Report No. 1455
January 12, 2022

The Honorable Amanda Hiller
Acting Commissioner of Taxation
and Finance
W.A. Harriman Campus
Albany, NY 12227

The Honorable Liz Krueger
Chair, Finance Committee
New York State Senate
NYS State Capitol Building
Albany, NY 12247

The Honorable Helene E. Weinstein
Chair, Ways and Means Committee
New York State Assembly
923 Legislative Office Building
Albany, NY 12248

Re: *Report No. 1455 – Report on New York State Tax Law Section 612(b)(41)*

Dear Acting Commissioner Hiller, Senator Krueger and Assemblywoman Weinstein:

I am submitting herewith for your consideration materials developed by the New York State Bar Association's Tax Section, relating to the above-referenced issue.

Thank you for your attention to this matter.

Respectfully submitted,

Gordon Warnke

Gordon E. Warnke
Chair

Enclosure

cc:

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Report No. 1455

NEW YORK STATE BAR ASSOCIATION TAX SECTION

REPORT ON NEW YORK STATE TAX LAW SECTION 612(b)(41)

January 12, 2022

New York State Bar Association Tax Section

Report on New York Tax Law Section 612(b)(41)[1]

1. Introduction

In 2013, the New York State Tax Reform and Fairness Commission (the "Commission") approached the NYSBATS to address (among other concerns) a perceived abuse related to incomplete gift non-grantor trusts (or "INGs").[2] The Commission was concerned that INGs were being "established for the primary purpose of avoiding New York State income tax on an individual's investment income."[3] As discussed in further detail below, prior to the enactment of what is now New York Tax Law ("Tax Law") Section 612(b)(41) ("Section 612(b)(41)"), an ING permitted a New York resident individual to shift income for a period of time to a trust for that individual's benefit that was not subject to New York State income tax.

[1] The principal drafters of this report (the "Report") were Austin Bramwell and Alan Halperin. Significant contributions were made by Sean Imfeld, Rebecca Zuks, Gordon Warnke, Philip Wagman and Michael Schler. This report reflects solely the views of the Tax Section of the New York State Bar Association (the "NYSBATS") and not those of the New York State Bar Association's Executive Committee or its House of Delegates.

[2] The Commission requested that the NYSBATS revisit Governor Patterson's New York State Executive Budget proposal from 2010 that would have eliminated the exemption from income tax with respect to many, but not all, New York State exempt resident trusts (the "2010 Proposal"). Under the 2010 Proposal, all New York State resident trusts that were created during the grantor's lifetime would be subject to New York State taxation on a proportionate share of their undistributed income with the proportions determined based on the number of "ascertainable beneficiaries" resident in and out of New York. The 2010 Proposal contained no definition of "ascertainable beneficiary." Additionally, all trusts that were created under the will of a New York State domiciliary would be subject to New York State taxation on undistributed income even if there were no New York State ascertainable beneficiaries. The NYSBATS submitted a report in response to the 2010 Proposal and recommended that the 2010 Proposal be deleted from the draft budget because of serious federal constitutional questions as well as certain practical considerations relating to the 2010 Proposal. *See* NYSBATS, Report Commenting on the 2010 – 2011 New York State Executive Budget Proposal to Modify Income Taxation of New York Resident Trusts, Report 1205, February 22, 2010. http://www.nysba.org/tax.

[3] NYSBATS, Report on Certain New York State Resident Trusts, Report No. 1293, November 18, 2013, p.5. http://www.nysba.org/tax.

In response to the Commission's 2013 request, the NYSBATS prepared a report (the "2013 Report"),[4] attached hereto together with its accompanying cover letter as Appendix 1, that considered various methods by which New York State could prevent INGs from avoiding New York State income tax.[5] The 2013 Report proposed three possible solutions. Consistent with the second recommended solution in the 2013 Report, in 2014 New York State amended, among other sections, Tax Law Section 612 in order to add Section 612(b)(41). Section 612(b)(41) now treats INGs created by New York residents as grantor trusts for New York State income tax purposes— that is, as trusts that are treated as owned by the grantor for New York State income tax purposes. By treating an ING as a grantor trust, the income of the ING is attributed to the resident grantor, thereby effectively preventing a New York resident individual from avoiding New York State income tax by shifting income-producing assets to an ING.

Section 612(b)(41), however, could be read to sweep more broadly than was intended. The intent of the 2014 legislation, as evidenced by the 2013 Report and the legislative history of Section 612(b)(41), is to tax "residents who are grantors of exempt resident trusts that qualify as non-grantor incomplete gift trusts on the income from such trusts."[6] It is clear from this history that Section 612(b)(41) was intended to address only INGs. Nevertheless, under an expansive reading of Section 612(b)(41), it could capture not only INGs but also certain charitable remainder trusts (or "CRTs") and trusts qualifying as individual retirement accounts (or

[4] *Id.*

[5] *See generally* the 2013 Report.

[6] NY Bill Jacket, NYSA 12590-15, L. 2014, Ch. 59, pages 1 and 2. The legislation also addresses the taxation of New York residents who are beneficiaries of other exempt resident trusts or nonresident trusts on the distributions of accumulated income that they receive from such trusts. This aspect of the legislation is not affected by the issues raised in this Report.

"IRAs").[7] If Section 612(b)(41) did indeed convert CRTs and IRAs (CRTs and IRAs sometimes referred to herein together as the "Specified Exempt Trusts") to grantor trusts treated as owned by the grantor, it would reverse decades of New York's policy of following the federal rules on the Specified Exempt Trusts. Further, as discussed below, the result would not be necessary to cause the income from the Specified Exempt Trusts to continue to be taxed to New York resident grantors. It does not appear that the change enacted by Section 612(b)(41) contemplated that the Specified Exempt Trusts might be subject to the statute.

This Report provides a recommended path forward to address any potential ambiguity or concern regarding the application of Section 612(b)(41) to the Specified Exempt Trusts. We believe the guidance we are suggesting would further the intent and policies that underlie the provision.

This Report is organized as follows: Part I provides background information on INGs. Part II provides background information on CRTs. Part III briefly describes the special tax treatment of IRAs formed as trusts. Part IV identifies the issue with Section 612(b)(41) as it relates to the Specified Exempt Trusts. Part V examines the statutory language of Section 612(b)(41) and its legislative history. Part VI describes this Report's recommendations, including methods by which the issue highlighted in this Report may be addressed.

[7] Another possible inadvertent target of Section 612(b)(41) are wholly charitable trusts, including those that qualify as tax-exempt under Section 501(c)(3) of the Code. This concern has been raised with respect to CRTs by tax practitioners in California, which is considering legislation similar to Section 612(b)(41). *See* Legislative Proposal C presented to the California Franchise Tax Board on Nov. 10, 2020, proposing new Section 17082 to treat INGs created by California residents as grantor trusts for California income tax purposes. https://www.ftb.ca.gov/tax-pros/law/regulatory-activity/lp-c.pdf. However, for the same reasons, IRAs that are structured as trusts might also inadvertently be captured under Section 612(b)(41).

2. Discussion

I. Incomplete Gift Non-Grantor Trusts

Generally, an ING is a separate taxpayer for income tax purposes, transfers to which are incomplete for gift tax purposes. An ING is carefully structured to be a non-grantor trust[8] (that is, to avoid being treated as owned by the grantor or another person under Sections 671 through 679 of the Code).[9] An ING's non-grantor status, effectively permits the grantor to shift income from one taxpayer—namely, the grantor—to another—namely, the ING.

Before the enactment of Section 612(b)(41), the shift of income from the grantor to the ING made it possible, under New York's rules for taxing trusts, for a New York resident grantor to remove trust assets from New York State's tax net, thereby limiting or avoiding state income tax on accumulated income and capital gains within the trust. New York State generally does not tax the undistributed income of a non-grantor resident trust[10] if (i) all of the trustees are

[8] When the creator, or grantor, of a trust retains (or other persons are given) certain interests or powers over the trust, the trust is classified as a "grantor trust" for income tax purposes and the grantor (or other person) is required to include all of the trust's income on his or her own income tax return. *See* Sections 671-679 of the Internal Revenue Code of 1986, as amended (the "Code"). When the trust is not classified as a grantor trust, the income is taxable to the trust, to the extent it is not distributed (or deemed distributed) to a beneficiary of the trust. If the income of a non-grantor trust is distributed to the beneficiary, the income is included in the income of the beneficiary and is deducible by the trust. *See* Subchapter J of the Code.

[9] This outcome is somewhat difficult to achieve when the grantor is either a discretionary beneficiary of the trust or otherwise has certain powers with respect to distribution of trust property, both of which are characteristic of INGs. However, based on several Internal Revenue Service private letter rulings, grantor trust status apparently can be avoided by imposing carefully tailored limitations on the grantor's ability to (i) receive distributions and (ii) make decisions with respect to distributions. *See, e.g.*, private letter rulings 200148028 (Nov. 30, 2001), 200247013 (Nov. 22, 2001), 200502014 (Jan. 14, 2005), 200612002 (Mar. 24, 2006), 200637025 (Sep. 15, 2006), 200647001 (Nov. 24, 2006) and 200715005 (Apr. 13, 2007). The Internal Revenue Service has announced that it will no longer issue private letter rulings on this issue. *See, e.g.,* Rev. Proc. 2022-3. A detailed discussion of these provisions is outside the scope of this Report.

[10] A New York State resident trust generally is a trust whose grantor was a domiciliary of New York at the time the trust became irrevocable. Pursuant to Tax Law Section 605(b)(3), a resident trust includes: (i) a trust or a portion of a trust consisting of property transferred by the Will of a decedent who at his or her death was domiciled in New York State; (ii) a trust or portion of a trust consisting of the property of (a) a person domiciled in New York State at the time such property was transferred to the trust, if such trust or portion of a trust was then irrevocable, or if it was then revocable and has not subsequently become irrevocable or (b) a person domiciled in New York State at the time that the trust or portion of the trust became irrevocable, if it was revocable when such property was transferred to the trust but has subsequently become irrevocable.

domiciled outside of New York State, (ii) the trust has no New York State source income, and (iii) the trust has no real or tangible personal property located in New York State (commonly referred to as a "NYS Exempt Resident Trust").[11] Accordingly, prior to the 2014 legislation, it was possible for a New York State resident to establish an ING that, if the foregoing three conditions were met, would not be subject to New York State income taxation on its accumulated income and capital gains.

Despite the purported shift of income from the grantor to the trust, an ING is typically drafted so that the grantor remains a beneficiary eligible—albeit in the discretion of parties that are adversely affected—to receive distributions of both income and principal. Under prior law, a distribution from the ING to the grantor would only cause the grantor to be taxed on income realized by the trust in the year of distribution. Income realized in prior years would escape New York State income tax entirely.

Lastly, the federal gift tax did not inhibit the creation of INGs. Because a transfer to an ING is incomplete for gift tax purposes, no gift tax is due as a result of the transfer.[12] This permits the grantor to fund the trust without using the lifetime gift tax exemption (in 2014, $5,340,000) or otherwise incurring federal gift tax liability, while simultaneously shielding the assets from New York State income tax. In short, without adverse gift tax consequences, an ING permitted a New York resident individual to avoid New York State income tax on income-

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[11] Tax Law Section 605(b)(3)(D). These rules were developed in response to the decision of the New York State Court of Appeals in *Mercantile Safe Deposit & Trust Co. v. Murphy*, 203 N.E.2d 490 (N.Y. 1964) and the constitutional concerns it raised with imposing an income tax on a New York resident trust solely because the grantor was a resident of New York State.

[12] Generally, a transfer to a trust is a taxable gift, unless the trust is "incomplete," meaning the grantor retains "dominion and control" over the property. *See* Treas. Reg. Section 25.22511-2(b) ("if upon a transfer of property (whether in trust or otherwise) the donor reserves any power of its disposition, the gift may be wholly incomplete, or may be partially incomplete and partially complete, depending on all the facts in the particular case.").

producing assets, despite an expectation that the income, once accumulated, would ultimately be returned.

In 2014, following the 2013 Report and consistent with the recommendation made therein, New York State enacted Section 612(b)(41). Section 641(b)(41) provides that, in determining New York adjusted gross income, federal adjusted gross income is modified by adding back:

> In the case of a taxpayer who transferred property to an incomplete gift non-grantor trust, the income of the trust, less any deductions of the trust, to the extent such income and deductions of such trust would be taken into account in computing the taxpayer's federal taxable income if such trust in its entirety were treated as a grantor trust for federal tax purposes. For purposes of this paragraph, an "incomplete gift non-grantor trust" means a resident trust that meets the following conditions: (i) the trust does not qualify as a grantor trust under section six hundred seventy-one through six hundred seventy-nine of the internal revenue code, and (2) the grantor's transfer of assets to the trust is treated as an incomplete gift under section twenty-five hundred eleven of the internal revenue code, and the regulations thereunder.[13]

With the enactment of Section 612(b)(41), a New York resident who has created an ING is subject to New York income tax on the trust's taxable income even though, for federal income tax purposes, the trust is a separate taxpayer and the income of the trust is not included in the resident's federal adjusted gross income. Accordingly, it is as if the ING is a grantor trust for New York State income tax purposes, but a non-grantor trust for federal income tax purposes. The reform, by attributing the income of an ING to the grantor for New York State income tax purposes, effectively prevents a New York resident from using an ING to avoid New York State income tax on income-producing assets.

[13] Tax Law Section 612(b)(41).

II. Charitable Remainder Trusts[14]

A CRT is a form of trust that pays an annual amount[15] to one or more non-charitable beneficiaries (often the donor and/or the donor's spouse) for a specified period. Upon expiration of the period, the remainder is paid over to charities or is held exclusively for charitable purposes.

If structured properly, a CRT is subject to a unique income tax regime under Section 664 of the Code. In particular, a CRT is generally exempt from taxation under Code Section 664(c) and does not pay tax on income, including gains, realized by the trust.[16] The tax exemption of CRTs is based on the principle that, because the corpus of the trust remaining on termination will pass to tax-exempt remainder beneficiaries, the trust itself should be tax-exempt as well. Otherwise the charitable remainder beneficiaries would bear the burden of taxes that they would not pay if they owned the trust assets directly.[17] Distributions to the non-charitable beneficiary or beneficiaries to satisfy the annual payment requirement carry out current income, as well as accumulated income to the extent not previously carried out to the non-charitable beneficiaries, and the non-charitable recipient is subject to income tax on the distribution in the year in which

[14] The discussion in this Report regarding CRTs generally relates to CRTs that are established during a donor's lifetime, as opposed to testamentary CRTs.

[15] The annual amount paid to the non-charitable beneficiaries may be defined either as fixed annuity or as a unitrust amount (that is, a percentage of the fair market value of trust assets, determined annually). For purposes of this Report, such annuity or unitrust distributions to the non-charitable beneficiary or beneficiaries is referred to as the "annual payments."

[16] However, if a CRT has unrelated business taxable income ("UBTI"), as defined under Section 512 of the Code, for any tax year, the CRT will incur an excise tax equal to the amount of the UBTI. In effect, there is a 100% excise tax on UBTI earned by a CRT. *See* Section 664(c)(2)(A) of the Code; Treas. Reg. Section 1.664-1(a)(1)(i).

[17] *See generally* Schmolka, "The Income Taxation of Charitable Remainder Trusts and Decedents' Estates: Sixty Six Years of Astigmatism," 40 Tax L. Rev. 1 (1984). In part to prevent abuse of the CRT's tax exemption since the Tax Reform Act of 1969, Section 664 of the Code, has imposed strict requirements on the qualification of a trust as a valid CRT. *See* S. REP. 91-552, S. Rep. No. 552, 91ST Cong., 1ST Sess. 1969, 1969 U.S.C.C.A.N. 2027, 1969 WL 5896.

the non-charitable recipient is entitled to the distribution.[18] These unique rules override the provisions—including the grantor trust rules—that, but for Section 664 of the Code, would otherwise govern the taxation of CRTs and their beneficiaries.[19]

Importantly, a donor's gift to a CRT is in many cases considered to be incomplete for gift tax purposes. A common fact pattern is as follows:

> D, a New York resident, creates a CRT. D retains the right to receive annual payments (in a form approved under Section 664(d) of the Code) for D's lifetime. At D's death, the remainder passes to charities designated in the trust instrument. However, D retains the right to change the designated charities, so long as they are charities described in Section 170(c) of the Code at the time that the remainder is paid over.

In this example, neither D's retained right to annual payments[20] nor D's retained power to designate substitute charities[21] disqualifies the trust from being a CRT. For gift tax purposes, however, the combination of D's retained rights means that D does not surrender sufficient dominion and control for D's gift to the CRT to be considered complete for gift tax purposes.[22]

III. Individual Retirement Accounts

An IRA is a form of retirement account that is structured as a trust or custodial account and meets certain requirements.[23] A bank or similar institution acts as the trustee or custodian of

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[18] Code Section 664(b) imposes ordering rules that dictate the income tax character of distributions from a CRT to an individual beneficiary. Distributions carry out ordinary income, followed by capital gains, followed by other income (for example, tax exempt income), followed by a return of corpus. Each tier must be exhausted before distributions can be deemed to come from the next tier and the tiers are maintained on a cumulative basis for the duration of the trust.

[19] Section 664(a) of the Code; Treas. Reg. Section 1.671-1(d).

[20] Treas. Reg. Section 1.664-2(a)(3)(i); Treas. Reg. Section 1.664-3(a)(3)(i).

[21] Rev. Rul. 76-8, 1976-1 CB 179.

[22] Treas. Reg. Section 25.2511-1(e); Treas. Reg. Section 25.2511-2(c).

[23] Code Section 408; Treas. Reg. Section § 1.408-2.

the funds and investments contributed by the individual (or the owner) to the trust. The IRA trust agreement must provide that the entire interest of the owner for whose benefit the trust is maintained must be distributed to him or her within certain timeframes specified in the Treasury Regulations.[24]

Pursuant to Section 408(e) of the Code, IRAs are generally exempt from taxation. Therefore, the items of income, deductions and credits against tax that are attributable to the IRA are not included in the computing of the taxable income and credits of the owner (unless distributed), and the IRA trust is not a grantor trust. Moreover, because the income and principal of the IRA is payable to the owner, the owner may withdraw the IRA and the owner generally has the right to change the remainder beneficiaries of the account, a transfer by an owner to his or her IRA trust is not considered a completed gift.

IV. Potential Inadvertent Application of the Anti-ING Statute

The combination of the unique income tax regimes that govern the Specified Exempt Trusts and the fact that many transfers to Specified Exempt Trusts are incomplete for gift tax purposes may suggest that, although presumably unintended, Section 612(b)(41) applies to many Specified Exempt Trusts. To illustrate, in the example in Part II, the CRT is not a grantor trust, despite the grantor's retained right to receive annual payments, because the CRT regime overrides the application of grantor trust principles.[25] Yet the CRT is also incomplete for gift tax purposes, as discussed. Thus, arguably, Section 612(b)(41) applies to the CRT for New York income tax purposes.

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[24] Treas. Reg. Section 1.408-2(b)(6).

[25] Section 664(a) of the Code; Treas. Reg. Section 1.664-1(a)(4).

Put more generally, (1) certain powers or interests commonly retained by the donor of a CRT or the owner of an IRA trust often cause the transfer to be an incomplete gift for federal gift tax purposes,[26] and (2) under Section 664 of the Code and Section 408 of the Code, respectively (and the Treasury Regulations thereunder), CRTs and IRAs are not grantor trusts for federal income tax purposes and receive separate treatment. Accordingly, certain Specified Exempt Trusts technically might be viewed as "incomplete gift non-grantor trusts" for purposes of Section 612(b)(41).

If Section 612(b)(41) were to apply to the Specified Exempt Trusts, then the federal regimes for the Specified Exempt Trusts would not apply for New York State income tax purposes. Rather, a portion or all[27] of the taxable income in the Specified Exempt Trusts, instead of being carried out to the non-charitable beneficiaries or to the owner in accordance with the terms of the governing trust and corresponding federal regime, would be attributed directly to the New York resident grantor under the grantor trust rules. The federal income tax treatment of the Specified Exempt Trusts would be unaffected.

V. Statutory Language and Legislative Intent

A. Statutory Language

Section 612(b)(41) applies to a resident trust if (1) the trust "does not qualify as a grantor trust <u>under section six hundred seventy-one through six hundred seventy-nine of the internal revenue code</u>, and (2) the grantor's transfer of assets to the trust is treated as an incomplete gift

[26] Such retained powers or interests often include (i) the donor being named as the recipient of the annual payments during the initial term of the trust; (ii) the donor reserving a testamentary power to revoke a successor life estate; and/or (iii) the donor reserving the right to change the charitable remainder beneficiary(ies).

[27] It is unclear whether, if Section 612(b)(41) did apply, the entire CRT would be treated as owned by the grantor. The corpus irrevocably payable for charitable purposes might instead be taxed at the trust level. *Cf.* Section 674(b)(4) of the Code.

under section twenty-five hundred eleven of the internal revenue code, and the regulations thereunder." (Emphasis added.)

This definition has two prongs. The first prong (the "Income Tax Prong") bears on the federal income tax status of the trust (that is, grantor or non-grantor trust status); and the second prong relates to the federal gift tax consequences of transfers to the trust. Significantly, the Income Tax Prong turns on the tax status of the trust under Sections 671 through 679 of the Code.

B. Legislative History and Policy

The 2013 Report did not contemplate that any of the proposed solutions would apply to trusts other than INGs. The letter accompanying the 2013 Report provides that the 2013 Report recommended "three alternative approaches in response to the Commission's inquiry as to how New York State could tax on a current basis the income of so-called [ING] Trusts."[28] The text of the 2013 Report agreed with the Commission's view that INGs "created by New York State grantors should be subject to New York State income tax, given that [ING] Trusts appear to be primarily established to avoid state income taxation" and therefore recommended that the Commission consider legislation based on one of three proposed solutions that would make the income of an ING settled by a grantor who is a New York State domiciliary subject to New York State income tax.[29] Moreover, the legislative history for Section 612(b)(41) explicitly states that the changes were made "in relation to taxing residents who are grantors of exempt resident trusts that qualify as non-grantor incomplete gift trusts on the income from such trusts." Conversely,

[28] NYSBATS Letter dated November 18, 2013 accompanying the 2013 Report and attached hereto as part of Appendix 1.

[29] 2013 Report, p.19, p.24.

there is no indication from the legislative history of Section 612(b)(41) that it was intended to reverse New York's decades-long policy of conforming to the congressional strategy behind the special treatment for the Specified Exempt Trusts.

Finally, a deviation from the federal rules for CRTs or IRAs would not address any perceived abuse. When a donor creates a CRT and retains the right to receive annual payments, the donor is still taxed on current distributions under the CRT rules. In other words, in contrast to an ING created for the grantor's own benefit, a CRT for the donor's own benefit does not shift income away from the donor, other than any portion that is not carried out to the noncharitable beneficiaries but is instead accumulated for the tax-exempt remainder beneficiary. Similarly, distributions from an IRA to an owner are generally taxed to the owner in the year of the distribution as ordinary income.[30]

VI. Recommendations

Any ambiguity suggesting that Section 612(b)(41) might apply to the Specified Exempt Trusts should be addressed. We recommend below two alternative approaches to clarify that Section 612(b)(41) does not apply to CRTs or IRAs. One alternative is for the Department of Taxation and Finance (the "Department") to address the issue administratively, such as by a technical memorandum (a "TSB-M") or a regulation confirming that, under a technical reading of Section 612(b)(41) and as a matter of policy, the Specified Exempt Trusts are excluded from its application. If the Department determines that it is unable to address the issue administratively, we recommend that Section 612(b)(41) be amended to clarify that the Specified Exempt Trusts are excluded.

[30] Code Section 408(d)(1); Treas. Reg. §1.408-4(a). There are limited exceptions to this rule, for example, with respect to distributions that are subsequently rolled over into another IRA in accordance with the provisions of Section 408(d)(3) of the Code.

A. Administrative Solutions

It is possible for the Department to clarify ambiguity in (but not amend) an existing law and notify the public of the proper interpretation of a law through the issuance of administrative guidance. As described below, there is a good argument that the statute, as written, does not apply to the Specified Exempt Trusts. Therefore, we suggest that this clarification be handled administratively via a TSB-M or through the issuance of regulations. Because we understand that the issuance of a TSB-M is an informational statement of existing department policies, and would be simpler to implement than a regulatory change, we suggest the use of a TSB-M to make the clarification, unless the Department determines that a regulatory clarification is more appropriate.

Under two alternative readings of the statute, along with the clear legislative intent, it is possible to read Section 612(b)(41) as having no application to CRTs or IRAs. Both readings are based on the Income Tax Prong, which states that in order to be an ING, a trust "does not qualify as a grantor trust under section [671] through [679] of the internal revenue code."

Under the first reading, one looks only to Sections 671 through 679 of the Code to determine whether the trust is a non-grantor trust for purposes of Section 612(b)(41). If one looked exclusively at those Sections, then many CRTs would be grantor trusts, at least in part if not wholly,[31] under Section 677 of the Code due to their payment of the annual amounts to the donor and/or the donor's spouse.[32] Treasury Regulation Section 1.664-1(a)(4) provides that the

[31] Given that corpus is irrevocably dedicated to charity, it is possible that the grantor trust rules would not result in the entire CRT being treated as owned by the grantor. *See* Section 674(b)(4) of the Code.

[32] Code Section 677(a)(1) provides that "the grantor shall be treated as the owner of any portion of a trust … whose income without the approval of any adverse party is, or in the discretion of a nonadverse party, or both, may be distributed to the grantor of the grantor's spouse."

other rules of subchapter J are overridden, and CRTs are deemed to be non-grantor trusts.[33] However, while this means CRTs are non-grantor trusts, it is not because of Sections 671 through 679 of the Code. It is because of Section 664 of the Code and the Treasury Regulations thereunder.

Similarly, the typical IRA trust would qualify as grantor trust under Section 677 of the Code due to the ability of the grantor to withdraw income from the account. However, through the rule found in Section 408(e) of the Code (and not under Sections 671 through 679 of the Code) the IRA is exempt from tax. And, as noted earlier, the Income Tax Prong of Section 612(b)(41) refers only to trusts that are non-grantor trusts under Sections 671 through 679 of Code. Under this first reading, most Specified Exempt Trusts would be considered grantor trusts under Sections 671 through 679 of the Code and would therefore fail the Income Tax Prong.

Under the second reading, one looks to see whether the tax status as a non-grantor trust is mandated by rules found outside of Sections 671 through 679 of the Code. Said another way, if the trust is a non-grantor trust based on rules outside of Sections 671 through 679 of the Code (regardless of what the tax status of the trust would be under those Sections), then the trust in question would fail the Income Tax Prong and would not be considered an ING. Again, because the tax status of a CRT as a non-grantor trust is determined under Section 664 of the Code (and the Treasury Regulations thereunder) and the tax status of an IRA as a non-grantor trust is determined under Section 408 of the Code (and not under Sections 671 through 679 of the Code), these trusts would fail the Income Tax Prong. Note that under this second reading, even a

[33] Treasury Regulation Section 1.664-1(a)(4) provides, in part, that "neither the grantor nor his spouse shall be treated as the owner of the trust under such subpart E merely because the grantor or his spouse is named as a recipient." Treasury Regulation Section 1.671-1(d) further provides that the "provisions of subpart E are not applicable with respect to … a charitable remainder annuity trust as defined in paragraph (1) of section 664(d) and the regulations thereunder, or a charitable remainder unitrust as defined in paragraph (2) of section 664(d) and the regulations thereunder."

trust that would otherwise be partially grantor and partially non-grantor (such as some CRTs) would fail the Income Tax Prong, provided that a rule outside of Sections 671 through 679 of the Code, such as Section 664(a) or 408(e) of the Code, overrides grantor trust status.

In either case, the Specified Exempt Trusts would fall outside of the statute and therefore would not be considered INGs for purposes of Section 612(b)(41). Given the alternative statutory constructions of Section 612(b)(41), which exclude all Specified Exempt Trusts from its application, as well as the legislative history, we believe that the Department may provide clarity through administrative action (which would not result in a change in the law). Accordingly, we recommend that the Department issue a TSB-M (or regulation) confirming that CRTs and IRAs are not considered incomplete non-grantor trusts within the meaning of Section 612(b)(41).[34] Any guidance relying on the first reading should apply exclusively to CRTs and IRAs.[35]

B. Legislative Solution

If the Department determines that it is unable to address the issue through a TSB-M or a regulation, we recommend that Section 612(b)(41) be amended to clarify that the statute has no

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[34] We note that in the case of some CRTs there may be other arguments that Section 612(b)(41) does not apply. For example, many CRTs, such as a CRT for the initial benefit of a spouse where the donor retains the right to designate charitable beneficiaries, are only partially complete for gift tax purposes. It is unclear whether partial completion of a gift is sufficient to defeat Section 612(b)(41). So that taxpayers do not attempt to avoid Section 612(b)(41) by creating INGs (or ING-equivalents) that are mostly but not entirely incomplete for gift tax purposes, we recommend this theory should not be treated in guidance as sufficient to prevent Section 612(b)(41) from applying to any partially incomplete CRTs.

[35] In particular, the guidance should avoid any implication that Section 612(b)(41) can be defeated by creating an ING that, while mostly treated as a separate taxpayer, has a small portion (such as the portion consisting of a specific asset) that is treated as owned by the grantor. This implication could arise in the CRT guidance if it is not limited to the Specified Exempt Trusts. The reason is that a trust that is in part irrevocably dedicated to charity may not be a wholly grantor trust. Rather, even if the grantor is treated as the owner of all other portions of the trust, the charitable portion may be taxed under the non-grantor trust rules. If the guidance suggests that a CRT avoids Section 612(b)(41) because there is a mere *portion* that would be treated as owned by the grantor under the grantor trust rules, then aggressive taxpayers may extrapolate the conclusion that it is possible to defeat Section 612(b)(41) by causing a small portion of an ING to be treated as owned by the grantor. To prevent that inference, the guidance should make clear that it only applies to the Specified Exempt Trusts.

application to CRTs under Section 664 of the Code and IRAs under Section 408 of the Code. Specifically, the proposed legislation might amend Section 612(b)(41) so that it would read as follows (with crossed-out text deleted and underlined text added):

> In the case of a taxpayer who transferred property to an incomplete gift non-grantor trust, the income of the trust, less any deductions of the trust, to the extent such income and deductions of such trust would be taken into account in computing the taxpayer's federal taxable income if such trust in its entirety were treated as a grantor trust for federal tax purposes. For purposes of this paragraph, an "incomplete gift non-grantor trust" means a resident trust that meets the following conditions: (~~i~~1) the trust does not qualify as a grantor trust under section six hundred seventy-one through six hundred seventy-nine of the internal revenue code, and (2) the grantor's transfer of assets to the trust is treated as an incomplete gift under section twenty-five hundred eleven of the internal revenue code, and the regulations thereunder; provided, however, the term "incomplete gift non-grantor trust" shall not include a trust (or the portion of a trust) that qualifies as a charitable remainder trust under section six hundred sixty-four of the internal revenue code or as an individual retirement account under section four hundred eight of the internal revenue code.

C. Effective Date

In either case, the clarifying rule should be effective as of the original enactment of Section 612(b)(41). Section 612(b)(41) clearly was enacted to deal with INGs, not to capture CRTs or IRAs, and there should be no suggestion that the statute might have reached the Specified Exempt Trusts during the period of possible uncertainty.

APPENDIX 1