneficiary a "Crummy" type power to withdraw the income paid to the trust.

      1) This would have the benefit of continuing the intentions of the grantor under the old trust, but having the trust income taxed to the beneficiary under the new trust.

      2) If the beneficiary exercised his or her right to the income under the "Crummy" power, the trustee would then have the option to refrain from making future distributions and to accumulate the income at old trust's 39.6% tax bracket.

      3) Under this arrangement, the trustee would pay income to the beneficiary sufficient to cover the beneficiary's income tax liability.

5. FORMING AN "S" CORPORATION

   a. The permitted under local law, the trustee could form a new corporation, transfer the trust's assets to the corporation in exchange for stock under IRC Sec. 351 and then elect "S" corporation status for the corporation.

   b. Although the corporation would hold passive activity investments, there would not be a personal holding company tax under IRC Sec. 541 since that section does not apply to "S" corporations.

   c. The trust, however, would have to either be a grantor trust or meet the requirements for a qualified subchapter "S" trust ("QSST") under IRC Sec. 1361(d)(3) and the beneficiary would have to make the election to be taxed under IRC Sec. 1361(d).

   d. The "S" corporation income, loss, credits and deductions would be taxed directly to the beneficiary, but until funds were distributed from the corporation to the trust, there would be no income to the trust in a fiduciary accounting sense.

      1) Distributions could be made to the trust when the trust needed to make distributions to the beneficiary.

      2) As a practical matter, annual distributions should be made to the beneficiary to cover his or her tax liability.

   e. The advantage to this approach is that once the beneficiary elects to be taxed, the trustee remains in control as to the timing of future distributions of income, except for the income necessary to cover the beneficiary's tax liability.

      1) Unlike the power to appoint income or principal under IRC Sec. 678, or the "Crummy" withdrawal power discussed above, the beneficiary will not have a power to withdraw the income or

principal generated by the corporation and the grantor's intent for the creation of the trust will remain intact.

f. The disadvantage to this approach is that the trust must comply with the restrictive provisions of the QSST. Generally, only a one beneficiary "educational" trust or similar trust would meet the requirements of a QSST.

1) Under IRC Sec. 1361(d), a QSST —

a) Must have only one beneficiary;

b) The income beneficiary must receive the trust's corpus if the trust terminates during his or her lifetime; and

c) The income must be distributed currently or be required under the terms of the trust to be distributed currently.

2) Because of these limitations, a grantor could not transfer S corporation stock to a single trust for the benefit of all his children, unless each child had a separate share of the trust and the trust provided that only named children could be beneficiaries.

a) Therefore, an accumulation trust providing for discretionary distributions among beneficiaries would not qualify as an QSST.

b) A grantor trust that upon the death of the grantor became a QSST with separate trust shares for each beneficiary, will be permitted to hold "S" corporation stock, according to Private Letter Ruling 9304017.

(1) This ruling is noteworthy since it recognizes that successive trusts can meet the QSST requirements.

g. An IRC Sec. 678 trust, a trust in which an individual (such as a beneficiary) other than the grantor is considered the owner for income tax purposes, may be eligible to hold "S" corporation stock.

1) Since IRC Sec. 1361(c)(2)(A)(i) would require the entire trust to be owned by the beneficiary, the beneficiary must have a power to withdraw all the principal of the trust.

2) The power to withdraw the entire principal has two drawbacks —

a) The beneficiary could withdraw the entire principal, something the grantor may not desire; and

(1) The power to withdraw the entire corpus would be considered a general power of appointment which would cause the entire trust principal to be included in the beneficiary's estate for estate tax purposes.

b) In Private Letter Rulings 8613054 and 8809043, the IRS held that where the sole income beneficiary had a noncumulative power of withdrawal over transfers to a trust, the trust would be

eligible to hold “S” corporation stock under IRC Sec. 1361(c)(2)(A)(i).

(1) According to these rulings, if the beneficiary failed to exercise the power of withdrawal, thereby allowing the power to lapse, the trust would still meet the grantor trust rule under IRC Sec. 677 and, therefore, could still own “S” corporation stock.