



AMERICAN BAR ASSOCIATION

Tax Section

VIRTUAL 2021 FALL TAX MEETING

Section 677 - The Ghost that Haunts the Divorced Grantor

Fiduciary Income Tax Committee

September 23, 2021

taxnotes[®]

Exclusive Diamond Sponsor

Panelist

Julie M. Dewberry is an attorney in the Trusts and Estates and Nonprofit Groups at Higgs Fletcher & Mack LLP in San Diego. She assists domestic and international clients on the tax-efficient accumulation, preservation, and transfer of assets. Julie excels at mitigating interfamily disputes, planning for spendthrift children, and assisting family businesses with their unique challenges, legal and otherwise. Clients count on her to break down complexity and offer practical solutions. In addition, she advises nonprofit organizations in formation and qualification before the IRS and state agencies, and ongoing operations. Julie is licensed in both California and Virginia. She earned her law degree, Tax Law Concentration, at George Mason University School of Law and her B.A. at the College of William and Mary.

taxnotes[®]

Agenda

- I. Background Concepts
- II. Overview of Section 677
- III. Mechanics of Section 677
- IV. Estate Planning Strategies under Section 677

I. Background Concepts

Grantor Trust Sections

- IRC § 671 through § 679 (Subchapter J, Subpart E) provide exceptions to the general rule of § 641 taxing income of a trust to the trust or its beneficiaries.
- The income, deductions, and credits of a trust that qualifies as a “grantor trust” are reportable on the grantor’s individual return.
- File Form 1041 or follow alternative reporting methods under Treas. Reg. § 1.671-4(b)(2).

taxnotes[®]

26 U.S. Code § 672 – Definitions and rules

- **(a) Adverse Party** — For purposes of this subpart, the term “adverse party” means any person having a substantial beneficial interest in the trust which would be adversely affected by the exercise or nonexercise of the power which he possesses respecting the trust. A person having a general power of appointment over the trust property shall be deemed to have a beneficial interest in the trust.
- **(b) Nonadverse Party** — For purposes of this subpart, the term “nonadverse party” means any person who is not an adverse party.

taxnotes[®]

26 U.S. Code § 672 – Definitions and rules (cont'd)

- **(c) Related Or Subordinate Party** — For purposes of this subpart, the term “related or subordinate party” means any nonadverse party who is—
 - (1) the grantor's spouse if living with the grantor;
 - (2) any one of the following: The grantor's father, mother, issue, brother or sister; an employee of the grantor; a corporation or any employee of a corporation in which the stock holdings of the grantor and the trust are significant from the viewpoint of voting control; a subordinate employee of a corporation in which the grantor is an executive.
 - For purposes of subsection (f) and sections 674 and 675, a related or subordinate party shall be presumed to be subservient to the grantor in respect of the exercise or nonexercise of the powers conferred on him unless such party is shown not to be subservient by a preponderance of the evidence.

taxnotes[®]

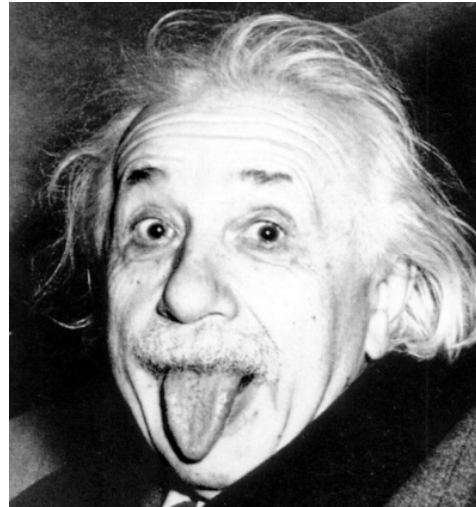
26 U.S. Code § 674 – Power to Control Beneficial Enjoyment

- **(a) General rule** The grantor shall be treated as the owner of any portion of a trust in respect of which the beneficial enjoyment of the corpus or the income therefrom is subject to a power of disposition, exercisable by the grantor or a nonadverse party, or both, without the approval or consent of any adverse party.
- **(b) Exceptions.** Lists eight powers that will not trigger grantor trust status – no matter who holds them.
- Power Exercisable Solely by Will. § 674(b)(3).

taxnotes[®]

§ 677 – “Income”

- **“Income”** for purposes of § 677 is taxable “income” and not fiduciary accounting income.



- **“The hardest thing in the world to understand is the income tax.”**
— Albert Einstein

taxnotes[®]

§ 677(a)(1) and (2) – “Spouse”

- **Spousal Unity Rule.** Treats a grantor as holding any power or *interest* held the grantor’s spouse at the creation of the power or interest. § 672(e).
- Before the repeal of § 682, “spouse” meant the person whom you are married, and the provision applied “during the period of the marriage of the grantor to a beneficiary.”

§ 677(a)(1) and (2) – “Spouse”

- Section 11051 of the 2017 Tax Act repealed § 682, for divorces or legal separation agreements after December 31, 2018.
- The repeal of § 682 is permanent and does not sunset after 2025.



Wallerotes®

II. Overview of Section 677

26 U.S. Code § 677 – Income For Benefit of Grantor

- **(a) General Rule** — The grantor shall be treated as the owner of any portion of a trust, whether or not he is treated as such owner under section 674, whose income without the approval or consent of any adverse party is, or, in the discretion of the grantor or a nonadverse party, or both, may be—
 - (1) distributed to the grantor or the grantor's spouse;
 - (2) held or accumulated for future distribution to the grantor or the grantor's spouse; or
 - (3) applied to the payment of premiums on policies of insurance on the life of the grantor or the grantor's spouse (except policies of insurance irrevocably payable for a purpose specified in section 170(c) (relating to definition of charitable contributions)).

taxnotes[®]

26 U.S. Code § 677 – Income For Benefit of Grantor (cont'd)

- **§ 677 (a)(3)Exception — Premiums for Charitable Purpose**

Policies of insurance irrevocably payable for a purpose specified in § 170(c).

- A valid charitable remainder trust cannot be a grantor trust, the income of which is taxed directly to the grantor or another person under § 671 - § 679. Treas. Reg. § 1.644-1(a)(4).

taxnotes[®]

26 U.S. Code § 677 – Income For Benefit of Grantor (cont'd)

- This subsection shall not apply to a power the exercise of which can only affect the beneficial enjoyment of the income for a period commencing after the occurrence of an event such that the grantor would not be treated as the owner under section 673 if the power were a reversionary interest; but the grantor may be treated as the owner after the occurrence of the event unless the power is relinquished.

taxnotes[®]

26 U.S. Code § 677 – Income For Benefit of Grantor (cont'd)

- **Exception – Right of Reversion.**
- Grantor shall not be treated as the owner of a trust when a discretionary right can affect the beneficial enjoyment of the income of a trust only after a period of time during which the grantor would not be treated as an owner under § 673 if the discretionary power were a reversionary interest.

taxnotes[®]

26 U.S. Code § 677 – Income For Benefit of Grantor (cont'd)

- **(b) Obligations Of Support** — Income of a trust shall not be considered taxable to the grantor under subsection (a) or any other provision of this chapter merely because such income in the discretion of another person, the trustee, or the grantor acting as trustee or co-trustee, *may be applied* or distributed for the support or maintenance of a beneficiary (other than the grantor's spouse) whom the grantor is legally obligated to support or maintain, except to the extent that such income is so applied or distributed. In cases where the amounts so applied or distributed are paid out of corpus or out of other than income for the taxable year, such amounts shall be considered to be an amount paid or credited within the meaning of paragraph (2) of section 661(a) and shall be taxed to the grantor under section 662.

taxnotes[®]

III. Section 677 Mechanics

§ 677(a)(1) and (2) – Mechanics

- § 677(a)(1) and § 677(a)(2) provide that a grantor is treated as the owner of any trust or trust portion the income of which the grantor or a nonadverse person (or both) may pay to the grantor or the grantor's spouse or accumulate for later distribution to the grantor or the grantor's spouse without an adverse person's consent.

taxnotes[®]

§ 677(a)(1) and (2) – Mechanics (cont'd)

- Note that § 677(a)(1) provides that a grantor is treated as the owner of any trust income that is or “**may be**” paid or accumulated for the grantor’s spouse without consent of an adverse party.
- § 677(a) power only results as the grantor being treated as the owner of the income of the trust and not the corpus. Treas. Reg. §1.677(a)-1(g), Ex. 1.

§ 677(a)(1) and (2) – Mechanics (cont'd)

- Be careful of unintended grantor trust status.
- Including grantor's spouse as a discretionary beneficiary will cause the trust to be a grantor trust as to the income under § 677 unless the consent of an adverse party is required.

taxnotes[®]

Exclusive Diamond Sponsor

§ 677(a)(1) and (2) – Mechanics (cont'd)

- If spouse included as discretionary beneficiary to cause grantor trust status:
 1. Toggling off may be difficult. Can give an independent trustee the power to remove the spouse as a discretionary beneficiary.
 2. Grantor trust status ends at the spouse's death (unless other grantor trust provision applies).



[Credit: Anodos](#)

taxnotes[®]

Exclusive Diamond Sponsor

§ 677(a)(3) – Mechanics

- Grantor is taxed on any trust income actually used to pay premiums on policies on the life of the grantor or the grantor's spouse. Treas. Reg. § 1.677(a)-1(b)(2).
- § 677(a)(3) provides the grantor is treated as the owner of any trust or part of a trust the income is or **can be** used.

§ 677(a)(3) – Mechanics (cont'd)

- Limitations:
 - Even if the trust owns policies on the grantor's life, the grantor may only be taxed to the extent of income used. *Weil v. Commissioner*, 3 T.C. 579 (1944), *acq.* 1944.
 - Power to purchase insurance policies and pay premiums from income is not enough to create a grantor trust. *Corning v. Commissioner*, 104 F.2d 329 (6th Cir. 1939).
 - But see PLR 8852003 (grantor will be treated as the owner of a trust whose income, with or without the consent of an adverse party, may pay premiums on policies on the grantor's life).

taxnotes[®]

§ 677(a)(3) – Mechanics (cont'd)

- I.R.C. § 167 (1939) vs. **1954.**

[w]here any part of the income of a trust ... is, or ... may be, applied to the payment of premiums upon policies of insurance on the life of the grantor ... then ~~such part of the income of the trust~~ shall be included in computing the net income of the grantor.

Any portion of a trust whose income.

taxnotes[®]

Exclusive Diamond Sponsor

§ 677(a)(3) – Mechanics (cont'd)

- Rev. Rul. 66-313 limits the application of the grantor's ownership under §677(a)(3) to the income actually used to pay premiums on life insurance policies on the life of the grantor or the grantor's spouse.
- Not useful to guarantee grantor trust status. If using as a grantor trust trigger, provide that the trustee can use income or principal to pay insurance premiums.

§ 677(b) – Mechanics

- § 677(b) provides that grantor trust treatment will not result just because the income could be used to provide to provide for the support or maintenance of a beneficiary that the grantor is legally obligated to support.
- Whether the grantor or the grantor's spouse has an obligation to support the distributee of the trust depends on state law.

IV. Section 677 Strategies

§ 677(a)(3) – Gift-Splitting

- Permits gifts by one spouse to be considered as being made $\frac{1}{2}$ by each spouse (provided neither are non-resident aliens). Both spouses must consent. § 2513.
- Spouse cannot split a gift to a trust where spouse's interest cannot be quantified. Rev. Rul. 56-439.
- The beneficial interest of the grantor's spouse in the trust will not cause inclusion in the spouse's estate for estate tax purposes unless the spouse is also a contributor to the trust.

§ 677 -- Wholly Grantor Trust

1. Make spouse a discretionary beneficiary as to both income and corpus.
2. Combination of § 677 and § 674(b).
 - Grantor or grantor's spouse receive annuity payments results in grantor trust treatment as to income. § 677(a)(1).
 - Grantor retains testamentary power of appointment to appoint trust assets results in grantor trust treatment as to the corpus. § 674(a) and § 674(b)(3).

§ 677 -- SLAT

- Spousal lifetime access trust, or “SLAT”
 - Irrevocable trust is created under which the grantor’s spouse is a discretionary beneficiary and some other person or persons are also beneficiaries.
 - ***If all goes well***, transfer the trust assets and all appreciation thereon out of his or her estate without fully relinquishing the assets or the appreciation.

Repeal of § 682

- "Next to being shot at and missed, nothing is really quite as satisfying as an income tax refund." — F. J. Raymond

Repeal of § 682 (cont'd)

- For existing trusts:
 - (1) negotiate in the divorce how income taxes will be paid on trust income;
 - (2) decant or modify the trust to eliminate the ex-spouse's interest;
 - (3) if the trust has other discretionary beneficiaries, the trustee can make distributions to beneficiaries other than the ex-spouse; or
 - (4) terminate.



taxnotes[®]

Exclusive Diamond Sponsor

Repeal of § 682 (cont'd)

- For new SLATs:
 - (1) require the consent of an adverse party to distribute to the spouse after a divorce; or
 - (2) eliminate or give some third party the ability to eliminate the grantor's spouse as a beneficiary following a divorce.

§ 677 -- SLANT, SLANG, INGT?

- **Spousal lifetime access non-grantor trust.**
- *Matal v. Tam*, 137 S.Ct. 1744 (2017).
- To avoid the common grantor inclusion items above, this trust will have an individual who has a vested interest in the trust, consent to distributions and avoid language and powers in the trust agreement allowing the grantor to substitute or have a power over the assets in the trust.



taxnotes[®]

Exclusive Diamond Sponsor

§ 677 – Non-Grantor Status for Capital Gains

- Intervivos QTIP does not *have to* hold or accumulate principal for future distribution to a spouse. § 677 (a)(2) not triggered.
 1. No ability to distribute principal.
 2. Only permitted with consent of an adverse party.

Disclosures

LEGAL, INVESTMENT AND TAX NOTICE: This information is not intended to be and should not be treated as legal advice, investment advice or tax advice. Readers, including professionals, should under no circumstances rely upon this information as a substitute for their own research or for obtaining specific legal or tax advice from their own counsel.

OTHER IMPORTANT INFORMATION: Opinions expressed and information contained herein are current only as of the date appearing in this material and are subject to change without notice.

taxnotes[®]

Exclusive Diamond Sponsor

Questions?

Attendees can submit questions via the Q&A feature on the virtual meeting interface

taxnotes[®]

For more information



Julie M. Dewberry

HIGGS | FLETCHER | MACK

401 West A Street, Suite 2600

San Diego, CA 92101

(t) 619-595-4293

dewberryj@higglaw.com

taxnotes[®]

Exclusive Diamond Sponsor