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A Beneficiary as Trust Owner: Decoding Section 678

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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 court[3] 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).

a grantor trust nor a tax-exempt trust[6] reaches the highest federal income tax bracket at a low threshold of taxable income ($11,150 for 2009), the trust may face lower income tax on the income it earns than the grantor would.[7] Also, a trust may be structured, in some cases, to avoid state or local income taxes that the grantor faces.[8] In addition, over time, the financial burden of paying tax on the trust's income may become unacceptably high.

This Article will provide a brief overview of the grantor trust rules and discuss in some detail Section 678, which deals with a person other than the grantor being treated as the income tax owner of all or a portion of a trust. Specifically, this Article will explore how an ascertainable standard such as the so-called health, education, maintenance and support standard limits the application of Section 678(a) and whether a lapse or complete release of a Section 678(b)(1) power constitutes a "partial release" or "modification" under Section 678(b) so that the powerholder thereafter remains the substantial owner of the trust. This Article will also examine the meaning of the exception under Section 678(b) when the income, deduction and credits against tax of a trust are attributed to the grantor under the grantor trust rules rather than to a third person other than the grantor treated as a substantial owner under Section 678(a) and what happens when the Section 678(b) exception no longer applies because the grantor is no longer the owner under the grantor trust rules.

Overview of Grantor Trust Rules and Section 678

Under Section 671, a trust is treated as a grantor trust for federal income tax purposes if it falls under circumstances described in one or more of Sections 673-679. To the extent a trust is a grantor trust, the income, deductions and credits of the trust are attributed to the grantor (or to a person other than the grantor treated as a substantial owner under Section 678). A trust, in general, will be a grantor trust with respect to the grantor in any one or more of the following situations: if the grantor holds a reversionary interest at the time of the trust's creation that is more than 5 percent of the value of the trust estate,[9] if the grantor or a nonadverse person as defined in Section 672(a) has the power to determine the beneficial enjoyment of either corpus or income,[10] if the grantor or the grantor's spouse has the power to revoke the trust without the consent of an adverse party,[11] if the grantor or a nonadverse person has the power to use the trust income for the benefit of the grantor or the grantor's spouse[12] or if the grantor is a United States person defined under I.R.C. §679(a) and the trust is a foreign trust that has one or more United States beneficiaries.[13] In addition, a trust may be a grantor trust with respect to the grantor if the trust instrument grants certain administrative powers that are viewed as exercisable for the grantor's benefit.[14] These administrative powers include the power to deal with trust assets for less than adequate and full consideration,[15] the power to borrow trust assets without adequate interest and security,[16] actual borrowing of trust assets without adequate interest or security and repayment during the taxable year[17] and certain administrative powers exercisable in a nonfiduciary capacity.[18] The foregoing are general rules only. The grantor trust rules are complex, and reference to the Treasury Department regulations that have been promulgated and other authority and commentary that deal with them must be consulted to determine the scope and application of the grantor trust rules.[19]

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6 Certain trusts, including a charitable remainder trust described in Section 664(b), except to the extent of its unrelated business income, are exempt from tax. Also, a foreign trust, described in I.R.C. §7701(a)(31)(B), is exempt from United States income tax on non-U.S. source income although adverse income tax consequences may arise with respect to contributions to and distributions from such trusts. *See* I.R.C. §§684 and 668.

7 There are at least two reasons why a trust may face lower income tax on the income it earns than the grantor would: (1) the taxable income may be below the threshold at which a trust reaches the highest tax bracket; and (2) the grantor may be subject to state and local tax where the trust is not.

8 *See, e.g.*, NY CLS Tax §605(b)(3) (an irrevocable non-grantor trust is not subject to New York income tax if the trust has no New York trustee, no New York source income and no New York situs asset, even if its grantor was a New Yorker).

9 I.R.C. §673.

10 I.R.C. §674.

11 I.R.C. §676.

12 I.R.C. §677.

13 I.R.C. §679.

14 I.R.C. §675.

15 I.R.C. §675(1).

16 I.R.C. §675(2).

17 I.R.C. §675(3).

18 I.R.C. §675(4).

19 For example, although I.R.C. §677(a)(3) expressly provides that a trust will be a grantor trust if the trustee (without the consent of any adverse party) may use assets of the trust to pay premiums on a policy of insurance on the life of the grantor or the grantor's spouse, case law suggests that I.R.C. §677(a)(3) will apply only if the policies are in existence during the year. Further, it seems likely that there must be some suggestion by the grantor that income be so used. However, this does not seem necessary if income is actually so used. Jonathan G. Blattmachr and F. Ladson Boyle, *Income Taxation of Estates and Trusts* (Practicing Law Institute 2007) at §4:5.4 (footnote with citations omitted). *See generally* Leo L. Schmolka, *Selected Aspects of the Grantor Trust Rules*, 9 INST. ON EST. PLAN. 1400 (1975).

Beneficiary Treated as "Owner" or "Grantor"

A trust also may be a grantor trust with respect to a person who is not a grantor of the trust. Under Section 678(a), a person other than the grantor may be treated as the owner of the whole or a portion of the trust if: (a) such person has the power, exercisable solely by himself or herself, to vest the corpus or income in himself or herself;[20] or (b) he or she has "partially released or otherwise modified such a power" so that, if the control were retained by the grantor, the grantor would be treated as the owner of the trust under the principles of Sections 671-677.[21] For example, assume a child has the unilateral right to withdraw all property in a trust created under the will of the child's deceased parent. This unilateral power of withdrawal triggers Section 678(a) causing the child to be treated as the trust's owner for purposes of Section 671 so that the income, deductions and credits against tax of the trust are attributed directly to the child. Two years later, the child partially releases the power. If the trustee (a person other than the child), without consent of any adverse party, may distribute the income and corpus to the child and because such a power to distribute income and corpus to the grantor would cause the trust to be a grantor trust with respect to the grantor under Sections 676 and 677, it remains a grantor trust with respect to the child.

Section 678 was added to the tax law as a result of the decision in *Mallinckrodt v. Commissioner*[22] by the United States Court of Appeals for the Eighth Circuit. In that case, the grantor created a trust for the benefit of a beneficiary and the beneficiary's family. The trust instrument provided that the trustees were to distribute trust income to the beneficiary upon his request. The Eighth Circuit held that, because the beneficiary could essentially direct the timing and amount of distribution of income from the trust, the beneficiary had the equivalent of ownership of the trust income for purposes of taxation and should be taxed as the owner of the trust. Some common examples of a *Mallinckrodt* power would be a beneficiary holding a general power of appointment over the trust income or corpus or a so-called "Crummey power."[23]

Section 678(b) provides an exception to the general rules described above. The person with the withdrawal power is not to be treated as the owner of the trust income if the grantor of the trust is otherwise treated as the owner of that *income* under the other grantor trust rules of Sections 673-677 or 679.[24] A plain reading of subsection (b) implies that, if a third person holds a power over the trust *principal*, Section 678(b) would not apply, and therefore the person with the withdrawal power would be taxed as owner of the trust. The key reconciling this seeming inconsistency between Section 678(b) treatment of a power over income and a power over principal seems to be in the definition of the word "income" (which will be discussed later in this Article). Section 678(c) provides another exception where a third person, in his or her capacity as trustee or co-trustee, will not be treated as the owner of the trust if he or she has the power merely to apply the income of the trust to the support or maintenance of a person whom such third person is obligated to support or maintain, except to the extent that such income is so applied.[25]

Section 678(a) and Ascertainable Standards

As discussed above, Section 678(a)(1) provides that "a person other than the grantor shall be treated as the owner of any portion of a trust with respect to which such person has a power exercisable solely by himself to vest the corpus or income therefrom in himself." The question is to what extent Section 678(a)(1) applies if the person's withdrawal power is subject to limitations such as an ascertainable standard.

For both income and transfer tax purposes, the type of control that a court is permitted to exercise over a discretionary act undertaken by a trustee or beneficiary can be critical. Depending on the context, it may be necessary for the discretionary act to be subject to different types of state court control in order to achieve the desired outcome.

[20] I.R.C. §678(a)(1).

[21] I.R.C. §675(a)(2). Note that I.R.C. §679 is not mentioned in I.R.C. §678(a) but is mentioned in I.R.C. §678(b).

[22] Mallinckrodt v. Commissioner, 146 F.2d 1 (8th Cir. 1945). Although the grantor trust rules were added to the Internal Revenue Code in 1954, the Treasury Regulations were promulgated under the Internal Revenue Code of 1939. *See* 1939 Treas. Reg. §111, §29.22(a)-21. The Treasury Regulations were codified into the Internal Revenue Code of 1954 with little change.

[23] *See* Crummey v. Commissioner, 397 F.2d 82 (9th Cir. 1968). *See generally* Georgiana J. Slade, Personal Life Insurance Trusts, Portfolio 807 Tax Management (BNA) Estates, Gifts, and Trusts, at A-9 thru A-18; Diana S.C. Zeydel, *How to Create and Administer a Successful Irrevocable Life Insurance Trust*, 34 Est. Plan. 3, 10-13 (2007).

[24] I.R.C. §678(b) which states, "Subsection (a) shall not apply with respect to a power over income, as originally granted or thereafter modified, if the grantor of the trust or a transferor (to whom I.R.C. §679 applies) is otherwise treated as the owner under the provisions of this subpart other than this Section."

[25] I.R.C. §678(c). This provision should be compared with Treas. Reg. §1.662(a)(4) which would attribute a distribution of income of a non-grantor trust to a person whose support obligation is satisfied by the distribution.

There are, in essence, five categories of cases. First, the governing instrument of the trust may give the beneficiary the right to withdraw assets from the trust for certain purposes but make the judgment of the beneficiary conclusive.[26] Where the instrument takes this form, the court is precluded from exercising any supervisory control regarding withdrawals.[27] Second, while the instrument may give the trustee extraordinarily broad discretion without imposing any standard to guide the trustee's decision making, it may nonetheless have the effect of giving the court the authority to review any exercise of discretion to make sure that it does not violate any type of mandatory fiduciary duty that may not be waived in the trust instrument, such as the duty to act in good faith. Third, the instrument may impose a standard designed to constrain the trustee's discretion. When a so-called ascertainable standard is used, a court has the authority to hold the trustee accountable for any decision that deviates from the standard. Fourth, the instrument may contain an ascertainable standard relating to the powerholder's health, education, maintenance or support (HEMS). This is a subset of the ascertainable standard category, with the court having the authority to hold the powerholder accountable for any withdrawal that is not consistent with the HEMS standard. As will be discussed, the HEMS standard is relevant only in determining whether a powerholder has a general power of appointment for transfer tax purposes. (Of course, the use of such a HEMS limitation converts what would otherwise be a general power of appointment into a non-general power.) Finally, in the fifth category of cases, a powerholder's discretion may be constrained not by trust law or by the trust instrument, but rather by a fiduciary duty that derives from corporate law.

In the first category of cases, where the powerholder may withdraw trust assets with impunity from judicial review, the powerholder is treated as the absolute owner of the trust's assets for all tax purposes. Thus, in such a case, the assets would be included in the powerholder's gross estate[28] and could be subject to gift tax were the power exercised or released[29] (subject to the "five-and-five" exception[30]). Similarly, for income tax purposes, the trust is treated as the powerholder's grantor trust under Section 678. As a result, the powerholder is in effect deemed to own the trust's assets outright, making all of the trust's income directly taxable to the powerholder. Absent this power, the trust would ordinarily be respected as a separate entity for income tax purposes and therefore taxable on its income, subject to subchapter J's pass-through regime.[31] This ownership-equivalence concept makes sense. After all, it would elevate form over substance to treat a powerholder with such an unfettered right to withdraw trust assets differently. Indeed, when Congress enacted Section 678, codifying the famous Mallinckrodt decision,[32] it explicitly made unrestricted or unfettered access the touchstone for triggering grantor trust status under Section 678.[33]

In the second category of cases, where the powerholder has unlimited discretion but the court nonetheless has some supervisory authority, the ownership-equivalence concept applies only for transfer tax purposes. To illustrate, assume that the trust instrument authorizes the powerholder to withdraw trust assets and that, as a matter of state law, the court may require the powerholder to reimburse the trust for a withdrawal if it determines that the powerholder did not act in good faith. For estate and gift tax purposes, the powerholder would be taxable on any lifetime transfer or transfer at death of the trust's assets.[34] Inasmuch as the powerholder would not have unfettered or unrestricted access to the trust's assets, however, Section 678 should not apply.

The transfer tax treatment of such a power is consistent with the approach the Supreme Court has taken in its Section 2036 jurisprudence. In *O'Malley v. United States*,[35] where the trust grantor served as trustee, the Court held that the trust's assets should be included in the grantor's gross estate under Section 2036(a)(2) because of the grantor's retained discretion, as trustee, to determine which beneficiaries should receive income distributions. In reaching this conclusion, the Court did not find that the duty of a trustee to act in good faith constituted a sufficient constraint on the trustee to justify excluding the value of the trust's assets from the grantor's gross estate.

The disparity in the income tax and transfer tax treatment of this type of power can perhaps be justi-

[26] *See, e.g.*, Matter of Woollard, 295 N.Y. 390 (1946). In re McCoy, 274 B. R. 751 (Bankr.N.D.Ill. 2002), *aff'd* 2002 WL 1611588. *But see* RESTATEMENT (THIRD) OF TRUSTS §58 (2003) (critiquing *McCoy*).

[27] *See, e.g.*, Woollard, supra; McCoy, supra.

[28] *See* I.R.C. §2041.

[29] *See* I.R.C. §2514.

[30] *See* I.R.C. §2514(e).

[31] *See* I.R.C. §§651-652, 661-662.

[32] Mallinckrodt v. Nunan, 146 F.2d 1 (1945).

[33] *See* S. Rept. No. 1622, 83d Cong., 2d Sess., p. 87 (I.R.C. §678 is to apply if the beneficiary "has an <u>unrestricted</u> power to take the trust principal or income" (Emphasis added). *See also* Stavroudis v. Commissioner, 27 T.C. 583 (1956) (indicating that I.R.C. §678 will only apply if the powerholder has the right to act arbitrarily); Trust No. 3 v. C.R.T., 33 T.C. 734, *rev'd* on other grounds, 285 F.2d 102 (7th Cir. 1960) (indicating that "unfettered command" is the touchstone of I.R.C. §678).

[34] Estate of Lanigan v. Commissioner, 45 T.C. 247 (1965).

[35] O'Malley v. United States, 383 U.S. 627 (1966).

fied. Whereas treating the powerholder as the owner for income tax purposes would require him or her to bear the burden of the tax, the question of who bears the tax burden is different for transfer tax purposes. When a person holding a general power dies, the resulting estate tax is paid not by the powerholder but by the person receiving the property that had been the subject of the power (in the absence of a contrary provision in the powerholder's will).[36] Thus, while the court's supervisory authority limits the powerholder's access to the trust's assets such that it may seem inappropriate to tax the powerholder on all of the trust's income, including the assets in the powerholder's estate does not so significantly impact the powerholder necessarily to warrant not taxing the trust as a part of the powerholder's estate.[37]

In *Mallinckrodt*, the beneficiary's power to demand a withdrawal of income was not limited by any standard. It would seem that, if a third party other than the grantor (*e.g.*, a trust beneficiary) has unfettered control over the trust income or corpus, then Section 678(a)(1) would apply to make that portion of the trust (the income portion or the corpus portion) a grantor trust with respect to the third party. If, however, the third party could withdraw only if a condition exists, it seems doubtful that Section 678(a) would apply unless and until the condition arises. For example, assume a trust created by will unilaterally permits a child to withdraw all of the property when she attains the age of 50. She has no other right to withdraw income or corpus prior to that time. It seems nearly certain that Section 678(a)(1) will apply only when the child reaches age 50.

In the estate tax context, a decedent's power to consume, invade, or appropriate property for her own benefit which is limited by an ascertainable standard relating to the health, education, support or maintenance of the decedent is not deemed to be a general power of appointment and therefore not subject to inclusion in the powerholder's gross estate for estate tax purposes.[38] Some practitioners take the position that, even though the withdrawal power is limited to a HEMS standard in order to avoid inclusion for estate tax purposes, it is nonetheless sufficient to trigger Section 678(a)(1) for income tax purposes. This, however, does not appear to be a tenable position. In cases where the withdrawal power is subject to a HEMS standard, Section 678(a)(1) cannot apply because the powerholder does not have unfettered access. In other words, if a state court has the authority to review the propriety of a distribution, Section 678(a)(1) would appear to be inapplicable. If, on the other hand, the governing instrument eliminates the state court's authority to approve or disapprove the distribution, then Section 678(a)(1) would apply.

The question is whether there is any "space" between Section 678(a)(1) and Section 2041 (or Section 2514, the gift tax analog to Section 2041). In the case of a HEMS-based standard, Section 678(a)(1) should not apply. Nor, of course, would Section 2041 apply. On the other hand, in the case of a non-HEMS-based standard, Section 2041 should apply, but Section 678(a)(1) should not apply given the lack of unfettered access. In short, one cannot draft an instrument that would produce estate tax exclusion while triggering Section 678 (i.e., any HEMS-based standard, which would be sufficient to preclude estate-tax inclusion, would concomitantly preclude application of Section 678(a)(1)). Conversely, an instrument could be drafted that would produce estate tax inclusion without triggering Section 678 (*e.g.*, a powerholder is given the right to withdraw based on a standard other than HEMS).

These conclusions are borne out in case law. In *Smither v. United States*,[39] a case decided before the enactment of Section 678 in 1954,[40] the court held that a beneficiary would not be treated as the owner of the trust because her withdrawal right was limited to her "support, maintenance, comfort and enjoyment."[41] In *Smither*, the decedent devised his entire estate to his widow for her own support, maintenance, comfort and enjoyment and for the support, maintenance, education, comfort and the enjoyment of their children.[42] The decedent's will further provided that the executors had the power to expend such part of the income and to invade the corpus for the support, maintenance, comfort and pleasure of the widow and of the children "as in the discretion of my said executors may appear to be proper or desirable."[43] The decedent's two brothers and his widow were appointed as executors. Some years later, the two brothers died and the widow remained as the sole executor. The IRS asserted that,

[36] *See* I.R.C. §2207.

[37] Note, however, a release or exercise of a general power would subject the powerholder to gift tax. *See* I.R.C. §2514. And there is no provision in the Code that would allow the powerholder to seek reimbursement of the gift tax from the person who receives the property.

[38] I.R.C. §2041. I.R.C. §2514(c)(1) provides for the same test for gift tax purposes.

[39] Smither v. United States, 108 F.Supp. 772 (S.D. Tex. 1952).

[40] I.R.C. §678 is the statutory adoption of Treasury Regulations that were promulgated under the Internal Revenue Code of 1939.

[41] *Smither v. United States, supra.*

[42] *Id.*

[43] *Id.* at 772-773.

in the years in question during which the widow was the sole executor, she had unlimited discretion to expend all or any part of the income for her own purposes and, therefore, should be treated as the owner of the income and be liable for the tax thereon.[44] The United States District Court rejected the Service's argument and held that the widow's withdrawal power was not unfettered but rather restricted by the terms of the will. The widow's power was subject to a "legal obligation," namely her power to withdrawal was limited to what was "necessary for her support, maintenance, comfort and enjoyment, with a similar right in favor of the children."[45] This standard, the court explained, was "sufficiently clear and definite to be both understandable and enforceable."[46] Therefore, the widow could withdraw "no more than that the needs of maintaining the family in the station in life to which it had become accustomed should be met,"[47] and the trust, and not the widow, was the proper taxpayer with respect to the trust income. By holding that the widow did not have unfettered control over the trust assets and that her power was subject to a legal obligation, the *Smither* Court indicated that it had the authority and indeed exercised that authority to review the propriety of distributions based on the HEMS standard as expressed in the decedent's Will. It is, therefore, reasonable that Section 678(a)(1) should not apply in this case.

The United States Courts of Appeal for the Ninth and Third Circuits reached similar decisions in *United States v. De Bonchamps*[48] and *Funk v. Commissioner*,[49] respectively. *De Bonchamps* was a consolidation of three cases where the IRS contended that all three life tenants were taxable as the owners of income. In all three cases, the taxpayers' powers to withdraw were subject to their "needs, maintenance and comfort."[50] The United States Court of Appeals for the Ninth Circuit ruled that the powers held by each of the taxpayers were "expressly limited to her needs, maintenance and comfort" and that, therefore, she did not have unlimited power to take the corpus for herself.[51] As a result, the taxpayers were not taxable on income.

Similarly, in *Funk*, the United States Court of Appeals for the Third Circuit focused on the word "needs" to bar income taxation to the beneficiary. In that case, the taxpayer had the power to make distribution to herself subject to her "needs, of which she shall be the sole judge."[52] The United States Tax Court seemed to have ignored the standard imposed in the governing instrument and held that the taxpayer should be taxable on the trust income because she had absolute control over the trust's income under the terms of the trust instrument.[53] The Court of Appeals reversed the Tax Court and ruled that the taxpayer was not the owner of the trust because her power was limited by the word "needs" in the trust instrument. The Court of Appeals explained that, although the word "needs" cannot be defined precisely, it nevertheless established a "standard effectively distinguishing this case from, and taking it out of the rule, of the Mallinckrodt...decision."[54] The Court of Appeals further explained that the word "needs" has been construed by the state court to mean what is reasonably necessary to maintain a beneficiary's station in life and it, therefore, "confined the trustee to limits objectively determinable."[55]

The effect of an ascertainable standard on the applicability of Section 678(a) is not beyond debate. There are at least two cases and one private letter ruling[56] that seem to support a contrary position. However, upon closer examination of these cases and private letter ruling, they seem to be distinguishable and can-

[44] *Id.* at 773.

[45] *Id.* at 774.

[46] *Id.*

[47] *Id.*

[48] United States v. De Bonchamps, 278 F.2d 127 (9th Cir. 1960).

[49] Funk v. Commissioner, 185 F.2d 127 (3rd Cir. 1950), *rev'd*, 14 T.C. 198 (1950).

[50] *De Bonchamps*, 278 F.2d at 128.

[51] *Id.* at 130.

[52] *Funk*, 185 F.2d at 128.

[53] *Id.* For discussion of this point in the Tax Court decision, see 14 T.C. at 213.

[54] *Id.* at 131.

[55] *Id.*

[56] It should be noted that Rev. Rul. 81-6, 1981-1 C.B. 385 is not inconsistent with the notion that section 678 can only apply where there is unrestricted or unfettered access to the trust's assets. In the ruling, the Service ruled that a minor beneficiary of a trust is treated as the owner of any portion of the trust with respect to which the minor has a power to vest the corpus or income in himself, despite the fact that no guardian has been appointed for the minor and the minor does not have the legal capacity to exercise such power. The Service explained that "[f]or purposes of Section §678 it is the existence of a power rather than the capacity to exercise such a power that determines whether a person other than the grantor shall be treated as the owner of any part of a trust." The ruling relied on *Trust No. 3 v. Commissioner*, 285 F.2d 102 (7th Cir. 1960), where the United States Court of Appeals for the Seventh Circuit held that minor beneficiaries with a power to terminate a trust and to take possession of the trust property have a vested present right to use all or any part of the trust property upon demand despite the fact that no guardians have been appointed. The Service acknowledged the Court of Appeals' reasoning that the appointment of a guardian is a routine step that should have no bearing upon the fundamental question of the legal right of the beneficiaries to terminate the trust.

not be said to offer contrary authority. The first of these cases is *Koffman v. United States*[57] where the decedent created a trust for the benefit of his widow to be used by her for her "personal support and maintenance, *the reasonableness thereof to be determined by her*" (Emphasis added).[58] The United States Court of Appeals for the Sixth Circuit ruled the widow should be taxable on the trust income because she had unfettered right to determine the reasonableness of her withdrawals for her support and that her power was not subject to any limitation.[59] At first blush, it seems that Section 678(a) applies even if the beneficiary's withdrawal right is limited to her support and maintenance. However, a closer examination of the decision indicates that the key language in *Koffman*, causing the Section to be triggered, may not have been the "support and maintenance" standard itself but rather the manner in which the standard was determined to have been met. The words "reasonableness thereof to be determined by her" could be interpreted to have granted the beneficiary the subjective right to determine whether the standard has been met. If the reasonableness of whether the standard has been met is to be determined solely by the beneficiary and cannot be questioned or enforced by another party, then the beneficiary essentially has unfettered control over the trust assets.[60] This is different from *Smither, De Bonchamps* and *Funk* discussed above, because unlike the governing instruments in those cases, the governing instrument in *Koffman* provided that the propriety of the distribution was to be judged solely by the beneficiary, essentially eliminating a state court's authority to review the propriety of the distribution. In *Smither, De Bonchamps* and *Funk*, the courts made clear that the standard in those cases was one that is "objectively determinable"[61] and "understandable and enforceable"[62] by the courts. In contrast, the court in *Koffman* could not objectively determine or enforce the standard set forth by the decedent in the governing instrument.

The second case is *Townsend v. Commissioner*,[63] in which the United States Tax Court held that the beneficiary widow was taxable on the amount of income deemed to be necessary for her support as determined by the state court. The case began as a contested proceeding in the state court involving the accounting of the trustees of a testamentary trust. The decedent's will provided that the income of the testamentary trust was to be payable to the decedent's widow as "she deems necessary for her own support and for the maintenance, education and support of [the decedent's] children."[64] The state court had previously determined that the widow was entitled to $30,000 per year from the trust income for her maintenance and support.[65] The Tax Court relied on this determination and held that the widow was taxable on this $30,000 of income. The Tax Court's holding that the beneficiary widow should be taxed as the owner of the $30,000 of the trust income does not appear to be based on the support and maintenance standard in the governing instrument but rather on the state court decree that $30,000 was the amount the widow was entitled to receive under such standard. Since a state court had determined what amount was payable to the widow subject to the standard, then the widow had unfettered right and control over that amount and should be taxable on that income. In the absence of any state court decree, it is unclear whether the standard would been met and whether the widow would be entitled to any income from the trust. It is also important to note that *Townsend* was decided prior to the United States Supreme Court's decision in *Commissioner v. Bosch*,[66] and it is doubtful that a subsequent court would follow a lower state court decision in its determination of a federal income tax issue. Lastly, *Townsend* was decided by the Tax Court in 1945, just a few years prior to Funk (where the Tax Court held that a beneficiary withdrawal power subject to a "needs" standard is not taxable to the beneficiary), yet *Funk* did not mention or cite *Townsend*. Therefore, it seems likely that the *Townsend* holding is limited to its facts and stands only for the proposition that, if the beneficiary's withdrawal right is subject to a standard and a state court has issued a decree (and thus exercised authority to review the propriety of distributions) granting the beneficiary the right to withdraw a certain amount based on that standard, then that amount will be taxable to the beneficiary under Section 678(a).

Another authority potentially contrary to the proposition that an ascertainable standard limits the applica-

[57] Koffman v. United States, 300 F.2d 176 (6th Cir. 1962).

[58] *Id.* at 176.

[59] *Id.* at 177.

[60] *Cf. Matter of Woollard*, 295 N.Y. 390 (1946) (ruling that a will that provided the decedent's widow with the right to income and principal of the trust, as the widow shall deem necessary for her maintenance, comfort or well being is a power granted to the widow that may not be questioned by anyone).

[61] *Funk*, 185 F.2d at 131.

[62] *Smither*, 108 F.Supp. at 774.

[63] Townsend v. Commissioner, 5 T.C. 1380 (1945).

[64] *Id.* at 1381.

[65] *Id.* at 1384.

[66] Commissioner v. Bosch, 387 U.S. 456 (1967) (ruling that only the decree of a state's highest court would be binding for Federal tax purposes). *Cf.* Rev. Rul. 73-142, 1973-1 C.B. 405 (IRS is bound if the court decree is entered before taxing event).

bility of Section 678(a) is PLR 8211057 (Dec. 16, 1981).[67] In this ruling, the IRS ruled that a beneficiary's power to invade corpus for her "support, welfare and maintenance" would be taxable under Section 678(a). However, "welfare" is not an ascertainable standard[68] and therefore is not subject to review by a state court. In addition, this private letter ruling serves only as an indicator of what the Service's position was at the time the ruling was issued. It has no precedential value.[69]

The authorities seem to suggest that there is indeed no space between Section 678(a)(1) and Section 2041 (or Section 2514). Therefore, where a goal is to avoid estate tax under Section 2041 (or taxable gift tax status under Section 2514), imposing a HEMS standard on a trust beneficiary's power of withdrawal will likely block grantor trust treatment under Section 678(a)(1) with respect to the holder of the power of withdrawal.[70] It would seem that consistent treatment should be applied to both the taxpayer during his or her lifetime for income tax purposes and his or her estate after his or her death for estate tax purposes (or to the taxpayer during his or her lifetime for gift tax purposes), although estate and income tax provisions, unlike gift and estate tax provisions, are not in *pari materia*.[71]

Indeed, a taxpayer probably should be cautious in taking the position that Section 678(a) applies, even if his or her withdrawal power is limited by an ascertainable standard, in order to make the trust a grantor trust with respect to himself or herself for income tax purposes. By taking that position, the taxpayer is essentially representing to the Service that his or her power to withdrawal is an unfettered one and that he or she has absolute control over the trust. If the taxpayer's withdrawal right were for income tax purposes considered not limited by an ascertainable standard, then would not that withdrawal right, not so limited, constitute a general power of appointment? It might be difficult for the taxpayer's estate successfully to take such inconsistent positions.

Tax return preparers and advisors also may be somewhat concerned about taking a position or providing advice that a trust is a grantor trust under Section 678 with respect to a beneficiary if the beneficiary has a withdrawal right that is subject to an ascertainable standard. Under amended Section 6694, a preparer may not take a position on a return and an advisor may not provide advice that the position may be taken unless there is "substantial authority" for the position or unless there is, in fact, a reasonable basis for the position and the position is specifically disclosed (generally by completing and attaching IRS Form 8275 to the return).[72] Otherwise, the preparer or advisor may be subject to a penalty under the Section. Fortunately, for both preparers and advisors, IRS Notice 2008-13 has at least temporarily relaxed those standards.[73] But because there may well be a substantial understatement of the trust's income tax liability if the trust is not a grantor trust but pays no income tax because the trustee treats it as a grantor trust, the trust's return would have to have the disclosure form attached to avoid the penalty under Section 6694, unless there is substantial authority to treat the trust as a grantor trust. Whether there is substantial authority for that position is an objective determination, not one of the preparer's belief (although the Section 6694 penalty does not apply if the preparer or advisor acted with reasonable cause, also likely an objective standard, and acted in good faith).[74] It seems questionable whether there is substantial authority for the position that a trust under which the beneficiary may withdraw

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[67] Under I.R.C. §6110(k)(3), neither a private letter ruling nor a national office technical advice memorandum may be cited or used as precedent.

[68] Rev. Rul. 77-60, 1977-1 C.B. 282 ("A power to use property for the comfort, *welfare* or happiness of the holder of the power is not limited by [an ascertainable] standard") (Emphasis added).

[69] Nevertheless, a private letter ruling may be used, in some cases, to meet a standard that may permit a taxpayer to avoid certain penalties. *See, e.g.*, Treas. Reg. §1.6662-4(d)

[70] Indeed, it appears that the only viable way to make a credit shelter trust a grantor trust with respect to the surviving spouse would be to "supercharge" it as discussed in Mitchell M. Gans, Jonathan G. Blattmachr & Diana S. C. Zeydel, *Supercharged Credit Shelter Trust℠*, 21 PROBATE & PROPERTY 52 (July-Aug. 2007).

[71] *Merrill v. Fahs*, 324 U.S. 308 (1945), 311 ("The gift tax was supplementary to the estate tax. The two are in pari materia and must be construed together"); *Farid-Es-Sultaneh v. Commissioner*, 160 F.2d 812 (2d Cir. 1947), 814 ("[I]ncome tax provisions are not to be construed as though they were in pari materia with either the estate tax law or the gift tax statutes").

[72] As a further alternative: the preparer includes the necessary disclosure form and the taxpayer removes it before filing it. *See* Mitchell M. Gans, Jonathan G. Blattmachr & Elisabeth Madden, *Notable Changes Seen With 2008 Amendments to §6694 and Treasury's Final Tax Return Preparer Penalty Regulations*, 2009 TAX MANAGEMENT ESTATES, GIFTS AND TRUSTS JOURNAL 120.

[73] *See generally* Mitchell M. Gans & Jonathan G. Blattmachr, *Notice 2008-13: Interim Guidance on Tax Return Preparation and Advice*, BNA Daily Tax Report, J-1 (Feb. 2, 2008).

[74] The Notice also does not require the disclosure form if the matter relates to a tax shelter defined in I.R.C. §6662(d)(2)(C)(ii). It may be that, if the trust was intentionally structured to permit the beneficiary to claim it is a Section 678 trust, it is a tax shelter. Nevertheless, it seems odd that a taxpayer would so contend as better opportunities exist to avoid substantial underpayment of income tax penalties under I.R.C. §6662 by not falling within the definition of a tax shelter. See I.R.C. §6662(d)(2)(C)(i).

under an ascertainable standard is a Section 678 grantor trust.[75] Indeed, it is possible a court would conclude that there is not even a reasonable basis for such a position. If there is no reasonable basis, the penalty on the preparer or advisor is imposed (unless he or she can establish there was reasonable cause for the position and he or she acted in good faith). It is possible that the trust will be structured so no income tax return needs to be filed if it is, in fact, a grantor trust. But failure to file a return is itself subject to penalty unless there was a reasonable cause for failure to file.[76] Cautious preparers, advisors and trustees may well wish to file at least a grantor trust "information" return[77] and attach a disclosure form in the event that, as the authorities cited and discussed above suggest, such a trust is not a Section 678 trust. Those preparers and advisors who are practitioners under Circular 230 face similar duties under Section 10.34 of the Circular. Those who violate the Circular in preparing returns and giving advise also face potential sanctions including public censure, suspension of practice or disbarment of practice before the IRS.

"Lapse" of a Section 678(a) Power

Section 678(a)(2) provides that a person other than the grantor may be treated as the owner of the whole or any portion of a trust if "such person has previously partially released or otherwise modified such a power and after the release or modification retains such control as would, within the principles of Sections 671 to 677, inclusive, subject a grantor of a trust to treatment as the owner thereof." In other words, if a third party partially releases or otherwise modifies a power that would have caused the third party to be treated as the owner of that portion of the trust under Section 678(a), and after such partial release or modification, that third party retains an "interest" in or "control" over the trust that would have caused him or her to be treated as the owner under the grantor trust rules of Sections 671-677 had she created the trust,[78] then that third party would continue to be treated as the owner of that portion of the trust over which she has partially released or otherwise modified the power. As discussed above, an example of this would be a trust created under the Will of a child's deceased parent which gave the unilateral right to the child to withdraw all property in the trust. This unilateral power of withdrawal triggers Section 678(a) causing the child to be treated as the trust's owner for purposes of Section 671 so that the income, deductions and credits against the tax of the trust are attributed directly to the child. Two years later, the child partially releases the power to withdraw. However, because the trustee (or a person other than the child), without consent of any adverse party, may distribute the income and corpus to the child and because such a power to distribute to the child, had she been the grantor of the trust, would have caused the trust to be a grantor trust with respect to the child under Sections 676 and 677, the portion of the trust over which the child released her power of withdrawal would cause the trust to remain a grantor trust with respect to the child under Section 678(a)(2). Suppose, instead, the Will provides that the child's unilateral right to withdraw lapses at some time pursuant to the terms of the Will. The question then is whether such a lapse of the child's withdrawal constitutes a partial release or other modification under Section 678(a)(2).

Neither the Code nor any regulation addresses that issue. In Rev. Rul. 67-241, 1976-2 C.B. 225, the Service discussed the application of Section 678(a) to a trust in which the beneficiary has a right of withdrawal. In the ruling, the IRS considered a situation where the decedent created a trust under his will and gave his widow a power, exercisable solely by her, to require the trustees to distribute to her from corpus an amount equal to the greater of 5 percent of the value of the trust corpus or $5,000 each year. The widow's right to withdraw was noncumulative and lapsed at the end of each calendar year.[79] The Service ruled that the widow's power was subject to Section 678(a)(1) and the widow must be treated as the owner of that portion of the trust for income tax purposes. The Service did not address the issue of whether the widow would continue to be treated as the owner of that portion of the trust over which the power of withdrawal has lapsed.

Similarly, in Rev. Rul. 81-6, 1981-1 C.B. 385, a parent created an irrevocable inter vivos trust for the benefit of his child. The child had a noncumulative power in any calendar year to withdraw a portion of

[75] *See generally* Jonathan G. Blattmachr & Bridget J. Crawford, *Grantor Trusts and Income Tax Reporting: A Primer*, 16 PROBATE & PROPERTY 18, 19 (2002).

[76] *See* I.R.C. §6651(a).

[77] *See* Treas. Reg. §1.671-4.

[78] I.R.C. §678(a)(2) uses the word "control" but apparently would include any interest, power or circumstance where the trust would be a grantor trust with respect to its grantor.

[79] Under I.R.C. §§2041(a)(2) and 2514(b), a release of a general power of appointment is equivalent to exercising the power. Under I.R.C. §§2041(b)(2) and 2514(e), a lapse is considered a release but only to the extent that the property which could have been appointed by exercise of such lapsed power exceeds in value the greater of $5,000 or 5 percent of the aggregate value of the assets out of which, or the proceeds of which, the exercise of the lapsed power could be satisfied.

the trust principal up to the lesser of the amount added to the trust during each year or the sum of $3,000. The child also had the power to withdraw the entire income of the trust until the child reached age 25 (when the trust terminates). The IRS ruled that under Section 678(a), the child is treated as the owner of any portion of the trust with respect to which the child had a power to vest the corpus or income in the child. The Service left open the question of whether the child would continue to be treated as the owner of that portion of the trust over which the power of withdrawal has lapsed.

Despite the lack of guidance from these revenue rulings, the Service has consistently ruled in multiple private letter rulings that a lapsed power is considered "partially released or otherwise modified" for purposes of Section 678(a)(2), causing the third party to be treated as the owner of that portion of the trust for income tax purposes even after the lapse of the power.[80] For example, in PLR 200104005 (Sept. 11, 2001), the grantor created a trust for the benefit of her husband. The husband was granted a noncumulative power to withdraw from the principal of the trust, not to exceed $5,000 or 5 percent of the then aggregate market value of the trust property, otherwise known as a "five or five power." The IRS ruled that, for each year that the husband failed to exercise the five or five power, he "*will be deemed to have partially released the power* to withdraw the portion of the trust corpus subject to that power under Section 678(a)(2)." (Emphasis added). The Service further explained that after each succeeding year in which the husband fails to exercise his power, he is treated as the owner of an increasing portion of the trust corpus. The annual increase in the trust corpus that the husband would be deemed to own is the product of the amount which he could withdraw multiplied by a fraction, the numerator was the portion of the trust corpus that he is not already treated as owning, and the denominator was the total trust corpus from which the withdrawal could be made. In this private letter ruling, the Service expressly treated a beneficiary's failure to exercise a withdrawal power (i.e., a lapse) to be the same as if the beneficiary has partially released the power under Section 678(a)(2). The IRS, however, did not explain how it reached this conclusion.

The same conclusion was reached in PLR 200147044 (Aug. 22, 2001).[81] In this ruling, the grantor created a separate trust for each of his grandchildren. The trustees had a discretionary power to distribute the income and principal of the trust for the benefit of the grandchild as the trustees deemed to be in the best interests of the beneficiaries. Any income not so distributed would be added to the principal of the trust. The grandchild was given a noncumulative right to withdraw each calendar year from the trust an amount equal to the contributions made to the trust. The Service ruled that, because each contribution to the trust was subject to the withdrawal power of the grandchild, the grandchild would be treated as having a power to vest each contribution in himself or herself within the meaning of Section 678(a)(1). The Service further ruled that, "[i]f [the grandchild] fails to exercise the withdrawal power, [he or she] will be treated as having released the power, while retaining a right to have all trust income (ordinary income and income allocable to corpus), [which] in the sole discretion of the trustee [may be], distributed to [the grandchild], or accumulated for future distribution to [the grandchild], for purposes of Sections 678(a)(2) and 677(a)." (Emphasis added).

Similarly, in PLR 200022035 (Mar. 3, 2000),[82] the IRS also concluded that the lapse of a beneficiary's withdrawal power falls within the meaning of Section 678(a)(2). In this ruling, the grantor created a trust where the beneficiary had an annual noncumulative "five or five" power. The beneficiary had a lifetime power to appoint all or any part of the trust income. The Service first ruled that the five or five power was a power to vest in the beneficiary part of the trust corpus and that, therefore, the beneficiary would be treated as the owner for each year of that portion of the trust "until the beneficiary's power is exercised, released or *allowed to lapse*." (Emphasis added). This implies that a lapse has the same effect as an exercise or release. For purposes of Section 678(a)(2), the Service further ruled that, if the beneficiaries failed to exercise the five or five power, the beneficiary "would be deemed to have *partially released*" the power. (Emphasis added). Accordingly, because the beneficiary had retained a power over the income of the trust that would have subjected a grantor of the trust to income tax under Section 677, the beneficiary would also be treated as an owner of the trust corpus under

[80] Under I.R.C. §6110(k)(3), neither a private letter ruling nor a national office technical advice memorandum may be cited or used as precedent.

[81] *See also* PLR 200011054 (Mar. 20, 2000) (reaching the same conclusion on substantially the same facts).

[82] *See also* PLR 9504024 (Jan. 27, 1995) (reaching the same conclusion on similar facts—the beneficiary's withdrawal power was not subject to the five or five rule limitation and lapsed within 60 days of notice of contribution to the trust).

Section 678(a)(2). In this ruling, the IRS again equated a lapse to a partial release of power.[83]

Although the Service did not elaborate on the reasoning behind its position in the above private letter rulings, the proposition that a lapse should be treated as a partial release or modification under Section 678(a)(2) appears to be logical. First, it would seem that, if Section 678(a)(2) is only limited to a partial release or modification, then it would have very limited application as the lapse of a power to withdrawal is much more common than a release or modification.[84] Second, if a lapse is not covered by Section 678(a)(2), then similarly situated taxpayers would receive different tax treatments simply because one beneficiary took an action to partially release a power while the other failed to take such action and let the power lapse.[85] In neither case is the beneficiary's power exercised; the only difference is in the mechanical means by which the beneficiary chooses not to exercise the power.

However, the terms "partially released" and "otherwise modified" do not appear to encompass the term "lapse." In other words, a complete lapse does not seem to be a partial release or otherwise a modification of the power to withdraw. Moreover, the word "lapse" is expressly missing in the statute and the regulations. One may assume that Congress intentionally omitted the word for a reason. In fact, just a few years prior to the enactment of Section 678, Congress enacted statutes that expressly treat a lapse as a release of a power of appointment for gift and estate tax purposes.[86] Yet, Congress did not include the concept of lapse in Section 678(a)(2).[87]

The legislative history to the Internal Revenue Code of 1954 did not address the issue of "lapse." The legislative history of Section 678 is brief and only provides a very general description of the Section. It does not discuss Section 678(a)(2) specifically or the concept of a lapse.[88] Nonetheless, it is important to note that it does appear to contemplate broad application of the release/modification concept.[89]

Another possible argument as to why a withdrawal power that has lapsed is not considered "partially released or otherwise modified" under Section 678(a)(2) is that a lapse could be characterized as a *complete* release of a power and Section 678(a)(2) only refers to a *partial* release of a power. Commentators have suggested that, perhaps, a lapse would be categorized under the "otherwise modified" language.[90] Although a "lapse" implies that no action is taken by the powerholder and "modify," in contrast, implies an action of some kind, the "otherwise modified" language could be viewed as a catch-all, intended to apply to any change to a power that would otherwise subject the third party to Section 678(a).

If a lapse is a complete release and is, therefore, outside the application of Section 678(a)(2), then similarly situated taxpayers would be treated differently depending on the manner in which a given taxpayer allows her withdrawal power to become no longer exercisable. A taxpayer who relinquishes or permits to lapse her withdrawal power on a yearly basis would be treated differently from a taxpayer who relinquishes or permits to lapse her entire withdrawal power, including the power to withdraw in future years. Substantively, the end result is the same but due to the difference in the way the relinquishment or lapse occurs, one taxpayer would not be treated as the owner of the trust for income tax purposes while the other one would.

Perhaps, a possible explanation is that a lapse is a partial release of the power if one considers the power as a whole over the entire term of the trust.[91] On at least one occasion, the Service has made a distinction between a complete release and a partial release. In

[83] *See also* PLR 9450014 (Dec. 16, 1994) (ruling that, if a beneficiary who was granted a withdrawal power allowed the power to lapse, then the beneficiary's retained right to have all the income and corpus paid, or accumulated for later distribution, to the beneficiary would cause the beneficiary to be the owner of the trust under I.R.C. §677(a)(1) and (a)(2)); PLR 9448018 (Dec. 2, 1994) (reaching the same conclusion); and PLR 8308033 (Nov. 23, 1982) (reaching the same conclusion).

[84] *See* Jonathan G. Blattmachr and Frederick M. Sembler, *Crummey Powers and Income Taxation*, THE CHASE REVIEW, July 1995 at 4.

[85] *Id.*

[86] For gift tax purposes, I.R.C. §2514(e) provides that "[t]he lapse of a power of appointment created after October 21, 1942, during the life of the individual possessing the power shall be consider a release of such power." Similarly for estate tax purposes, I.R.C. §2041(b)(2) provides "[t]he lapse of power of appointment created after October 21, 1942, during the life of the individual possessing the power shall be considered a release of such power."

[87] *See generally* Blattmachr and Sembler, *supra*, at 8.

[88] *See* H.R. REP. NO. 1337, at 4357 (1945); S. REP. NO. 1622, at 5013 (1945). *See also* SENATE FINANCE COMMITTEE REPORT TO ACCOMPANY H.R. 8300, Part 7 of 10 (Comm. Print 1954); HOUSE WAYS AND MEANS COMMITTEE REPORT TO ACCOMPANY H.R. 8300, Part 6 of 10 (1954).

[89] *See Id.* (Indicating that "a person other than the grantor may be treated as the substantial owner...if he has modified the power (by release or otherwise)"...).

[90] Blattmachr and Sembler, *supra*, at 6. *See also* David Westfall, *Lapsed Powers of Withdrawal and the Income Tax*, 39 TAX L. REV. 63, 69 (1983-1984); William Natbony, *The Crummey Trust and "Five and Five" Powers after ERTA*, TAXES—THE TAX MAGAZINE, 501 (July 1982).

[91] Blattmachr and Sembler, *supra*.

PLR 7943153 (Jul. 30, 1979), the grantor created a trust in which the beneficiary has a lifetime power to withdraw principal from the trust. The Service ruled that, if the beneficiary "completely released the power to vest corpus" in himself "(as opposed to a partial release or modification)," the beneficiary will not be the owner of the trust under Section 678(a)(2).[92] This ruling seems to suggest that, if a third party relinquishes her withdrawal power for all future years, then Section 678(a)(2) would not apply, but, if the third party simply allows the power to lapse with respect to the property for one year, then Section 678(a)(2) would continue to apply. This ruling may lend support to the argument that an annual lapse is a partial release within the meaning of Section 678(a)(2). On the other hand, a complete lapse (as opposed to an annual one) is more difficult to view, as indicated above, as a partial release (or modification).

In addition, a review of the language used by the Service in all the private letter rulings cited in this section indicate that the Service has consistently held that a third party who has allowed a withdrawal power to lapse each year or after a number of days (as opposed to a complete lapse of the power to withdraw in future years) has either "released" or "partially released" the power.[93] With the exception of PLR 7943153 discussed above, it does not appear that the Service, at least in recent years, has made a distinction between a third party who has "released" or "partially released" a withdrawal power in the context of a lapse.

In any case, it is uncertain that a trust will remain a Section 678 trust after a beneficiary's withdrawal power lapses. As a consequence, it may not be wise to rely on its continuing Section 678 status where loss of that status could cause adverse effects.[94]

Section 678(b) and the Definition of "Income"

Section 678(b) provides that the rules under Section 678(a) "shall not apply with respect to a power over income, as originally granted or thereafter modified, if the grantor of the trust or a transferor (to whom Section 679 applies) is otherwise treated as the owner under the provisions of this subpart other than this Section." (Emphasis added). Therefore, on the face of Section 678(b), at least with respect to the *income* of a trust, if the grantor is also treated as the owner of the trust, then the third party who is otherwise treated as the owner of the trust under Section 678(a) would not be treated as the owner of the trust for income tax purposes. In other words, the grantor trust rules with respect to the grantor "trump" the grantor trust rules with respect to the third party when determining who should be taxed as the owner of the trust. However, because Section 678(b) addresses only "income," it is unclear, at least on the face of Section 678(b), what would happen if both the third party and the grantor are treated as the owners of the trust *corpus* under the various grantor trust rules.

The answer may be in the definition of "income."[95] The word "income" in Section 678(b) seems to mean taxable income (as opposed to accounting income) which includes income in a tax sense allocated to trust accounting income *and* corpus. Treas. Reg. §1.671-2(b) provides that, for purposes of Subpart E of Part I of Subchapter J of Chapter 1 (i.e., the grantor trust rules)[96] the word "income," unless specifically limited, refers to income determined for tax purposes and not income for trust accounting purposes. Treas. Reg. §1.671-2(b) further explains that, if it is intended that income is to refer to income for trust accounting purposes, it would use the phrase "ordinary income."[97]

[92] PLR. 7943153 (Jul. 30, 1979).

[93] PLR 200104005 (Jan. 29, 2001) (a lapse of a power to withdraw after the calendar year is considered "partially released"); PLR 200011054 (Mar. 20, 2000) (a lapse of a power to withdraw after 30 days is considered "released"); PLR 9504024 (Jan. 27, 1995) (a lapse of a power to withdraw after 60 days is considered "released").

[94] For example, the powerholder sells an appreciated asset to a Section 678 trust for a note. No gain is recognized. *See* Rev. Rul. 85-13, *supra*. However, if Section 678 status ends before the note is paid and the powerholder dies, gain might occur. *See* Jonathan Blattmachr, M. Gans & Hugh Jacobson, *Income Tax Effects of Termination of Grantor Trust Status by Reason of the Grantor's Death*, JOURNAL OF TAXATION 149 (Sept. 2002).

[95] Rev. Rul. 81-6, *supra*, states, in part, "Section 678(b) provides that Section 678(a) shall not apply if the grantor of the trust or a transferor (to whom Section 679 applies) is otherwise treated as the owner under the provisions of subpart E of Part I of subchapter J, other than Section 678" without limiting that statement to a case where the I.R.C. §678 power is only over "income" as the statute provides. Although that could be claimed to be a concession by the IRS on the issue, such a claim likely would be unsuccessful as the statement is at most just a general description and is not critical to the holding of the ruling.

[96] It is interesting to note that Treas. Reg. §1.671-2(b) specifically provides that the definitions are to apply as "stated in the regulations under subpart E," leaving open the possibility that the definitions may not apply as stated in the Code. Treas. Reg. §1.671-2(b) states "[a]ccordingly, *when it is stated in the regulations* under subpart E that 'income' is attributed to the grantor or another person, the reference, unless specifically limited, is to income determined for tax purposes and not to income for trust accounting purposes." (Emphasis added.) However, Treas. Reg. §1.678(b)-1 essentially repeats the language of I.R.C. §678(b). Therefore, it is likely that the definitions under Treas. Reg. §1.671-2(b) are to apply to both I.R.C. §678(b) and Treas. Reg. §1.678(b)-1.

[97] Indeed, the Treasury Regulations under Subpart E of Part I of Subchapter J of Chapter 1 use the word "ordinary income" on twelve other occasions.

This suggests that, for purposes of Section 678(b) (which is under subpart E of Part I of subchapter J of chapter 1), the word "income" refers to taxable income (as opposed to accounting income) and includes tax income allocated to both accounting income and corpus of the trust. Therefore, if both a third party and a grantor are deemed the owners of income allocated to trust accounting income or corpus, or both, then, under Section 678(b), the grantor, and not the third party, would be treated as the owner of that portion of the trust.

Section 643(b) further lends support to this proposition. Section 643(b) provides that. for purposes of Subparts B, C and D of Part I of Subchapter J, the word "income" means the "amount of income of the estate or trust for the taxable year determined under the terms of the governing instrument and applicable local law." The omission of a reference in Section 643(b) to Subpart E, the grantor trust rules, seems to suggest that, if the word "income" is used in Subpart E, it would not have the meaning of accounting income. Indeed, it seems that the definition of income (that is, taxable income) under Treas. Reg. §1.671-2(b) controls for the provisions under Subpart E, including Section 678(b).

The Service's position seems to be consistent with the above proposition. In several private letter rulings, the Service has consistently taken the position that, if a grantor is treated as the owner of a trust under the grantor trust rules, then the grantor will be treated as the owner of the trust despite the fact that a third party is treated as the owner of the trust *corpus* under Section 678.[98] For example, in PLR 2007320101 (May 1, 2007), the grantors created a trust for their children and provided that an advisory committee had the right, without the approval or consent of the grantors or any adverse party, to add one or more tax-exempt charities as permissible beneficiaries of the trust. The grantor's children were given the power to withdraw from the trust principal an amount equal to the value of the property added to the trust, up to the amount of the applicable gift tax annual exclusion amount. The ruling held that the withdrawal power granted to the children would result in the children being treated as the owners of their respective portions of the trust subject to their withdrawal power unless the grantor is treated as the owner under Section 678(b). The power to add tax-exempt charities as beneficiaries affects the beneficial enjoyment of the trust and caused the grantors to be treated as the owners of the trust under Section 674(a). Therefore, the Service concluded that, "[b]ecause [the trust] is a grantor trust under §674 with respect to [the grantors], it is a grantor trust in its entirety with respect to [the grantors] notwithstanding the powers of withdrawal held by the beneficiaries that would otherwise make them the owners under § 678." The ruling referenced Section 678(b) but did not discuss its application to a "Crummey" power over trust corpus. Instead, the IRS simply reached the conclusion as stated above and held that the trust in its entirety was treated as a grantor trust with respect to the grantors.

On March 27, 2007, the Service issued a series of private letter rulings which seem to support the proposition that the grantor would be treated as the owner of a trust despite the fact that a third party otherwise would be treated as the owner of the trust *corpus* under Section 678(a).[99] The facts are similar in all of the rulings: the grantor created a irrevocable trust and retained the power in a non-fiduciary capacity to acquire trust property and to substitute other property in its place which would make such trust a grantor trust under Section 675(4)(C). The beneficiary of the trust was given a withdrawal power over an amount equal to the additions made to the trust each year not to exceed the applicable annual exclusion amount. The Service ruled that under such circumstances the grantors were treated as the owners of the trust under Sections 675 and 678(b). Similar to PLR 200732010, the Service did not provide a detailed analysis of how it reached this conclusion.

Another example in which the Service suggested that corpus also falls within the meaning of Section 678(b) is PLR 200603040 (Jan. 20, 2006). In this ruling, the grantor created an *inter vivos* trust where the trustees were directed to distribute as much income and principal of the trust to the spouse and the grantor's issue as the trustee may determine. The spouse was given a right to withdraw an amount equal to the value of each contribution to the trust up to the amount of the gift tax annual exclusion. The taxpayer sought a ruling that the trust was a grantor trust under Section 671 in its entirety with respect to the grantor. The Service granted the ruling and ruled that, because both income and corpus were payable to the spouse during the grantor's life, the grantor was treated as the owner of the trust under Section 677(e). The Service further held that, "[b]ecause Trust is a grantor trust under §677 with respect to Grantor, it is a grantor trust in its entirety with respect to Grantor notwithstanding the powers of withdrawal held by Spouse that would

[98] Under I.R.C. §6110(k)(3), neither a private letter ruling nor a national office technical advice memorandum may be cited or used as precedent.

[99] PLR 200729005 (Mar. 27, 2007) through PLR 200729016 (Mar. 27, 2007).

otherwise make her an owner under §678." This private letter ruling is consistent with the Service's positions in prior rulings.[100]

A possible counterargument to the above may lie in the wording of Section 678 itself. On two occasions, Section 678 specifically refers to "corpus" and "income," thus implying that there is a distinction between the two.[101] Similar distinctions are also contained in other parts of the grantor trust provisions that apply to the trust's grantor.[102] If the definition of income under Treas. Reg. §1.671-2(b) includes income allocated to both accounting income and corpus, then the use of the word "corpus" in two parts of Section 678 would seem superfluous. This internal inconsistency in the statutory language is perhaps a legislative oversight as suggested by some commentators.[103]

When Section 678(b) Exception No Longer Applies

As discussed above, Section 678(b) provides that, when the grantor is treated as the owner of a trust, then the third party who is otherwise treated as the owner of the trust under Section 678(a) will not be treated as the owner of the trust. However, what happens when the grantor is no longer treated as the owner of the trust? Grantor trust status with respect to the grantor ends when the grantor dies or when a condition under which the grantor was deemed to be the owner of the trust no longer applies. In such case, will Section 678(a) operate to cause the third party to be treated as the owner of the trust?

To the extent that a third party is treated as the owner under Section 678(a) after the grantor trust status with respect to the grantor has been "turned off," it seems that the trust would be treated as a grantor trust with respect to such third party. That would seem to be the case if the third party continues to hold the unilateral drawdown power after grantor trust status with respect to the grantor ends. It seems logical that, if Section 678(b) is no longer applicable, then the third party who would otherwise be treated as the owner under Section 678(a) would be treated as the owner of the trust. As stated, this would seem to be true for a third party who has a unilateral power to withdraw after the grantor trust status with respect to the grantor has been "turned off." This would also seem to be true for a third party who has partially released or modified a power described under Section 678(a)(2) during the time the grantor is treated as the owner of the trust. Once the grantor trust status with respect to the grantor has ended, then Section 678(a) would seem to become operative to make the trust a grantor trust with respect to the third party (which provides for the "regular" grantor trust rules to trump Section 678(a)).

Neither the Code nor the Regulations addresses this issue. However, the Service adopted the above view in PLR 9026036 (Mar. 28, 1990). In this ruling, the wife created a trust for the benefit of her husband and provided for income to her husband for life. The wife was the trustee of the trust. The trust agreement granted the husband the power to withdraw all or any portion of the trust within 30 days after the date of the execution of the trust agreements by written notice to the Trustee. The husband did not exercise his withdrawal power and allowed the power to lapse. The Service ruled that, while the wife (who was the grantor) is alive, she would be treated as the owner of the trust for income tax purposes, but, upon her death, the husband would be treated as the owner of the trust for income tax purposes. Although the Service did not provide any analysis or reasoning in its ruling, it would seem that the analysis would be as follows: While the wife is alive, the wife is treated as the owner

[100] *See also* PLR 9309023 (Dec. 3, 1992) (reaching the same conclusion in a case involving almost identical facts); PLR 9141027 (Jul. 11, 1991) (ruling that the grantor is treated as the owner of the trust for income tax purposes because all the income of the trust may possibly be distributed to the grantor's spouse (I.R.C. §677) and the grantor's spouse holds a power of appointment over the trust corpus (I.R.C. §674) despite the beneficiaries' "Crummey" powers of withdrawal).

[101] I.R.C. §678(a)(1) provides that "[a] person other than the grantor shall be treated as the owner of any portion of a trust with respect to which such person has a power exercisable solely by himself to vest the *corpus* or the *income* therefrom in himself." (Emphasis added). I.R.C. §678(c) provides that "[s]ubsection (a) shall not apply to a power which enables such person, in the capacity of trustee or co-trustee, merely to apply the *income* of the trust to the support or maintenance of a person whom the holder of the power is obligated to support or maintain except to the extent that such *income* is so applied. In cases where the amounts so applied or distributed are paid out of *corpus* or out of other than *income* of the taxable year, such amounts shall be considered to be an amount paid or credited within the meaning of paragraph (2) of I.R.C. §661(a) and shall be taxed to the holder of the power under I.R.C. §662." (Emphasis added).

[102] *See, e.g.*, I.R.C. §§674(a), 674(b)(4)-(8), 674(c)(2) and 674(d).

[103] William R. Swindler et al., *Beneficiary Withdrawal Powers in Grantors Trust—A Crumm(e)y Idea?*, 34 EST. PLAN. 30, 33 (Oct. 2007) ("Treasury officials have informally indicated that they view the failure to include 'corpus' in I.R.C. §678(b) as a legislative oversight"). *See also* Jonathan E. Gopman, *Crummey, the Saga Continues*, 25 BNA TAX MGMT. EST., GIFTS & TR. J. 194 (Jul. 13, 2000) (citing other commentators who have suggested that the failure to include "corpus" in I.R.C. §678(b) is a drafting oversight).

of the trust under Section 677 because her husband is an income beneficiary of the trust. During this same time, the husband would also be treated as the owner of the trust under Section 678(a)(2) because he allowed an unilateral withdrawal power to lapse while retaining "control" over the trust that would have caused him to be treated as the owner under Section 677. However, because the trust is a grantor trust with respect to the wife (the grantor), while she was alive, the husband would not be treated as the owner of the trust under Section 678(b). Upon the wife's death, Section 678(b) is no longer applicable and Section 678(a)(2) would then apply to make the husband the owner of the trust for income tax purposes.

Interestingly, PLR 9026036 was essentially revoked three years later by PLR 9321050 (Feb. 25, 1993).[104] In this ruling, the Service reconsidered its position in PLR 9026036 and reversed the holding relating to the ownership for federal income tax purpose of the trust upon the wife's death. The Service did not provide any explanation of its reversal or any analysis of its new position. The Service simply ruled that, after the wife's death, the husband will *not* be treated as the owner of the trust for income tax purposes. The Service did not clarify who, if anyone, would be the owner of the trust for income tax purposes. Presumably, because the wife is deceased and the husband is not the owner of the trust, the trust is no longer a grantor trust.

The Service's reversal of its position in PLR 9321050 would suggest that, if grantor trust status with respect to the grantor is "turned off," then Section 678(a) is no longer operative. In order words, if the third party has partially released or otherwise modified a power that would have made the trust a grantor trust with respect to the third party under Section 678(a)(2), the third party would not be deemed the owner of the trust during and *after* the time that the trust was a grantor trust with respect to the grantor. Although the ruling did not address the situation of a third party being treated as the owner under Section 678(a)(1), it arguably suggests that, even in such a case, the trust would not be a grantor trust with respect to the third party after the grantor trust status with respect to the grantor has been "turned off."

The income tax treatment under Section 678 is unclear for the situation where the trust ceases to be a grantor trust with respect to the grantor. Without further guidance from the Service, it is difficult to understand the Service's reason in revising its position in PLR 9321050. Taxpayers who find themselves in this situation may be well advised to seek a private letter ruling to clarify this issue.

Conclusion

Section 678 provides an important rule for the income tax treatment of a trust with respect to a third party who is not a substantial owner of the trust and the grantor herself. It seems likely that, if a third person's power to vest trust corpus or income in herself under Section 678(a)(1) is subject to an ascertainable standard, Section 678(a)(1) will not apply to cause the third party to be treated as the owner of that portion of the trust subject to that power. If the third party allowed a power under 678(a)(1) to lapse, it appears that the lapse would be considered a partial release or modification under Section 678(a)(2) which may cause the third party to remain the owner of that portion of the trust subject to such power for income tax purposes. Section 678(b) would seem to suggest that, even if the third party's power under Section 678(a)(1) applies over the trust corpus, the grantor of the trust may still be treated as the owner of the trust corpus for income tax purposes if the grantor is also treated as the owner of the trust corpus under the grantor trust rules. Lastly, there does not seem to be a clear answer as to what the income tax treatment would be once the trust ceases to be a grantor trust with respect to the grantor.

[104] It is also interesting to note that in the interim, the Service refused to rule on the income tax consequences of a similar trust upon the death of the grantor. PLR 9141027 (Jul. 11, 1991).