Does A Wind-Up Trigger The Grantor Trust Rules In Spousal Remainder Trusts?

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Under a spousal remainder trust, the income from the trust is paid to a beneficiary (e.g., the grantor's child) for a term of years, and at the end of the term the remainder passes to the grantor's spouse. If the spousal remainder trust achieves its intended objective, the trust's income will be taxed to the beneficiary because the trust is not encompassed by the "grantor trust" rules contained in sections 671 to 677 of the Internal Revenue Code of 1954.

Moreover, depending on the amount transferred and the term of the trust, creation of the trust has either no or minimal gift tax consequences. The term interest given to the beneficiary qualifies for an annual exclusion,1 and the remainder interest given to the grantor's spouse qualifies for the gift tax marital deduction.2

If the present value of the term interest (when combined with other gifts to the beneficiary during the calendar year) is less than $10,000, the donor doesn't have to file a gift tax return.1

Three events combined to bring the spousal remainder trust, which is of relatively recent vintage,3 into the estate planning picture. Enactment of the unlimited marital deduction, in the Economic Recovery Tax Act of 1981, eliminated any gift tax consequences for a qualifying gift to the donor's spouse. Thus the remainder given to the spouse in a spousal remainder trust is free of gift tax.

In the Dickman case,4 decided in 1984, the Supreme Court ruled that an interest-free loan has gift tax consequences even if the loan is payable on demand. This decision, and the statutory rules for the taxation of such loans enacted later in 1984, have all but eliminated the use of the interest-free loan as a means of shifting income to a low-bracket taxpayer.7

The third event was the promulgation, in October 1983, of the ten percent tables for valuing term interests,6 making Clifford trusts less attractive as income-shifting arrangements. Under the regulations, the factor used to value a ten-year term interest is .614457 of the principal amount.

Only $16,250 (by a single person, or $32,500 for a married couple) can be transferred to a ten-year trust without exceeding the $10,000 per-donee annual exclusion under the federal gift tax. By contrast, the factor used to value a three-year term interest is .248685 of the principal amount.

If the donor spouse transfers assets worth $40,000 to a spousal remainder trust for a term of three years, the value of the term interest falls within the $10,000 annual exclusion under the federal gift tax.

Clifford trusts are not recognized as an income-shifting arrangement unless the trust term is for at least ten years.9 On the other hand, the term of a spousal remainder trust can be as long or as short as the grantor wishes.

Indeed, the shorter the term, the greater the amount that can be transferred in trust within the annual exclusion. Thus the grantor can secure the benefits of shifting income without tying up his property for ten years.

What makes the spousal remainder trust available as an income-shifting arrangement? In 1969, section 677(a) was amended to provide that the grantor shall be treated as owner of a trust (and thus taxable on the trust's income) if the income:

is, or, in the discretion of the grantor or a nonadverse party, or both, may be —
1. distributed to the grantor or the grantor's spouse;
2. held or accumulated for future distribution to the grantor or the grantor's spouse; or
3. applied to the payment of premiums on policies of insurance on the life of the grantor or the grantor's spouse.

However, only section 677(a) was amended to bring distributions to a spouse within the statutory scheme. Section 673, which sets forth the "reversionary interest" rule, was not amended. If on termination the trust corpus passes to the grantor's spouse rather than to the grantor, the disposition does not trigger the grantor trust rules.

Because of the substantial tax benefits that are obtainable through the use of spousal remainder trusts, it is not surprising that the Treasury Department moved swiftly to curb their use (and also Clifford trusts), as part of Treasury's broader assault on the use of trusts to shift income.

Under Treasury proposals published in November 1984,10 and the President's continued on page 49
Does a Wind-up Trigger the Grantor Trust Rules?

By MITCHELL M. GANS
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Upon expiration of the term of years that precedes the spouse's remainder in a spousal remainder trust, the trustee is required under state law either to distribute the income to the spouse during the wind-up period or to accumulate it and distribute it together with the principal at the completion of the wind-up period. Assuming that the spousal remainder trust is as a general matter effective to shift the income to the income beneficiary, should the trust be treated from its inception as a grantor trust (with the consequence that the trust's income is taxable to the grantor) when the income during the wind-up period inures to the benefit of the grantor's spouse?

Professor Johanson argues that the trust is a grantor trust solely during the wind-up period, not from the trust's inception. In my view, if income inures to the benefit of the spouse during the wind-up period, the trust is a grantor trust from its inception (so long as the wind-up period commences during the first ten years of the trust).

When a Grantor Trust?
To start, let's hypothesize the creation of a trust which requires that income be paid to the grantor's son for five years and that it then be paid to the grantor's spouse for one year, with remainder in the grantor's spouse — a fact pattern that is equivalent to a spousal remainder trust with a one-year wind-up period.

Professor Johanson's view of this hypothetical situation is that, assuming spousal remainder trusts are valid as income-shifting devices, the income is taxable to the son during his term and that the income during the spouse's one-year term is taxable to the grantor by virtue of Section 677.

My view, on the other hand, is that under Section 677 the trust is a grantor trust from its inception because income is required to be distributed to the grantor's spouse within 10 years of the trust's creation.

Obviously, an examination of these differing views requires an analysis of Section 677. In essence, the section contains a general rule and an exception. The general rule provides that the grantor is taxed on the trust's income if that income "is, or, in the discretion of the grantor or a non-adverse party, or both, may be" distributed to the grantor or the grantor's spouse.

The exception, found in the flush language of Section 677(a), provides that the section does not apply to a discretionary power over income that is not exercisable until more than 10 years after the trust's creation; when the exception applies, the trust is treated as a grantor trust only for the year in which the power is exercisable.

Year-by-Year vs. Inception Rule
What is clear from the face of the statute is that, with respect to powers becoming exercisable beyond the ten-year period, the section is applied on a year-by-year basis. That is, the trust is not a grantor trust from inception but merely becomes such a trust when the power becomes exercisable after the 10-year period.

Where, however, the power is exercisable within the ten-year period, the trust is a grantor trust from its inception.

What is not clear from the face of the statute is whether a year-by-year or inception rule applies where the trust contains a mandate to distribute income, a situation not involving a power and, therefore, not within the scope of the flush language.

Three Solutions
This ambiguity in the statute with respect to non-powers can be resolved in one of three ways:
(1) an inception rule, which would require that the trust's income be taxed to the grantor from the time the trust is created if income will be distributed to the grantor or the grantor's spouse at any time during the trust's term;
(2) a year-by-year rule, which would require that the trust's income be taxed to the grantor only for those taxable years in which the income is to be distributed to the grantor or the grantor's spouse;
(3) an amalgam of the year-by-year and inception rules, which would require an inception approach if income is to be distributed to the grantor or the grantor's spouse only for those taxable years in which the income is to be distributed to the grantor or the grantor's spouse;
(4) an amalgam of the year-by-year and inception rules, which would require an inception approach if income is to be distributed to the grantor or the grantor's spouse at any time during the trust's term and a year-by-year approach if income is not to be so distributed until beyond the ten-year period.

Professor Johanson argues for the
second approach, a year-by-year rule, in the non-power context. To support his argument, he hypothesizes a trust which requires that income be paid to the grantor’s son for 11 years and then to the grantor for ten years (Example 4). It is universally understood, as Professor Johanson points out, that this trust is not a grantor trust from its inception. Rather, the grantor will merely be taxed on the trust’s income during his ten-year term. Professor Johanson infers from this that Section 677(a), as applied to non-powers, must contemplate a year-by-year approach; for the application of an inception rule would make the grantor taxable on the income required to be distributed to his son during the son’s 11-year term, a result that would violate our universal understanding.

What is implicit in this reasoning is that it is inappropriate to apply a ten-year rule similar to that found in the flush language to income distributions in the non-power context. I disagree. In my view, mandatory (i.e., non-power) income distributions should be treated in a fashion that is reflective of the manner in which the flush language treats powers.

**Amalgam Approach**

In other words, I believe that neither the inception rule nor the year-by-year rule is always appropriate. Instead, I opt for an amalgam of the two rules. So, in the trust hypothesized, I would agree that Section 677 does not apply during the son’s eleven-year term. But my agreement with Professor Johanson’s conclusion is predicated on a different rationale.

He believes that Section 677 is always applied on a year-by-year basis in the non-power context and that, therefore, the section cannot begin to apply until beyond the ten-year period. But what would his conclusion be if we amended the trust to make the income distributable to the grantor’s spouse dependent upon the exercise of discretion by a non-adverse trustee? I assume that in this power context Professor Johanson would apply the flush language and conclude that the trust is a grantor trust from its inception because the power becomes exercisable within the ten-year period.

**The Tax-Control Link**

I am troubled by these two conclusions. Considering these two trusts from a policy perspective, I would argue that the trust which mandates an income distribution to the grantor’s spouse presents a much stronger case for applying grantor-trust principles than does the trust containing the discretionary provision.

The predicate for this argument is the inveterate principle that the greater the control the taxpayer retains over income, the more appropriate it is for him to be taxed on it. And since the grantor has certainly retained more control over the income where he mandates a distribution to his spouse — as opposed to the income being distributable to the spouse in the exercise of a trustee’s discretion — I would think that the mandatory-distribution case should produce not a lesser but indeed a greater tax burden to the grantor than the discretionary-distribution case. To be sure, it would be surprising if Congress intended in enacting Section 677 to produce a greater tax burden for the grantor in those cases where he has retained less control.

**Regulation Authority**

The amalgam approach that I have set forth can be derived from the regulations. The regulations, in my view, contemplate parallel treatment for powers and non-powers — i.e., a year-by-year approach for both, except that the inception approach is applicable when the power becomes exercisable or the income becomes distributable during the first ten years of the trust term. Reg.

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*YES*
The almost certain demise of the spousal remainder trust does not diminish the importance of the issues considered in this article and in the companion article written by Professor Gans. Quite a few of these trusts have been created over the past several years. The grantors of these trusts (and their attorneys) have obviously contemplated that the trust income will be taxed to the beneficiaries, not to the grantor.

Are spousal remainder trusts valid as income-shifting arrangements, or are they subject to the grantor trust rules?

Jonathan Blattmachr was apparently the first person to raise this provocative issue. Blattmachr pointed out that "the theory of why the spousal remainder trust is not a grantor trust is that the spouse receives a remainder from (as opposed to a continuing income interest) the trust when it terminates."

He noted, however, that the regulations to section 641 recognize that there is inevitably a "wind-up" period between the time a trust formally terminates and the time the trustee actually makes final distribution. Under the regulations, "the trust continues after the death of a life beneficiary for a period reasonably necessary to a proper winding up of the trust." Because a spousal remainder trust presumably will continue for a brief period after the term interest ends, and because the spouse is entitled to the income during this wind-up period, "it is at least arguable," suggested Blattmachr, "that the grantor's spouse will be receiving the 'beneficial enjoyment of the income' of the trust during the wind-up period," thus triggering section 677(a) and the grantor trust rules.

Blattmachr's suggestion, and Professor Gans' article written in response to my paper, are bound to trouble attorneys who have prepared spousal remainder trusts for their clients. The purpose of this article is to lay those concerns to rest.

I suggest that the spousal remainder trust is not subject to the grantor trust rules as they exist today. Explicit statutory language — which, as noted above, is assuredly forthcoming — is required to eliminate spousal remainder trusts as effective income-shifting arrangements.

**Safe for Two Reasons**

There are two responses to the concerns raised by Gans and Blattmachr. The first — which I regard as the most telling and as dispositive of the issue — is that the wind-up regulation cited by Blattmachr, and the wind-up theory upon which Gans' analysis is predicated, have no application to the grantor trust rules contained in Subpart E of Subchapter J.

Rather the wind-up regulation sets forth an income tax accounting rule applicable only to trusts that are regarded as taxable entities under Subparts A through D of Subchapter J.

Second, even if a wind-up theory is somehow read into the grantor trust rules — the explicit statutory language and the Commissioner's own regulations notwithstanding — the wind-up period would make the trust a grantor trust for only the wind-up period.

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Section 1.677-(a)(1)(b)(2) provides: "...the grantor is treated, under Section 677, in any taxable year as the owner . . . of a portion of a trust of which the income for the taxable year or for a period not within the exception described in paragraph (e) of this section [inasmuch as paragraph (e) is the portion of the regulation interpreting the flush language, "a period not within the exception described in paragraph (e)" must refer to any of the first ten years of the trust’s term] is, or in the discretion of the grantor . . . may be distributed to the grantor or the grantor’s spouse . . ."

To paraphrase this regulation, the grantor is treated as the owner of a trust in any taxable year if (1) the trust’s income for that taxable year is or may be distributed to the grantor (i.e., a year-by-year approach) or (2) the trust’s income for any of the first ten years of the trust is or may be distributed to the grantor (i.e., an inception approach where the income is or may be distributed in the first ten years).

To put it simply, if, as Professor Johnson suggests, the regulation contemplates a year-by-year approach only in the context of non-powers, why does the above-quoted regulation, which applies to powers and non-powers, explicitly incorporate both an inception and a year-by-year approach?

**Draftsman’s Intent**

Perhaps, it is arguable that the draftsman of the regulation inserted the inception approach with the intent of making it applicable only to powers. However, as I read the regulation, the inception and year-by-year rules can both be applicable in the power and non-power context.

Indeed, the regulation sets forth the year-by-year approach ("for the taxable year") and the inception approach ("a period not within the exception described in paragraph (e)") in the disjunctive and makes no attempts to limit the application of either of these approaches to the power or non-power context.

Had the draftsman intended to so limit the application of these approaches, he could have easily provided one rule for powers in one sentence and a separate rule for non-powers in another sentence. But he did not. Rather, he combined powers and non-powers

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with an inception and a year-by-year rule all in one sentence without any differentiation. And this suggests to me that the draftsman intended to make both rules potentially applicable to both powers and non-powers — in short, to adopt the amalgam approach.

Seeking support for his argument in the regulations, Professor Johanson makes reference to the first sentence of the regulation dealing with accumulations of income: “If income is accumulated in any taxable year for future distribution to the grantor (or his spouse in the case of property transferred ... after Oct. 9, 1969), section 677(a)(2) treats the grantor as an owner for that taxable year.” (Emphasis provided by Professor Johanson.) Reg. Section I.677(a)-1(f).

Conflicting Interpretations

He then applies the quoted sentence to a hypothesized trust, (Example 2 (revised), which is to last for 11 years; for the first five years, income is to be paid to the grantor’s son; in year six, income is to be accumulated for ultimate distribution to the grantor’s spouse at the time of the trust’s termination; in years seven through 11, income is again to be paid to the grantor’s son.

Professor Johanson concludes that only the income accumulated in year six is taxable to the grantor in that year and that Section 677 does not attribute to the grantor the income payable to the son in the other ten years of the trust’s term. His premise is that, with respect to such accumulations, the grantor is only taxed “for that taxable year,” the year of accumulation.

I do not believe that the quoted phrase, “for that taxable year,” is intended, where trust income is to be accumulated for the grantor’s spouse at any time during the first ten years, to preclude the grantor from being taxed on trust income from the trust’s inception.

Rather, in my view, the phrase is merely intended to make clear that, where the accumulation occurs beyond the ten-year period, the grantor is taxed on the accumulated income in the year of accumulation, not the later year in which it is to be paid to the grantor’s spouse. And so, unlike Professor Johanson, I would conclude that, in the trust hypothesized by him, the grantor should be taxed on the trust’s income from inception.

My view finds support in the second sentence of paragraph (f):

The exception set forth in the last sentence of section 677(a) does not apply merely because the grantor (or his spouse in the case of property transferred in trust by the grantor after October 9, 1969) must await the expiration of a period of time before he or she can receive or exercise discretion over previously accumulated income of the trust, even though the period ... [is greater than ten years].

Two Propositions

Two propositions can be extracted from this sentence. First, a grantor cannot qualify for the year-by-year approach provided for in the flush language merely because the trust requires that income accumulated during the first ten years be distributed after the ten-year period.

Second, an inescapable inference inherent in the first proposition is that an accumulation failing to qualify for the year-by-year approach of the flush language — i.e., an accumulation occurring within any of the first ten years of the trust term — triggers an inception approach. In other words, where income is to be accumulated within any of the first ten years of the trust for later distribution to the grantor’s spouse, the grantor is taxed on the trust’s income from inception.

On the other hand, if the accumulation is not to be effected until after the first ten years, application of the year-by-year approach will only subject the grantor to taxation on the trust’s income in the year of accumulation — and if the accumulated income is to be distributed in a later year, the grantor is nevertheless subject to tax in the year of the accumulation.

Moreover, I think it is unlikely that the draftsman of paragraph (f) was mindful of the kind of hypothetical trust posited by Professor Johanson — an 11-year trust with income to the grantor’s son in years one through five, an accumulation of income in year six continued on page 55.
A trust does not automatically terminate upon the happening of the event by which the duration of the trust is measured. A reasonable time is permitted after such event for the trustee to perform the duties necessary to complete the administration of the trust. Thus, if under the terms of the governing instrument, the trust is to terminate upon the death of the life beneficiary and the corpus is to be distributed to the remainderman, the trust continues after the death of the life beneficiary for a period reasonably necessary to a proper winding up of the affairs of the trust. However, the winding up of a trust cannot be unduly postponed and if the distribution of the trust corpus is unreasonably delayed, the trust is considered terminated for Federal income tax purposes after the expiration of a reasonable period for the trustee to complete the administration of the trust.18

In short, the wind-up regulation establishes a sensible accounting rule that determines the proper duration of a trust as a taxable entity. It has no application to a trust that was not a taxable entity to begin with because of the rules set forth in Subpart E.

Unlike Blattmachr, Gans makes no reference to the wind-up regulations under section 641. Instead, it appears that he simply assumes that a wind-up period is inevitably a part of any trust — impliedly within the trust's terms — even though not explicitly set forth in the trust instrument.

Bright-Line Test

Even if it were conceded that such a wind-up period should be recognized as a matter of practical trust administration, should such an "implied" wind-up period trigger the grantor trust rules?

No, it should not. The purpose of the statutory grantor trust rules is to establish a "bright line" test for determining when a trust is, or is not, to be recognized as a taxable entity. First promulgated as the Clifford Regulations in 1946,9 and then incorporated in statutory form in the Internal Revenue Code of 1954, these rules "established standards by which the taxpayer might regulate his future conduct."19

As to whether a trust falls within or outside the grantor trust rules, this is determined by the language contained in the trust instrument itself: the interests expressly created and the powers explicitly granted. The trust's terms are then measured against the rules delineated in the statute as enacted by Congress.

Nowhere in the statute, or in the regulations to Subpart E, is reference made to any implied or inferred wind-up period. A taxpayer is fairly entitled to rely on the bright-line tests set out in the statute and its implementing regulations.

As one commentator has noted, "Dominion and control as grounds for taxation are limited to those specified in Subpart E . . . . So long as the trusts are drafted within the permissible framework and the trustees act within it, . . . the trusts must receive tax recognition."21

In my mind, the foregoing analysis disposes of any concern that a wind-up theory may be read into either the statutory grantor trust rules or the trusts that are subject to those rules. Any further discussion of the possible effect of a wind-up period may give more credibility to the contrary argument than it deserves.

Let us assume, however, that a wind-up period is impliedly within the terms of any trust and that the grantor trust rules are somehow relevant. Even if this were the case, the wind-up period would not make a spousal remainder trust a grantor trust for its entire term. Rather, the trust would be a grantor trust only for the wind-up period.

Section 677(a) begins by stating: "The grantor shall be treated as the owner of any portion of a trust . . . ." The central issue turns on the meaning to be given the term "portion."

The only guidance is given in the regulations at section 1.671-3. Here it is pointed out that the "portion" owned by the grantor (or another person) may be the trust's ordinary income, the trust's corpus, or both income and corpus.

This regulation also recognizes that the "portion" may consist of specific trust property, a fractional interest in the trust, or a specific dollar amount of income or corpus. However, I suggest that for purposes of section 677(a), the "portion" owned by the grantor (or

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another person) may be a time-slice; i.e., the right to one year's income. Consider the following example.

Example 1. On July 1, 1985, H transfers securities worth $100,000 to a trust for a term of 11 years. Under the trust, 90 percent of the income shall be paid to H's son S. The trustee may in its discretion distribute the remaining 10 percent of income to H's wife W. On termination of the trust, the trustee shall distribute the trust principal, and any income accumulated from the 10 percent share, to W.

Since trust income "may be . . . distributed . . . to the grantor's spouse," the trust in Example 1 is a grantor trust — but only with respect to 10 percent of the trust. The regulations recognize such an "undivided fractional interest in the trust," although not with this explicit an example.

The trust in Example 1 might be called a "vertical portion" trust, since it splits the trust's income interest vertically into the 90 percent and 10 percent shares.

I suggest that the term "portion" also applies to a "horizontal portion" trust, where the trust's income is split up in time segments. That is, if section 677(a) and not section 673 applies, the grantor can be the owner for one year within the ten-year period without making the entire trust a grantor trust.

Example 2. On July 1, 1985, H transfers securities worth $100,000 to a trust for a term of 11 years. The trustee shall pay all trust income to S for five years, until June 30, 1990. The trustee shall accumulate the income for Year Six (July 1, 1990, to June 30, 1991) for distribution to H's wife W on termination of the trust. From July 1, 1991, through June 30, 1996, the trustee shall pay all trust income to S. On termination of the trust, the principal shall be distributed to H.

While the trust in Example 3 is clearly a grantor trust, this is not because of section 677(a). Nothing in section 677(a) (including the last sentence thereof, relating to powers that can be exercised after ten years) applies to make the trust in Example 3 a grantor trust.

Although the term "powers" is not expressly defined in Subpart E, it seems clear that the reference to "powers" is to the type of powers covered by sections 674 through 676. A provision calling for a mandatory distribution is not a "power." The reason that the trust in Example 3 is a grantor trust for the entire trust term is section 673(a):

The grantor shall be treated as the owner of any portion of a trust in which he has a revocatory interest in either the corpus or the income therefrom if . . . the interest will or may reasonably be expected to take effect in possession. . . ."

It can't be section 677(a) that causes us to apply the grantor trust rules to the entire trust simply because the grantor will receive income in some future year.

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which is to be distributed to the grantor’s spouse upon termination and income to the grantor’s son in years seven through 11 — when he inserted in the regulation the phrase “for that taxable year.”

The entire paragraph deals simply with accumulations occurring in one year that are to be distributed in a later year. Two types of such accumulations are contemplated: where the accumulation is to occur in each of the first ten years of the trust (see the example provided) and where the accumulation is not to occur until after the expiration of the first ten years of the trust term (see the second section of the paragraph).

The kind of trust hypothesized by Professor Johanson, where the accumulation is to occur in only one of the first ten years, is not discussed at all. Even Professor Johanson points out that the trust he hypothesized is not one anyone would want to create.

Given the impractical nature of the trust hypothesized and the two types of accumulations explicitly discussed in the paragraph, I believe it is likely that the draftsman of paragraph (f) did not have within his contemplation a fact pattern similar to the hypothetical.

Consequently, in my view, the draftsman did not intend, in using the phrase “for that taxable year,” to adopt the year-by-year result suggested by Professor Johanson in the kind of trust hypothesized by him.

Finally, Professor Johanson cites Reg. Section 1.671-3(c) for the principle that a grantor can be treated as the owner of a trust by virtue of his power over or right to a dollar amount of income. He argues that this dollar-amount-of-income concept can, as a practical matter, only be applied on a year-by-year basis and that, therefore, the draftsman of the regulations under Section 677 must have contemplated a year-by-year approach.

The trust hypothesized by Professor Johanson in support of this argument requires that the income be paid for five years to the grantor’s son and that $5,000 of the trust’s income be paid to the grantor’s spouse in year six; the balance of the income in year six, as well as the income in years seven through 11, is to be paid to the grantor’s son; upon termination, the trust principal is to be distributed to the grantor’s spouse.

In Professor Johanson’s view, the
portion of the trust attributed to the grantor can only be determined for year six, the year in which a dollar-amount of income is to be paid to the grantor's spouse. Consequently, as he sees it, no portion of the trust's income for years one through five can be attributed to the grantor. I disagree.

Reg. Section 1.677(a)-1(g) contains an example illustrating the application of the dollar-amount-of-income concept in the context of Section 677. The trust in the example requires that $5,000 of trust income is to be subject to a discretionary right in the grantor for the entire term of the trust. The conclusion reached is that the grantor "is treated as the owner [for each year of the trust] of a portion of the trust which will permit a distribution of income to him of $5,000."

Why can't the reasoning applied in the example contained in the regulations be applied to the hypothetical posited by Professor Johanson? Since the grantor's spouse is entitled to $5,000 of income in year six in Professor Johanson's hypothetical, it would be reasonable, I think, to apply the inception approach by assuming that the grantor's spouse is entitled to $5,000 of trust income in years one through five as well.

Using this assumption, I would then determine the portion or percentage of the trust to be attributed to the grantor in each of the first five years by reference to the ratio of $5,000 to the income of the trust in each of the years.

This method for determining the portion of the trust to be attributed to the grantor is not significantly different from the one that would be utilized were the grantor's spouse to be entitled to receive a fixed percentage of income in one of the first ten years.

If, for example, the grantor's spouse were to receive 10 percent of the trust's income in year six, then I would assume that an inception approach would require that 10 percent of the trust's income be attributed to the grantor in each of the first five years.

Would Professor Johanson find the same practical impediments in the application of the inception rule in the context of a power relating to a specific dollar amount? Assume, for example, that a trust requires that income be distributed to the grantor's son for five years and that a non-adverse trustee has discretion to distribute as much as $5,000 of the trust's income to the grantor's spouse in year six.

In this case, I would think that since a power is involved, even Professor Johanson would apply, despite his practical impediments concern, an inception approach and, therefore, attribute to the grantor a portion of the trust's income for all six years. If the dollar-amount-of-income concept can be so applied on an inception basis in the power context, it would seem that it could be just as easily applied on the same basis in the non-power context.

Without question, Section 677 is ambiguous insofar as non-powers are concerned. In my view, the amalgam approach is the most sensible construction of the statute. This construction provides parallel treatment for powers and non-powers. From a policy perspective, as I have argued, it is sound to treat powers and non-powers in a similar fashion. Significantly, the regulations, I believe, contemplate parallel treatment afforded by the amalgam approach.

FOOTNOTES

1. Of course, the trust instrument could provide that during the wind-up period the income be paid to someone other than the spouse. For example, the trust might provide that the beneficiary holding the term of years receive the income during the wind-up period.

2. In Professor Johanson's previous draft, on which my response is based, his premise was that the grantor-trust rules apply to a spousal-remainder during the wind-up period but not during the income beneficiary's term of years. He has, however, taken a different position in his final draft. Relying on the fact that the wind-up provision (Treas. Reg. Section 1.641(b)-3(b)) is not explicitly incorporated into the grantor-trust regulations, he now argues that the wind-up concept is not applicable to grantor trusts and that, therefore, once the term of years has expired, there is no longer a trust upon which the grantor-trust rules could operate.

Professor Johanson leaps from his argument that the wind-up regulation is not applicable to grantor trusts to his conclusion that grantor trusts are not considered trusts for tax purposes during the wind-up period. In my view, the absence of a specific wind-up provision in the grantor-trust regulations does not mean that a grantor trust is non-existent during the wind-up period. Under state law, a trust is deemed to continue for a period of time sufficient to allow the trustee to wind up trust affairs. And the courts have consistently held, quite aside from the regulation, that since state law recognizes the continuation of trusts during the wind-up period, they remain in existence during the wind-up period.
from page 54
Otherwise, the trust set out in Example 4 would be a grantor trust from its inception:

Example 4. On July 1, 1985, H transfers securities worth $100,000 to a trust for a term of 21 years. The trustee shall pay all trust income to $ for 11 years, until June 30, 1996. From July 1, 1996, through June 30, 2006, the trustee shall pay all trust income to H.

No one would assert that the above trust is a grantor trust for its first 11 years. By its terms, the trust in Example 4 is not subject to section 673. But isn’t this trust exempted by the last sentence of section 677(a)? No, it is not, because it does not involve “a power the exercise of which can . . . affect the beneficial enjoyment.”

Since it is understood that the trust illustrated by Example 3 is a grantor trust (since income is payable to the grantor within the ten-year period), it apparently is assumed that the result would be the same if the income were payable to the grantor’s spouse during the ten-year period. However, in such a case section 673 does not apply (since spouses are not mentioned in section 673); and, I submit, section 677(a) does not apply.

Let us revisit Example 2:

Example 2. On July 1, 1985, H transfers securities worth $100,000 to a trust for a term of 11 years. The trustee shall pay all trust income to $ for five years, until June 30, 1990. The trustee shall accumulate the income for Year Six (July 1, 1990, to June 30, 1991, for distribution to H’s wife W on termination of the trust. From July 1, 1991, through June 30, 1996, the trustee shall pay all trust income to $. On termination of the trust, the trustee shall distribute the principal, together with the income accumulated in Year Six, to W.

What do the regulations tell us as to how this case should be handled? The first sentence of section 1.677(a)-1(f) states: “If income is accumulated in any taxable year for future distribution to the grantor (or his spouse in the case of property transferred . . . after Oct. 9, 1969), section 677(a)(2) treats the grantor as an owner for that taxable year . . .”

The last sentence of the same regulation repeats this rule: “If income attributable to transfers after October 9, 1969, is accumulated in any taxable year during the grantor’s lifetime for future distribution to his spouse, section 677(a)(2) treats the grantor as owner for that taxable year even though his spouse may not receive or exercise discretion over such income prior to the grantor’s death.”

This is strong authority in support of the “horizontal portion” theory that I have propounded. In searching the secondary authorities, I have found little discussion of this issue — largely, I suspect, because there has been no reason to discuss it. The trusts used as examples in this paper are a professor’s classroom examples, and would not be encountered in a real-world setting.

However, language in a treatise of which Mr. Blattmachr is co-author supports this analysis.

It is questionable whether section 677 should be construed to tax the grantor on current income that cannot be distributed to or accumulated for him or his spouse even though income of some later year within the ten-year period may be distributed or accumulated (for example, where, upon the grantor’s death, after a short life expectancy, income becomes currently distributable to his widow)."

Another example from the regulations supports this analysis. Section 1.671-3(c) states that “if the grantor . . . is treated as an owner because of his power over or right to a dollar amount of ordinary income, he will first take into account a portion of those items . . . sufficient to produce income of the dollar amount required.”

The example illustrating this “dollar amount” rule is one in which the grantor is entitled to income of $5,000 per year for the entire trust term. Let us now return to Example 2 and twist it around.

Example 5. On July 1, 1985, H transfers securities worth $100,000 to a trust for a term of 11 years. The trustee shall pay all trust income to $ for five years, until June 30, 1990. With respect to the income for Year Six (July 1, 1990 to June 30, 1991), the trustee shall pay H’s wife W $5,000 of the trust’s income, and shall pay the remaining income to $. From
July 1, 1991, through June 30, 1996, trustee shall pay all trust income to S. On termination of the trust, the trustee shall distribute the trust principal to W.

The regulation quoted immediately above deals with the right to receive a specific dollar amount during each year of the trust. If, however, a trust as described in Example 5 were created, the only way to determine "a portion of those items of income and expense entering into the computation of ordinary income . . . sufficient to produce income of the dollar amount required" would be to look at taxable Year Six, and Year Six only.

Thus the regulations themselves, as well as the Michaelson & Blattmachr treatise on Income Taxation of Estates and Trusts, support this "horizontal portion" analysis of the grantor trust rules.

Let us now apply this analysis to a spousal remainder trust with (say) a two-year term during which trust income is payable to the grantor's son S.

Even accepting the dubious proposition that the spouse has a "wind-up" interest that triggers the grantor trust rules, this would make the trust a grantor trust for the wind-up period only, and would not taint the trust for the two years in which trust income is payable to S.

When the grantor trust rules were amended in 1969 to add references to the grantor's spouse in section 677, it may well be that failure to also make reference to the grantor's spouse in section 673 (created a 'void' or 'loophole' in the grantor trust rules where there is a remainder interest in the grantor's spouse rather than a continuing income interest to the spouse or a reverter to the grantor."

"Spirit" Not Determinative

It may also be argued that "the 'spirit' of the grantor trust rules is violated by the spousal remainder trust." However, the taxation of trusts, as with taxation of other arrangements or transactions, is governed by the statutes enacted by Congress, and not by 'spirits,' or by what Congress should have said but didn't say.

If it is decided that spousal remainder trusts should not be allowed as a means of shifting income within the family unit, corrective measures should be taken in Congress (as, it appears, will occur this year). The "problem" should not be corrected by reading into a trust a term that the trust instrument does not contain, or by reading into the grantor trust rules a term that is not set out in the statutes enacted by Congress.

The courts have consistently and properly noted that the tax consequences of a transaction are governed by statute and not by any considerations of oughtness, even though a "loophole" may be involved.

The spousal remainder trust, which appeared on our scopes just a few years ago, will not be with us for very long. The income-shifting benefits available under the arrangement are about to be legislated out of existence.

However, taxpayers who have established such trusts are properly and fairly entitled to rely on the "bright line" rules enacted by Congress, and the current grantor trust rules do not apply to such trusts.

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**FOOTNOTES**

1. 18 C.F. Tres. Reg. §25.2503-3(c) Example (4).
2. IRC §552.
3. IRC §6019.
6. IRC §7872.
9. Tres. Reg. §30.2021-7(f), Table B; 25.2312-5(f), Table B.
10. IRC §673.

Another advantage of the spousal remainder trust in non-community property states is that it provides a gift vehicle to cover the contingency of "deaths out of order." Frequently, one spouse (often the husband) owns the bulk of the marital assets. If the non-proprietary spouse dies first, she may not have sufficient assets to utilize the unified estate tax credit available to her estate. By transferring assets to the spouse, the spousal remainder trust achieves two planning objectives: temporary income-shifting and eventual equalization.


13. A "qualified beneficiary trust" would be a continued on page 60.
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