
A Beneficiary as Trust Owner: Decoding Section 678

by Jonathan G. Blattmachr, *New York, New York*
Mitchell M. Gans, *Hempstead, New York, and*
Alvina H. Lo, *New York, New York**

Editor's Synopsis: This article explores under what circumstances a person who did not actually contribute property to a trust can be considered its "owner" for income tax purposes. In particular, the article undertakes a detailed examination of whether a non-grantor holding a power to distribute trust property to himself or herself, subject to an "ascertainable standard," is properly treated as the trust's owner for income tax purposes and the extent to which a non-grantor who held an unrestricted power of withdrawal that has lapsed may continue to be treated, for income tax purposes, as the owner of the portion of the trust with respect to which the power lapsed.

Introduction

As a general rule, a trust is a taxpayer separate and independent of its grantor and its beneficiaries and is taxed in the same manner as an individual.¹ There are, however, certain special rules and limitations to this taxing regime. One exception is that a trust may be treated as substantially owned, under Section 671 of the Internal Revenue Code of 1986, as amended (the "Code" or "I.R.C."),² by its grantor (or a third person other than the grantor treated as a substantial owner). To that extent, the income, deductions and credits against tax of the trust are attributed for income tax purposes to its grantor (or a third person other than the grantor treated as a substantial owner), essentially as though the trust does not exist or, in other words, as if its grantor (or third person) owned the assets of the trust. Such a trust is called a "grantor trust." In fact, it

is the position of the Internal Revenue Service ("IRS" or "Service") and at least one court³ that the existence of a grantor trust is ignored for all income tax purposes.

Some Consequences of Grantor Trusts

One potentially significant gift, estate and generation-skipping transfer tax advantage of a grantor trust is that the grantor (or a third person other than the grantor treated as a substantial owner) pays the income tax on the trust's income which allows the trust assets, in effect, to grow income tax-free for the benefit of the trust beneficiaries. Certain empirical studies indicate that grantor trust status adds more value to a trust estate than ordinary market performance or valuation discounts.⁴

In certain circumstances, it may not be possible to make a trust a grantor trust with respect to its grantor (for example, if the grantor has died). In other cases, it may be more advantageous for a third person other than the grantor to be treated as a substantial owner of the trust and to pay the income tax on the trust's income. Section 678 provides the means to make a trust a grantor trust with respect to a third person other than the grantor.

A grantor trust may provide other income tax advantages. For instance, if the grantor of a grantor trust is a U.S. individual taxpayer, the trust automatically qualifies under Section 1361(c)(2)(A)(i) as an eligible shareholder of a so-called "S Corporation." Nonetheless, grantor trust status may be viewed in some cases as adverse.⁵ Although a trust that is neither

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¹ I.R.C. §641(b) directs that "[t]he taxable income of an estate or trust shall be computed in the same manner as in the case of an individual, except as otherwise provided."

² "Section," unless otherwise indicated, refers to a Section.

³ *Madorin v. Commissioner*, 84 T.C. 667 (1985) (ruling that a grantor should be treated as the owner of partnership interests the grantor transferred to his grantor trust). *But, cf.*, *Rothstein v. United States*, 735 F.2d 704 (2d Cir. 1984) (reaching a contrary position and ruling that a trust owned by a grantor must be regarded as a separate taxpayer capable of engaging in sales transaction with the grantor). In *Rev. Rul. 85-13*, 1985-1 C.B. 184, the IRS

announced it would not follow *Rothstein*.

⁴ See Jonathan G. Blattmachr et al., *Selected Comparisons of Selected Estate Tax Reduction Strategies*, Presentation at Fall 2007 Meeting of The American College of Trust and Estate Counsel.

⁵ Indeed, the grantor trust rules were long viewed as adverse, and a grantor trust often was referred to as a "defective" trust. See, e.g., Mitchell M. Gans, Stephanie E. Heilborn and Jonathan G. Blattmachr, *Some Good News About Grantor Trusts: Rev. Rul. 2004-64*, 31 EST. PLAN. 467, 469 (2004). That term continues to be in use today. See, e.g., James A. Busse Jr., *The Deficit Reduction Act Makes Estate Planning for the Needs of an Ill Spouse and a Well Spouse More Difficult*, 30 LOS ANGELES LAWYER 35 (2007).