By **Andrew S. Katzenberg**

Unlocking the Trapdoor of IRC Section 677(a)(3)

Avoid grantor trust status

Last year's Tax Court decision in *Webber v. Commissioner*[1] handed taxpayers a defeat in the area of private placement life insurance (PPLI). This first reported case on PPLI was littered with pages of facts revealing the taxpayer's use of agents to indirectly control the trust-owned PPLI policy. A footnote in the decision regarding grantor trust status has led some life insurance companies and other observers to conclude that it's better to use a non-grantor trust to own a PPLI product.[2] Yet, most practitioners may pause for a moment because they've come to believe that an insurance trust is synonymous with grantor trust status. Internal Revenue Code Section 677(a)(3) controls grantor trust status as it applies to life insurance. A fresh look at the application of IRC Section 677 reveals several possibilities and a labyrinth of issues that await the unwitting attorney draftsman attempting to avoid grantor trust status.

Often, taxpayers desire to create grantor trusts to take advantage of a host of benefits, such as the grantor being considered the owner of the trust assets for income tax purposes. One of the many triggers often relied on for grantor trust status is Section 677(a), which states:

> 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* . . . (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)). (*Emphasis added.*)

As explained below, it's much easier to fall within the scope of Section 677 than outside of it, which is often the reason it's used as a trigger. This is also one of the reasons for the misconception that an insurance trust can't be a non-grantor trust. A deeper analysis of Section 677 tells a different story by considering: (1) who's authorized to use the income, and (2) can income be applied towards premiums?

Adverse Party

One might think that the simplest way to negate the application of Section 677(a)(3) is to require an "adverse party's" approval or consent. However, no adverse party may exist. An adverse party is a person who has a substantial beneficial interest in the trust, which would be adversely affected by the exercise or nonexercise of a power.[3] To have an adverse effect in this scenario, the consenting person would need to be an income beneficiary of the trust, but not a beneficiary of the proceeds of the life insurance policy. The use of income to pay the premium would shift a beneficial interest away from the consenting person, making him adverse to the exercise. Though possible, it's a rare scenario.

Payment of Premiums

Our analysis of the authority to use income to pay premiums begins with Section 167(a) of the 1939 IRC, the predecessor to Section 677(a). Prior to the enactment of Section 677(a) in 1954, the Tax Court and U.S. Court of Appeals for the Sixth Circuit held that the

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mere possibility that a trust could buy a life insurance policy[4] and pay premiums on it wasn't enough to create a grantor trust. It must be actually possible for the trustee to pay premiums, and grantor trust status is limited to premiums paid or payable on existing policies owned by a trust.[5] In 1966, 12 years after the enactment of Section 677(a), the Internal Revenue Service also held that trust income used to pay premiums on life insurance owned by another trust was includible in the grantor's gross income.[6]

Some practitioners think these cases and this revenue ruling result in grantor trust status under Section 677(a)(3) only to the extent income is actually used to pay premiums. This limitation is an unwarranted extension of the holding of these cases. These cases stand for the principle that if a trust doesn't own insurance and isn't paying premiums for life insurance, it's not a grantor trust even though it could purchase life insurance and pay premiums of life insurance. Nevertheless, these cases can be reasonably interpreted to limit the application of grantor trust status to only the amount of the premium of the life insurance owned by a trust (whether paid or not). Any other interpretation would be a mischaracterization of the facts and holdings of these cases.

In more recent years, the IRS has begun to move away from the holdings under the case law, broadening the reach of Section 677.

Several other cases focused on trusts that owned insurance and paid premiums. In these situations, the Tax Court held only the amount of the premiums, rather than the entire income of the trust, was includible in the grantor's gross income.[7] Relying on its prior rulings, the Tax Court wouldn't impute the entire income of a trust to the grantor unless premiums on policies owned by the trust were actually outstanding. Therefore, prior to 1954, the income of a trust was only includible in the grantor's gross income to the extent of: (1) the amount of premiums paid (regardless of if the policy was owned by the trust), and (2) the amounts payable on existing policies owned by the trust.

IRS' Current Position

Beginning in the 1970s, the IRS began to take the position that if all income may be applied to the payment of premiums on a life insurance policy, then the entire trust is treated as owned by the grantor regardless of the actual amount of the premium.[8] In Private Letter Rulings 8007080 and 8014078, the trusts were intended to receive life insurance policies and were required to pay premiums first out of the income of the trust. The IRS held that, "[b]ecause the trust agreement provides that all of the income of the trust may be applied to the payment of premiums on the Policies at the discretion of the trustee . . . the grantor will be treated as owner of the entire trust."[9]

These PLRs don't contradict the holding in Revenue Ruling 66-313 that only trust income used to pay premiums is includible in the grantor's taxable income, because the facts are distinguishable. The revenue ruling dealt with a trust paying premiums for life insurance owned by another trust. The PLRs, by contrast, dealt with the same trust owning insurance and making premium payments on such insurance. Because the revenue ruling dealt with a trust that didn't own a policy, the possibility of payments was too speculative for inclusion of all income of the trust. Again, this reasoning is in line with case law, relying only on actual payment of premiums of insurance owned by a different trust as the barometer for grantor trust status.

In more recent years, the IRS has begun to move away from the holdings under the case law, broadening the reach of Section 677. Rev. Rul. 66-313 was unofficially abrogated in Field Attorney Advice Memorandum 2006-27-01F.[10] The facts were similar to those of the revenue ruling—a trust was paying premiums for life insurance on the life of the grantor owned by another trust. The IRS held that because the trust agreement authorized the purchase of life insurance and didn't limit the amount that the trustee could apply to the payment of premiums, the entire trust (not just the amount used to pay premiums) was a grantor trust. In PLR 8852003, the taxpayer wanted to qualify a trust as an eligible shareholder in an S corporation (that is, a grantor trust). The IRS held that the trustee's power to cause trust income to be used to acquire and service a life insurance policy caused the trust to be a grantor trust.[11] The IRS' position is a clear departure from the case law.

Possibly even more impactful to the broadening of Section 677, the Tax Court in *Petter v. Comm'r*, while

addressing a formula gift and sale, noted that a trust that permitted the purchase and payment of premiums on a life insurance policy on the life of the grantor was a grantor trust.[12] Yet, the opinion never addressed whether the trust owned or intended to own life insurance, nor did it make any reference to or analysis of the prior case law.

Practical Application

Attorneys need to analyze four scenarios regarding Section 677(a)(3) to determine if grantor trust status can be turned off. First, it's unclear whether a trust that neither owns life insurance nor pays premiums on life insurance, though authorized to do both, is a non-grantor trust. Under pre-1950s case law, it's clear that a trust that neither owns insurance nor pays premiums on life insurance, though authorized to do both, is a non-grantor trust. However, because those cases only dealt with the predecessor statute to Section 677 and considering the recent IRS rulings and the *Petter* decision, one should be cautious when relying on their holdings. It's possible, however, to negate the implications of these recent decisions through prudent drafting. Trust agreements that prohibit the use of income to pay premiums on life insurance should fall outside the scope of these recent decisions. Therefore, careful drafting in conjunction with the case law should assuage any fears of grantor trust status.

The second and third scenarios involve a trust that's paying premiums for life insurance owned by it or another trust. In both cases, the trust would be a grantor trust. The unanswered question is whether the entire trust would be a grantor trust or only the portion used to pay the premiums. Though the IRS initially didn't take the position that the entire trust was a grantor trust after the enactment of Section 677 (which changed the pertinent language in Section 167 from "such part of the income" to "any portion of a trust"), it's since changed course and now takes the position that the entire trust is a grantor trust. Arguments can be made that only a portion of the trust should be treated as a grantor trust, but advising a client otherwise might be more prudent.[13] And, since the *Petter* case, it's more likely than not a forgone conclusion that any trust that's paying premiums for life insurance is entirely a grantor trust.

Some practitioners have tried to circumvent Section 677(a)(3) when their clients are paying premiums by requiring premium payments from the principal of the trust rather than from the income. But, the IRS has rejected this strategy. The IRS has held that "income" in Section 677(a)(3) means taxable income and not fiduciary income.[14] The IRS relies on Treasury Regulations Section 1.671-2(b), which states:

> Since the principle underlying subpart E . . . is in general that income of a trust over which the grantor . . . has retained substantial dominion or control should be taxed to the grantor . . . , it is ordinarily immaterial whether the income involved constitutes income or corpus for trust accounting purposes. Accordingly, when it is stated in the regulations under subpart E that 'income' is attributed to the grantor . . . , the reference, unless specifically limited, is to income determined for tax purposes and not to income for trust accounting purposes. When it is intended to emphasize that income for trust accounting purposes (determined in accordance with the provisions set forth in § 1.643(b)-1) is meant, the phrase "ordinary income" is used.

Because the IRS takes the position that the mere ability to use income for premium payments makes a trust a grantor trust, the lack of payment won't prevent grantor trust status.

Therefore, the IRS ignores the trust's language and deems the premium payment as being paid first from income and then from principal.

The fourth scenario is a trust that owns life insurance but isn't paying premiums. The pre-1950s case law (discussed above) can't be relied on because the trust actually owns a policy. Because the IRS takes the position that the mere ability to use income for premium payments makes a trust a grantor trust, the lack of payment won't prevent grantor trust status. The technique

of prohibiting the use of income for premium payments might not work in this scenario either because the IRS has held that such prohibition only affects the income for trust accounting purposes. Therefore, the ability to use principal to pay premiums may be analogous to the ability to use income to pay premiums, resulting in grantor trust status.

However, if the trust prohibits both the use of income and principal to pay premiums, then there's no ability to use income (whether actual or through the principal). The grantor could pay the premiums on the insurance directly to the insurance provider. This payment would be considered an indirect gift to the trust for gift tax purposes, which would require *Crummey* withdrawal powers by the beneficiaries. Yet, because no assets of the trust could be or would be applied towards the premiums, it shouldn't fall within Section 677(a)(3) (unless in violation of the terms of the trust agreement),[15] resulting in non-grantor trust status.[16]

It's also possible to own insurance and be a non-grantor trust if there's no actual taxable income.[17] Either the trust assets could be invested in assets producing non-taxable income (for example, exempt bonds), or all income could be required to be distributed to the beneficiaries each year. However, both of these options may be counterproductive to the trust's ultimate goals of growth and creditor protection.

Whether the fears of insurance providers of PPLI are misplaced, it doesn't lessen the impact of inadvertently creating a grantor trust. The uncertainty in the law should cause all practitioners to look at their forms and consider what can be done better. As taxpayers continue to argue for or against grantor trust status, hopefully more clarity will come to this clearly unclear issue.

—The author would like to acknowledge Bruce D. Steiner, of Kleinberg, Kaplan, Wolff & Cohen, P.C. in New York City, for his valuable review and comments to this article.

Endnotes

1. *Webber v. Commissioner*, 144 T.C. No. 17 (June 30, 2015) (incidents of control held by the grantor resulted in the income (as generated by the investments inside the life insurance policy) being taxable to him rather than exempt from taxation inside the life insurance policy).
2. Footnote 17 states, "Petitioner is the tax owner of the underlying assets even though the Policies are nominally owned by the Trusts. If the Trusts were deemed to be the owners of the underlying assets, it appears that their income would be attributable to petitioner under the grantor trust rules." *Ibid.*
3. Internal Revenue Code Section 672(a).
4. All references to insurance policies mean insurance on the life of the grantor or the grantor's spouse.
5. *Corning v. Comm'r*, 104 F.2d 329, 333 (6th Cir. 1939) (trust didn't own life insurance and no trust income was used for premium payments), *rev'g* 36 B.T.A. 301 (1937); *Comm'r. v. Mott*, 85 F.2d 315, 317 (6th Cir. 1936), *aff'g* 30 B.T.A. 1040 (1934) (trustee only authorized to make payment on insurance "taken out" by trust, and trust didn't own insurance); *Moore v. Comm'r*, 39 B.T.A. 808, 812-813 (April 21, 1939) (a policy must exist and be limited to amount of premium).
6. Revenue Ruling 66-313.
7. *Iversen v. Comm'r*, 3 T.C. 756, 774 (May 9, 1944); *Weil v. Comm'r.*, 3 T.C. 579, 584 (April 6, 1944), *acq.*, 1944 C.B. 29; *see also Rand v. Comm'r.*, 40 B.T.A. 233 (1939), *acq.*, 1939-2 C.B. 30, *aff'd*, 116 F.2d 929 (8th Cir. 1941), *cert. denied*, 313 U.S. 594 (1941) (limited to premiums paid or payable on existing policies).
8. The cases supporting the limitation of includible income to the actual premium amount all dealt with IRC Section 167(a)(3). The major difference between Sections 677(a)(3) and 167(a)(3) made under the 1954 IRC was the change of the language "such part of the income" to "any portion of a trust."
9. Private Letter Ruling 8007080 (Nov. 6, 1979) and PLR 8014078 (Jan. 10, 1980).
10. Field Attorney Advice Memorandum 2006-27-01F (May 1, 2006) (reviewing a tax avoidance arrangement designed to save taxes and transfer assets offshore, in which a trust was involved).
11. PLR 8852003 (Aug. 31, 1988).
12. *Petter v. Comm'r*, T.C. Memo. 2009-280 (Dec. 7, 2009), *aff'd*, 653 F.3d 1012 (9th Cir. 2011).
13. Howard Zaritsky suggests that the change in the language in Section 677 was merely for consistency with the same change in terminology in every other section of the grantor trust rules made by Congress in 1954 and not intended to broaden its application. *See* Howard Zaritsky, *Tax Planning for Family Wealth Transfers During Life: Analysis With Forms*, par. 12.07[3][a][v] (Thomson Reuters/Tax & Accounting, 5th ed. 2013, with updates through September 2015) (online version accessed on Checkpoint (*www.checkpoint.riag.com*)).
14. PLR 8839008 (June 23, 1988) (trust agreement provided that no income would be applied towards the payment of insurance premiums; when trust purchased life insurance, Internal Revenue Service held trust was a grantor trust).
15. Even if there's a prohibition on the use of income to pay premiums in the trust agreement, if income is used in spite of that prohibition, the trust will be deemed a grantor trust. PLR 8839008 (June 23, 1988).
16. It's possible that the IRS could argue some form of a reverse "step-transaction" implying that the payment somehow was actually from the trust, and therefore, the income of the trust could be imputed to the payment of the premium. However, this would take some finessing by the IRS.
17. *Chandler v. Comm'r*, 41 B.T.A. 165 (Jan. 24, 1940), *aff'd*, 119 F.2d 623 (3d Cir. 1941).