

Estate & Succession Planning Corner

By *Lawrence I. Richman*

The Other Grantor Trust Section: Current Developments Regarding Code Sec. 678



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The grantor trust rules of Subpart E focus on those circumstances under which the income of a trust is taxed to the grantor or the transferor to a trust. When those rules are triggered, a trust is not considered a wholly separate taxpayer. Generally, the grantor of the trust is required to include in computing her taxable income those items of income, deduction and credit against tax, which are attributable to or included in any portion of such trust of which she is treated as the owner.¹

The Eighth Circuit in the *Mallinckrodt*² case expanded the grantor trust rules to apply to a person other than a grantor when such person holds certain broad powers over a trust. In 1954, Congress codified the court's approach and added to Subpart E Code Sec. 678, which defines those circumstances when someone other than the grantor is treated as the owner of the trust for income tax purposes. Code Sec. 678 provides that a person other than the grantor is treated as the owner of any portion of a trust over which such person has a power exercisable solely by himself to vest the corpus or income in himself.³ Significantly, Code Sec. 678 also contains an integration clause with the grantor/settlor focused grantor trust provisions of Code Secs. 671-677. Code Sec. 678(b) provides that someone other than the grantor will not be treated as the owner for income tax purposes "with respect to a power over income...if the grantor of the trust...is otherwise treated as the owner under the provisions of this subpart other than this section."⁴

Accordingly, a literal reading of Code Sec. 678 would indicate that if a grantor/settlor of a trust were taxable on the income and principal of the trust under Code Sec. 677 (because, for example, the settlor's



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spouse was a permitted recipient of the income and principal of the trust), then if another person, such as the settlor's daughter, had a power to withdraw the entire trust estate of the trust or had a lifetime general power of appointment over the trust estate of the trust, the income of the trust (e.g., dividends, interest, rents) would be taxable to the settlor/grantor and gain on the principal of the trust (e.g., capital gains on the disposition of securities, real property or business ownership interests) would be taxable to the daughter. A recent private letter ruling, however, indicates that the tax reporting and tax inclusion position of the IRS is somewhat different than the statutory language.

In LTR 200606006,⁵ the IRS considered a situation in which the grantor established an inter vivos irrevocable trust and named an independent trustee. The trust permitted discretionary distributions of income and principal to the grantor's spouse during the lifetime of the grantor. The spouse had a lifetime limited power of appointment exercisable in favor of the descendants of the grantor, which could not be exercised to cause a distribution that would be in lieu of any obligation of the spouse to support any person. The spouse also had the right to withdraw annual exclusion gifts to the trust. The spouse's withdrawal right lapsed in a manner so as not to trigger a taxable gift by the spouse to the trust.

The grantor retained a power to substitute trust property of equivalent value. Although much of the ruling is concerned with the gift and estate tax consequences of that retained power, it is the income tax aspects of the ruling that are important in understanding the relationship between the grantor trust rules of Code Secs. 671-677 and the other grantor trust rule of Code Sec. 678.

The ruling states that:

The power granted to Spouse to withdraw amounts contributed to Trust will result in Spouse being treated as the owner of the portion of the Trust subject to her withdrawal power, unless as

provided in Section 678(b), Grantor is treated as the owner. Under the terms of Trust, both income and corpus are payable to Spouse during Grantor's life. Accordingly, Grantor is treated as the owner of Trust under Section 677(a). Because Trust is a grantor trust under Section 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 otherwise make her an owner under Section 678. Accordingly, all items of income, deductions and credits against tax of Trust are included in computing the Grantor's taxable income and credits.⁶

Unlike the Code, which has the appearance of subtly integrating the tax treatment of income and principal in the interrelationship between Code Sec. 678 and Code Secs. 671-677, LTR 200606006 unambiguously states that Code Secs. 671-677 trump Code Sec. 678 with respect to the taxation of both income and principal. The words "in its entirety" are quite explicit. Interestingly, the position taken in this letter ruling is consistent with earlier rulings.⁷

Perhaps one reason for such clarity on the part of the IRS is on account of the legislative history of Code Sec. 678. The committee reports refer to both income and principal in explaining the exception to Code Sec. 678: "A person other than the Grantor may be treated as a substantial owner of a trust if he has an unrestricted power to take the trust principal or income or if he has modified this power (by release or otherwise), but has retained powers of the type which would make the grantor taxable unless the grantor himself is deemed taxable because of such a power."⁸

The apparent disparity between the IRS's and the legislative history's view that Code Secs. 671-677 clearly trump Code Sec. 678, when applicable, and the language in the Code that refers only to income (and makes no mention of principal) calls for clarification. Did I hear anyone say Technical Correction?

ENDNOTES

¹ Reg. §1.671-2.

² *Mallinckrodt v. Nunan*, CA-8, 45-1 USTC ¶9134, 146 F2d 1, cert. denied, 324 US 871, 65 SCt 1017 (1945).

³ Code Sec. 678(a)(1).

⁴ Code Sec. 678(b).

⁵ LTR 200606006 (Oct. 24, 2005).

⁶ *Id.*

⁷ See, e.g., LTRs 9141027 (Jul. 11, 1991) and 9309023 (Dec. 3, 1992).

⁸ H.R. REP. 8300, 83d Cong., 2d Sess. 63 (1954) at 4089; S. REP. NO. 1622, 83d Cong. 2d Sess. 87 (1954) at 87.

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