Invitation Accepted: Weighing In on the Grantor Trust Rules

To the Editor:

I accepted the invitation of Alan L. Montgomery and Ryan L. Montgomery (the "Authors") in their response letter published on May 2, 2022, also written by Kara Kalenius Novak and Kaitlyn Kelly Perez.[1] The invitation was to compare the Authors' March 28 article[2] to the April 25 letter[3] by Jonathan G. Blattmachr, F. Ladson Boyle, and Howard M. Zaritsky (the "Dissenters").

The Authors argue a peculiar view that one can be a grantor of an entire trust for purposes of the grantor trust rules found in sections 671 to 677 by creating a trust and retaining certain powers listed in section 675 over all the trust assets, even if the creator did not contribute all the assets to the trust. Indeed, the Authors argue that this is true if the creator (or co-creator) contributed as little as 5 percent of the trust assets (and presumably made any contribution). In contrast, the Dissenters say, "one can, however, be deemed to own the trust assets as a grantor only to the extent that she contributed assets to the trust." The Authors say the Dissenters' letter "cites no authority [which, to the Authors' knowledge, does not exist] to support this incorrect statement."

One does not have to look far to find authority in support of the Dissenters' statement. Sections 673 to 677 all begin, "General Rule. The grantor shall be treated as the owner of any portion of a trust." That language stating when the grantor trust rules apply to a grantor has been in the Internal Revenue Code at least since the code was recodified in 1954. It has long been established under the common law of trusts and for federal tax purposes that a "person who furnishes the consideration for the creation of a trust is the settlor, even though in form the trust is created by another."[4]

"The settlor is sometimes called the 'trustor,' or particularly in tax contexts the 'grantor.'"[5] That only a person who furnished the consideration could be taxed under the grantor trust rules is clear enough that reg. section 1.671-2, which has the "applicable principles" for the grantor trust rules, did not define "grantor" from the time it was adopted in 1956 until, prompted by an unrelated statutory change, it was amended in 1999 and 2000, as is discussed below. Further, a careful review of reg. section 1.671-2 shows that every use of the words "grantor" and "owner" therein is consistent with the Dissenters' statement.

In contrast to this widespread understanding of who the grantor trust rules apply to, the Authors ground their argument on reg. section 1.671-2(e)(1), which they assert provides "two methods by which a person may become a grantor." They quote that regulation as follows:

> A grantor includes any person to the extent such person either [1] creates a trust or [2] directly or indirectly makes a gratuitous transfer . . . of property to a trust. . . . However, a person who creates a trust but makes no gratuitous transfers to a trust is not treated as an owner of any portion of a trust under sections 671 through 677 or 679.

The portion of the regulation above, as quoted by the Authors, is not remarkable. Given that it is a basic concept of the common law of trusts that the creation of a trust requires a contribution of property, one might even ask how the clause identified by the Authors as [1] adds anything to the clause identified as [2].

A review of the history of that regulation provides the answer. Subsection (e) was added to

[1] Montgomery et al., "Authors' Response to Blattmachr, Boyle, and Zaritsky," *Tax Notes Federal*, May 2, 2022, p. 751.

[2] Montgomery and Montgomery, "The Joint and Survivor Grantor Trust and the S Election," *Tax Notes Federal*, Mar. 28, 2022, p. 1815.

[3] Blattmachr, Boyle, and Zaritsky, "Grantors Cannot Override the Grantor Trust Rules," *Tax Notes Federal*, Apr. 25, 2022, p. 619.

[4] *Lehman v. Commissioner*, 109 F.2d 99, 100 (2d Cir. 1940).

[5] *Restatement of the Law of Trusts* 3d (2001), section 3, cmt. a.

reg. section 1.671-2 in 1999 as a temporary regulation that was finalized without change in 2000.[6] This addition was done primarily in response to the foreign trust rules in sections 672(f) and 643(h) that were amended in 1996.[7] Those 1996 changes also included an amendment to section 6048(a)(1) that required "the responsible party" to provide written notice of certain "reportable events" to the secretary. Congress included within the definition of a "responsible party" both (1) the grantor in the case of the creation of an *inter vivos* trust and (2) the transferor in the case of a reportable event.[8] Thus, Congress was imprecise in equating the creator of an *inter vivos* trust, even one who made no contribution to the trust, with being a "grantor"; however, the damage was limited to a reporting requirement in section 6048 and did not infect the grantor trust rules found in sections 671 to 679.

Unfortunately, Treasury picked up Congress's imprecise language in section 6048 and carried it into the regulations under section 672. In Part 2 of its Explanation of Provisions and Revisions in T.D. 8831, Treasury noted that it had previously, in 1997, issued proposed regulations under that section that defined a grantor "to include any person to the extent such person either (i) creates a trust or (ii) directly or indirectly makes a gratuitous transfer to a trust. Commenters questioned why a nominal creator who has made no transfer to a trust should be treated as a grantor and asked for an explanation of the tax significance of such treatment." Treasury answered the commenters:

> Treating a nominal creator as a grantor ensures that someone will be responsible for reporting the creation of a foreign trust by a U.S. person even if the trust is not immediately funded. See section 6048(a)(3)(A)(i) and (a)(4)(A). At the same time, Treasury and the IRS believe that an accommodation grantor, such as an attorney who creates a trust on behalf of a client, (although a grantor) should not be treated as an owner of the trust. Accordingly, the temporary regulations provide that a person who either creates a trust, or funds a trust with an amount that is directly repaid to such person within a reasonable period of time, but who makes no other transfers to the trust that constitute gratuitous transfers, will not be treated as an owner of any portion of the trust under sections 671 through 677 or 679.

Language omitted by the Authors from their quotation of reg. section 1.671-2(e)(1) included "if a person creates or funds a trust on behalf of another person, both persons are treated as grantors of the trust (See section 6048 for reporting requirements that apply to grantors of foreign trusts.)."

The Authors take this imprecise use of the term "grantor" and erect a wobbly structure on it, including making up their own unique terms to distinguish between two different kinds of grantors, whom they named "creator grantor" and "transfer-only grantor." Neither of those terms occurs in the grantor trust tax law, nor do they have any corollary to any similar terms. The Authors then take these terms and read distinctions into the regulations that are not there.[9] Similarly, the Authors take what T.D. 8831 called an "accommodation grantor" and the simple concept that such a "grantor" who did not make her own contribution to the trust should not be treated as an owner of the trust for grantor trust purposes and remake it into their "straw person" rule.[10] They give as an example of their rule "one who transfers no property to the trust and is nominally named as the trust creator in furtherance of an abusive trust scheme." There is no basis for the Authors' assertion that one who

[6] *See* T.D. 8831 and T.D. 8890.

[7] T.D. 8831 Summary.

[8] Section 6048(a)(4).

[9] *See, e.g.*, their discussion of examples 1 and 3 of reg. section 1.674-2(e)(6).

[10] In footnote 5 of their response, the Authors say, "Reg. section 1.671-2(e)(1) prevents a 'straw person' trust creator (for example, one who transfers no property to the trust and is nominally named as the trust creator in furtherance of an abusive trust scheme) from being treated as a deemed owner ('. . . a person who creates a trust but makes no gratuitous transfers to a trust is not treated as an owner of any portion of a trust. . . .'). However, that straw person is still a 'creator grantor' (see reg. section 1.671-2(e)(6), Example 3)." Of course, Example 3 does not say anything about a "creator grantor." It does say that an accommodation grantor is not an owner for grantor trust purposes but is a responsible party for purposes of section 6048.

nominally creates a trust funded by another is doing so "in furtherance of an abusive trust scheme."

The Authors also make much of the fact that the "numerator of the concurrent deemed owner fraction defined in reg. section 1.671-3(a)(3) above is 'the amount which is subject to the control of the grantor' rather than 'the amount attributable to the transfer of the grantor.'" They draw this distinction based on their strained reading of reg. section 1.671-2(b); however, the latter regulation was first adopted in 1999 and the former regulation was adopted in 1956, so it is not persuasive that grantor trust treatment as provided in language adopted in a 1956 regulation relies on a definition of grantor introduced in 1999.

Further, the Authors' reliance on a 1982 Tax Court memorandum decision and a private letter ruling from 1993 cannot be viewed as an interpretation of a definition of grantor introduced into the regulations in 1999. Finally, comparing the language of section 675, which was in the Internal Revenue Code when it was enacted in 1954, to section 679, which was added in 1976, and concluding that Congress, per the Authors' cited *expressio unius* canon, meant for the word "grantor" not to have its common meaning in section 675 is doubtful.[11] The Authors' wobbly structure topples under scrutiny.

The Authors in their response call the Dissenters' "two-calculations" language "imaginary." But the clear language of sections 673 to 677 shows that there are two elements to the application of the grantor trust rules. As noted above, these sections all begin with "the grantor shall be treated as the owner of any portion of a trust." Under the common law meaning of grantor, these sections only apply to the extent that the taxpayer contributed to the trust, which is the first element. Then the specific provisions of sections 673 to 677 specify the second element, which provides when the grantor is treated as the owner of the contributed portion of the trust for federal income tax purposes.

Before the imprecise use of the term "grantor" was introduced into the regulations in 1999, there was no question but that the amount subject to grantor trust treatment was the portion of the amount attributable to the transfer of the grantor over which the grantor had control. Thus, the Authors create a false dichotomy when they say that the "numerator of the concurrent deemed owner fraction defined in reg. section 1.671-3(a)(3) above is 'the amount which is subject to the control of the grantor' rather than 'the amount attributable to the transfer of the grantor.'" However, the proper determination of the numerator requires an evaluation of both portions.

Finally, the Authors, in their invitation to the reader to decide for themselves, suggest that their analysis of the statutory and regulatory language can be limited to the facts of the particular case described in the article. But there is no limiting principle to their analysis. If they are right, when the surviving spouse is deemed to be the 100 percent owner of the joint and survivor grantor trust, she is responsible for 100 percent of the income tax arising from that trust's assets. Perhaps the surviving spouse is OK with that tax liability. But what of A, who created the trust in Example 7 of reg. section 1.671-2(e)(6), if A holds a distribution power over the trust for his brother B's benefit? A might have been willing to bear the burden of being liable for the income tax on $100,000, but is A willing, and able, to bear the burden of being liable for the income tax on the entire $1 million, when 90 percent of it was contributed by Uncle C?

Likewise, if the Authors were correct, the problem of funding a large beneficiary defective inheritor's trust (a BDIT) is not a problem at all. The technique initially has the beneficiary fund the BDIT with $5,000, which becomes a grantor trust under section 678 when the beneficiary lets a withdrawal power lapse. The BDIT is structured to be outside of the beneficiary's taxable estate, and the lapse of a $5,000 withdrawal right does not cause estate inclusion. The problem has always been how to get substantial additional assets into the BDIT without ruining the exclusive

[11] In their footnote 35, the Authors argue that if their reading of the law is not correct, "there would be no purpose to the distinction made in reg. section 1.671-2(e)(1) between a creator grantor and a transfer-only grantor." But as set forth above previously, the distinction between (1) what the common law has called a grantor and (2) what the regulations also call a grantor, but who has only created a trust without making a contribution to it, is because Treasury wanted to call attention to section 6048's reporting requirements that are imposed on both the latter and the former.

grantor trust status as to the beneficiary and without using excessive amounts of leverage. But if the Authors are correct in their reading of the law, if the beneficiary holds a swap power under section 675, other family members can put an unlimited amount into the BDIT while the beneficiary continues to be the grantor of 100 percent of the BDIT. But as explained above, such is not the law.

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Pillar 2: Down but Not Out

To the Editor:

I write regarding the excellent article by Heydon Wardell-Burrus.[1] What must be puzzling to many readers is that this article (and many other articles in *Tax Notes* and elsewhere) assumes that pillar 2 will in fact be implemented, while recent news reports cast doubt on whether that is the case. The collapse of negotiations over a limited Build Back Better Act (H.R. 5376) in the United States indicates that no pillar 2 legislation is likely to be enacted this year, and if the Republicans take over either the House or the Senate in November, it will not be possible to enact any legislation embodying pillar 2 until 2025 at the earliest. Also, the opposition of Hungary has for now stopped the EU from adopting a directive embodying pillar 2.

As frequently noted, pillar 2 can be implemented without the United States, although that will have negative consequences for U.S. multinationals (especially if there is no foreign tax credit for "extraterritorial" foreign taxes under the new regulations).[2] But it is hard to see how pillar 2 can be implemented without the EU, because if it is implemented by neither the United States nor the EU, then most of the world's multinationals will not be covered by the income inclusion rule, which would mean that source countries will have no incentive to enact either the undertaxed payments rule or the qualified minimum domestic top-up tax (QMDTT). That outcome would mean that there will be no global minimum tax and no limit to tax competition (the two goals of pillar 2).

However, pillar 2 is not "dead on arrival" even if the Hungarian opposition cannot be overcome, because the EU is not needed. It is enough if the members of the EU that are part of the G-20 (France, Germany, and Italy) adopt pillar 2, which can be implemented by each country unilaterally. That outcome seems very likely because the larger EU economies were the drivers of pillar 2 in the first place. In that case, it is also plausible that

[1] Wardell-Burrus, "Can Pillar 2 Be Leveraged to Save Pillar 1?" *Tax Notes Int'l*, July 18, 2022, p. 317.

[2] *See, e.g.*, Reuven S. Avi-Yonah and Mohanad Salaimi, "Minimum Taxation in the United States in the Context of GloBE," *Intertax* (July 2022).