BENEFICIARY-GRANTOR TRUSTS:
EFFECTIVE PLANNING WITH DEFECTIVE TRUSTS

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ESTATE PLANNING COUNCIL OF NORTH TEXAS

March 19, 2025
Plano, Texas

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I. INTRODUCTION

A "678 trust" is any trust that utilizes section 678 of the Internal Revenue Code (the "IRC")[1] to make a person other than the trust's grantor the deemed owner of the trust for income tax purposes. By doing this, the income tax burden for the trust will shift to such person who, for income tax purposes, will be treated as being the same person as the trust. This makes planning strategies available not only with respect to income tax, but estate and gift tax, GST tax, and state law as well. However, these trusts historically have been employed sparingly, or more accurately, have often not been recognized when employed. The lack of employment and recognition of 678 trusts has led to a scarcity of reliable precedent relative to other planning tools. The uncertainties involved with 678 trusts and the complexity in dealing with such uncertainties may cause some planners to look elsewhere to accomplish their clients' goals. At the same time, some other planners overprescribe 678 trusts, making claims for them that lack merit.

Regardless, our estate planning toolboxes should include 678 trusts. This paper will consider the use of this tool, including the basics of 678 trusts, the different types and their structures, and their potential advantages and disadvantages.

II. BACKGROUND

Recognizing that 678 trusts are simply a unique kind of grantor trust, some general background on grantor trusts and the grantor trust rules[2] will be useful, given their shared planning concepts and techniques with other grantor trusts. First, the meaning of "grantor" is so clear that the IRC does not define the term; however, it is clear that it is the person who has parted with property to fund the trust.

A grantor trust is any trust in which the trust's grantor is treated as the owner of the trust for income tax purposes, thereby shifting income tax liability away from the trust itself and instead to the trust's grantor during the grantor's lifetime. Grantor trusts arose almost a century ago when high bracket income taxpayers attempted to shift part of their income to trusts while they retained interests in or powers over the trusts ("income-shifting trusts"). The opportunity to do this existed in times now long gone when the income tax brackets for trusts were more favorable and the tax law relating to trusts was less developed. Grantor trusts were considered to be "defective" because they failed to achieve their grantor's goal of shifting taxable income from the grantor's high marginal income tax brackets to the trust's lower income tax brackets. In other words, a grantor trust was an income-shifting trust that failed to work. Adding insult to the injury, grantors found themselves to be personally liable for the trust income taxes, instead of having those income taxes paid from the trust assets.

The enactment of the Tax Reform Act of 1986 brought a broadened income tax base in exchange for only two income tax brackets, 15 percent and 28 percent, being imposed on individuals, trusts, and estates. The amount of income taxable at the 15 percent bracket for trusts and estates was relatively small. As a result, the use of income-shifting trusts was gutted for all practical purposes. As the promise of the Tax Reform Act of 1986's low top marginal brackets has been eroded with higher top marginal income tax rates for individuals, trusts, and estates, income-shifting trusts have become worse than useless.[3]

But tax planners then came to realize that while income-shifting trusts had become useless as a shield against high individual income tax brackets, using the failed version, grantor trusts, could be advantageous in estate planning. Thus, the "Intentionally Defective Grantor Trust" ("IDGT") became a useful tool: (a) to avoid the high income tax rates imposed on non-grantor trusts; (b) to allow the grantor to pay the income taxes on the trust's taxable income without making a "taxable gift" for gift tax purposes despite the clear economic benefit being provided to the trust; and (c) to allow the grantor to engage in transactions with the trust without income tax recognition but with effect being given for transfer tax and state law purposes. As a result of these advantages, grantor trusts have become one of the most commonly utilized estate planning devices, with decades of reliable authority to guide their use in many situations.

Under the grantor trust rules, if the grantor of a trust retains any of the rights or powers set forth in the rules over the trust after its creation, then the grantor will be the deemed owner of the trust, and thus the person liable for the trust's income taxes.[4] The rights and powers that the rules focus on for triggering grantor trust status are those that give the grantor substantial benefits or control

[1] All section references are to the IRC unless stated otherwise.

[2] The applicable IRC provisions are found in Subpart E of Part I of Subchapter J of Chapter 1, §§671-679. Foreign trusts with one or more U.S. beneficiaries are governed by §679 are beyond the scope of this article.

[3] As of the year of this paper (2024), trusts reach their highest tax bracket of 37% at $15,200, while individuals do not reach their highest tax bracket of 37% until $609,350 for unmarried individuals and $731,200 for married individuals filing jointly.

[4] §671.

over the trust and its assets as if the grantor, and not the trust, was the owner. Each of the sections that deal with a different situation when a grantor is treated as the owner of a trust begins with, "The grantor shall be treated as the owner of any portion of a trust" and then proceeds to provide the provisions that govern reversionary interests (section 673), powers to control beneficial enjoyment (section 674), administrative powers (section 675), powers to revoke (section 676), or income for the benefit of the grantor (section 677). In each of these situations, the grantor has failed to put the portion of the trust property to which the grantor trust rules apply clearly beyond the grantor's arm's length reach. One common example is if the grantor has the power to revoke the trust, which makes the trust a grantor trust.[5] Or, if a trust provides for distributions for a period of years to the grantor's niece, and afterwards will terminate and disburse the trust's assets to the grantor, then the trust will be a grantor trust.[6] Another example is if the grantor has a nonfiduciary power to reacquire the trust corpus by substituting other property of an equivalent value, which is often referred to as a "swap power."[7] IDGTs are often created by giving the grantor a swap power because a swap power will cause a trust to be a grantor trust, but will have no effect with respect to gift, estate, and GST tax, or with respect to state law.[8]

By being a grantor trust, the IDGT reduces the assets in the grantor's estate, and thus subject to estate tax, not only by the gifts from the grantor to the trust (the same as with a non-grantor trust), but also by income tax payments made by the grantor to the Internal Revenue Service ("IRS") during her life for income generated on the trust's assets. Unlike the gifts made by the grantor to the trust, which are subject to transfer tax, the grantor's income tax payments are entirely free of transfer tax consequences despite them adding value to the trust. The trust's assets are allowed to grow income tax free.

Another advantage of IDGTs is that the trust's income taxes are paid under the income tax brackets applicable to individuals rather than those applicable to trusts. Further, a grantor trust can largely avoid the need to file an income tax return for the trust separate from the grantor's individual income tax return, as well as navigate the income tax laws applicable to trusts, which can add additional administration requirements, complexity, and accounting expenses.

In addition, because the IDGT and the grantor are treated as being the same person for income tax purposes, transactions between the grantor and the IDGT are not recognized for income tax purposes.[9] At the same time, for purposes of estate and gift tax, GST tax, and state law, the grantor trust and the grantor are treated as two different persons, allowing a transfer tax "asset freeze" technique called a sale to an IDGT, in which the grantor sells (not gifts) assets to the IDGT, causing all appreciation of the assets from that point forward to be outside of the grantor's estate, free of gift and estate tax (and, if allocated, GST tax) and protected from creditors under state law.[10] Since the sale transaction is ignored for income tax purposes, no capital gain or loss will be realized by the grantor when she sells the assets to the trust. This technique is well-known and generally long accepted by the IRS.

A. Example 1: IDGT for Annual Exclusion Gifts to Grandchild

Grant creates an irrevocable trust for the benefit of his granddaughter, and appoints his son-in-law, who is also his granddaughter's father, as trustee. The purpose of the trust is to receive contributions from Grant each year in the maximum annual gift tax exclusion amount and for the term of the trust to continue after the granddaughter's 21st birthday. During the granddaughter's life, the trustee can distribute to her so much of the net income and corpus of the trust as the trustee deems necessary for the granddaughter's health, education, maintenance, and support. Grant's brother also has the power to add any individual or charity to the beneficiaries who may receive distributions of corpus. The granddaughter is granted a testamentary power to appoint the trust's undistributed income and corpus among her descendants. If the power of appointment is not exercised by the granddaughter, following the granddaughter's death the remaining trust assets are to be allocated and distributed to trusts for her descendants, per stirpes, under similar terms.

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[5] §676(a).

[6] §673(a).

[7] §675(4)(C).

[8] Rev. Rul. 2008-22.

[9] Rev. Rul. 85-13.

[10] The sale to the IDGT is structured so that the grantor, as seller, sells the subject assets to the IDGT, as buyer, at fair market value (as determined by a qualified appraisal or other reliable method) in exchange for a promissory note in the amount of the sales price with interest at the applicable federal rate. A "seed gift," typically a ninth of the sales price (resulting in a 10% equity and 90% debt structure), is contributed by the grantor to the IDGT. This gift will be included on a gift tax return filed by the grantor for the year of the gift and exemption will either be applied or gift tax paid. Family limited partnerships or limited liability companies are also often utilized to hold the underlying assets (with the FLP or LLC interests being the assets sold) to reduce the valuation of the assets (and thus the amount of exemption used or gift tax paid) through discounting due to the economic disadvantages of holding an interest in an illiquid entity that the holder does not control.

To qualify for the annual gift tax exclusion, each annual contribution to the trust must be a present interest.[11] To accomplish this, the trust instrument grants the granddaughter the right to withdraw each contribution for a 30-day period after she receives notice of the contribution (*i.e.*, a *Crummey* withdrawal right).[12] If the granddaughter lets her withdrawal right lapse during the 30-day period, then the contribution will remain a part of the trust corpus.[13]

Grant retains a nonfiduciary power to reacquire any trust assets by substituting assets of equivalent value (*i.e*., a swap power).

Consequences: For income tax purposes, due to the swap power, the trust is a grantor trust and as such Grant will be treated as its owner.[14]

For gift and estate tax purposes, contributions to the trust will be free of gift tax because they will be limited to the annual gift tax exclusion amount and will be considered present interests due to the *Crummey* withdrawal right.[15] However, the lapse of the withdrawal right, which is a general power of appointment held by the granddaughter, will be a potential gift from the granddaughter to the trust for contribution amounts exceeding the 5 and 5 amount (discussed below).[16] Because the granddaughter has a testamentary power of appointment, the excess above the 5 and 5 amount will not be a completed gift by the granddaughter (a) until her death, when the power is exercised or lapses, and included in her taxable estate or (b) except as distributions of corpus are made to someone else who has been added as a beneficiary by Grant's brother, and becomes a taxable gift made by the granddaughter.[17] Further, if the granddaughter were to die while holding a *Crummey* withdrawal right prior to its lapse, then the amount subject to the withdrawal right would be included in her estate, with no amount having yet lapsed with respect to that gift.[18]

For GST tax purposes, each contribution to the trust will be subject to GST tax (with Grant being the transferor) because the trust corpus is not includable in the granddaughter's taxable estate and therefore does not qualify for the GST tax annual exclusion.[19] Accordingly, Grant will have to either use some of his GST tax exemption or pay GST tax. In addition, at the granddaughter's death, the trust corpus will be subject to GST tax because the *Crummey* withdrawal right will cause the granddaughter to have become the transferor, making any of Grant's allocated GST tax exemption of no further benefit.[20]

For state law purposes, the trust qualifies as a spendthrift trust because annual contributions to the trust, and thus the amounts subject to the *Crummey* withdrawal right, will be limited to the annual gift tax exclusion amount.[21]

B. Example 1A: IDGT for Annual Exclusion Gifts to Grandchild

The facts are the same as in Example 1 except the grantor, Grant, does not retain a swap power but names himself trustee, instead of his son-in-law.

Consequences: The consequences are the same as in Example 1. The trust will be a grantor trust not because of the retained swap power but because Grant, as trustee, will have the power to distribute and accumulate trust income that is not within any of the exceptions listed in subsection 674(b). Grant, as trustee, can hold the power to make distributions from the trust under an ascertainable standard without causing the trust assets to be included in his taxable estate.[22]

III. SECTION 678

Section 678 is unique among the various sections that provide when a trust is a grantor trust because it provides that a person other than a trust's grantor can be treated as a grantor and thus liable for the trust's income taxes. This person need not be identified in the trust instrument as being a beneficiary, but must have, or have had, a general power of appointment over the trust, or a portion of the trust, to which section 678 applies. So, of course, he is treated as being a grantor.

Section 678 has five subsections. Like the other grantor trust rules, subsection (a) sets forth the general

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[11] §2503(b)(1).

[12] *See Crummey v. CIR*, 397 F.2d 82 (9th Cir. 1968) (finding that beneficiaries holding a withdraw right over trust contributions held a present interest in such contributions).

[13] Minor beneficiaries can trigger §678(a)(1). *See* Rev. Rul. 81-6.

[14] §§675(4)(C) and 678(b).

[15] §2503(b)(1); Rev. Rul. 73-405.

[16] §§2041(b)(2) and 2514(e).

[17] Treas. Reg. §25.2511-2(b) and (c).

[18] §2041(a)(2).

[19] §§2611(a), 2612(c), 2613(a), and 2642(c).

[20] §§2041(a)(2) and 2652(a)(1).

[21] Under the Texas Trust Code, a beneficiary will not be considered the grantor of a trust if there is a "lapse, waiver, or release of … the beneficiary's right to withdraw a part of the trust property to the extent that the value of the property affected by the lapse, waiver, or release in any calendar year does not exceed the greater of: (A) the amount specified in Section 2041(b)(2) or 2514(e) . . .; or (B) the amount specified in Section 2503(b) . . . with respect to the contributions by each donor." TEX. PROP. CODE §112.035(e)(2) and (f)(3).

[22] *See, e.g., Estate of Budd v. Comm'r*, 49 T.C. 468 (1968), acq. 1973-2 CB 1.

rule of what causes a powerholder to be subject to the statute, while the next three subsections, (b) - (d), provide exceptions to subsection (a). The fifth and final subsection, (e), provides a cross-reference to the qualified subchapter S trust provisions.[23]

Subsection 678(b) provides that the general rule in subsection (a) does "not apply with respect to a power over income, as originally granted or thereafter modified, if the grantor of the trust . . . is otherwise treated as the owner under the provisions of [sections 671 to 677]." Although the statute's language only references "income" and omits the term "corpus," it likely causes section 678 not to be applicable to the extent that any portion of a trust is a grantor trust as to the grantor, whether income or corpus.[24]

Subsection 678(c) provides that the general rule in subsection (a) does not apply simply because a person holds a power as trustee to distribute trust income for support of someone that the person is obligated to support, except to the extent the trust income is actually distributed. An example would be a parent serving as the trustee who has a power to make a distribution to a minor child that satisfies the parent's duty to support the child. In such case, subsection (a) does not tax the income to the parent serving as trustee except to the extent such a distribution is made.

Subsection 678(d) provides that subsection (a) does not apply with respect to a power that is "renounced or disclaimed within a reasonable time after" the powerholder first becomes aware of its existence.

Accordingly, if none of subsections 678(b), (c), or (d) applies, then subsection 678(a) applies.

Subsection 678(a) provides, "A person other than the grantor shall be treated as the owner of any portion of a trust with respect to which:

> (1) such person has a power exercisable solely by himself to vest the corpus or the income therefrom in himself, or
> (2) 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."

The general rule is found in subsection (a)(1) and provides that a person is the deemed owner of a trust to the extent she holds a power to alone vest the trust's corpus or income in herself (such a withdrawal power is sometimes called a *Mallinckrodt* power[25]). Such a power is a general power of appointment for estate and gift tax purposes. As with a general power of appointment, simply holding the power, rather than using it, triggers subsection 678(a).

For example, assuming the trust is not a grantor trust as to the grantor, if a person has the power to withdraw the entire corpus of a trust, then she will be the deemed owner of the trust's entire corpus. Further, if the person has the power to only withdraw a portion of the trust's corpus (rather than the entirety), then she will be the deemed owner of only the portion subject to the power. Some other powers that would trigger subsection 678(a)(1) with respect to a powerholder, assuming the trust is not a grantor trust as to the grantor, are: (i) an inter vivos general power of appointment over the trust's corpus (*i.e.*, a power to appoint to the powerholder or her creditors); (ii) a power to distribute the trust's corpus to the powerholder in her sole discretion not subject to an ascertainable standard (*e.g.*, where she is the sole trustee and a trust beneficiary); and (iii) an unexercised *Crummey* withdrawal right that has not lapsed. In addition, a withdrawal power over the trust's "income" will trigger subsection 678(a)(1) as to the income (for instance, the power in *Mallinckrodt* was over the trust's income).[26]

The other circumstance in which subsection 678(a) is triggered, under subsection (a)(2), is when a person "*has previously partially released or otherwise modified*" a general power of appointment and afterwards retains a power that, were she the grantor, would cause her to be deemed the owner under the grantor trust rules applicable to grantors. For example,

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[23] It cross-references §1361(d), which provides that a beneficiary of a "qualified subchapter S trust" that makes an election under §1361(d)(2) will be treated as the owner of the portion of the trust consisting of S corporation stock.

[24] This is because, under Treas. Reg. §1.671-2(b), any reference in the grantor trust rules to "income" without further qualification is to "taxable income," which includes both accounting income and income attributable to corpus. This interpretation aligns with the IRS's application of §678(b) in multiple private letter rulings in which no distinction between income and corpus is made, although they do not provide the reasoning for such. PLR 200732010 (May 1, 2007); PLR 200729005 (March 27, 2007) through PLR 200729016 (March 27, 2007).

[25] Named after the case that led Congress to ultimately enact §678, *Mallinckrodt v. Nunan*, 146 F.2d 1 (8th Cir. 1945). In *Mallinckrodt*, the court held that a non-grantor co-trustee was the deemed owner of a trust because under the trust instrument, after certain other payments and distributions were made, the trustees were directed to pay him the residue of annual trust income upon his request, despite him never having requested a distribution.

[26] The section below discussing BDOTs will consider the argument that a withdrawal power over the trust's income alone, rather than corpus, can potentially shift all of a trust's income tax liability to the powerholder.

if a trust beneficiary to whom support distributions might be made also has a right to withdraw the entire corpus of a trust and vest it in herself, then the general power of appointment triggers subsection 678(a)(1) and makes her the deemed owner of the entire trust corpus. If the trust beneficiary later "partially release[s] or otherwise modifie[s]"[27] her general power of appointment but retains her beneficial interest in the trust (regardless of the ascertainable standard of support), the beneficiary will be deemed the owner of the entire trust corpus under subsection 678(a)(2). This is because, after the beneficiary's general power of appointment was released, she still had the right to receive distributions from the trust, which, had the beneficiary instead been the grantor of the trust, she would have been taxed as the owner of the trust under subsection 677(a)(1).

A. Example 1B: 678 Trust for Annual Exclusion Gifts to Grandchild

The facts are the same as in Example 1A except (a) the objects of the granddaughter's testamentary power of appointment is expanded from among her descendants to include any person or organization the granddaughter desires except for herself, her estate, her creditors, and the creditors of her estate and (b) no one has a power to add a beneficiary who may receive distributions of corpus.

Change in Consequences: This change impacts the income tax consequences. By granting the granddaughter such a "broad special testamentary power of appointment," Grant's power to distribute trust income to the granddaughter or to accumulate it in the trust will not cause him to be treated as the owner of income for grantor trust purposes.[28] Removing the power of Grant's brother to add a beneficiary who can receive distributions of corpus, Grant will not be treated as the owner of corpus for grantor trust purposes.[29] The granddaughter's withdrawal right and its impending lapse make the trust a 678 trust.[30] As such, the granddaughter will be treated as its owner beginning when the withdrawal period starts and continuing after the withdrawal right lapses because the trustee can make trust distributions to her in the future.

For gift, estate, and GST tax and state law purposes, the results are the same as Example 1.

B. Example 1C: 678 Trust for Annual Exclusion Gifts to Grandchild

The facts are the same as in Example 1B, with the granddaughter having a broad special testamentary power of appointment, except that Grant provides in the trust instrument that the granddaughter can also exercise the testamentary power to appoint to her estate, her creditors, and the creditors of her estate.

Change in Consequences: The income tax consequences are the same as in Example 1B.

The gift and estate tax[31] and the state law consequences are the same as in Example 1.

For GST tax purposes, each contribution to the trust will be free of GST tax because it qualifies for the annual GST tax exclusion.[32] This is because (i) the granddaughter, a skip person, is the trust's sole beneficiary, (ii) due to the testamentary general power of appointment, the trust corpus is includible in the granddaughter's estate if she were to die before it terminates, and (iii) each contribution will otherwise qualify for the annual gift tax exclusion. At the granddaughter's death, the trust corpus will be subject to GST tax because the *Crummey* withdrawal right will cause the granddaughter to have become the transferor.[33]

C. Example 2: 678 Trust for Annual Exclusion Gifts to Grandchildren

Grant creates an irrevocable pot trust for the benefit of his six grandchildren and appoints his son-in-law as trustee, who is the father or uncle of each of the grandchildren. The purpose of the trust is to receive contributions from Grant each year in the maximum annual gift tax exclusion amount for each of the six grandchildren. During the term of the trust, the trustee can distribute among them so much of the net income and corpus of the trust as the trustee deems necessary for their health, education, maintenance, and support. These distributions are not required to be equal. The trust will terminate on the date that none of the six grandchildren are under age 40 and at such time the remaining trust corpus will be distributed outright to the surviving grandchildren and the descendants of any deceased grandchild in such shares as the trustee shall decide. No testamentary power of appointment is provided. So that each contribution will be a present interest, the trust instrument grants each grandchild a *Crummey* withdrawal right applicable to their share of

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[27] *See* section titled Releases, Lapses, Etc., which covers what is potentially meant by "partially released or otherwise modified" in §678(a)(2).

[28] §674(b)(6)(A)

[29] §674(b)(5).

[30] §678(a).

[31] While the practical consequences are the same, there is a technical difference in that the testamentary power of appointment gives rise to estate tax inclusion in Example 1C whereas in Example 1 the tax arises from the completion of the gift.

[32] §2642(c).

[33] §2652(a)(1).

the contributions. The trust is not a grantor trust as to Grant.

Consequences: The income tax consequences are that the trust is a 678 trust and as such each grandchild will be treated as its owner with respect to her or his one-sixth share of the trust contributions.[34] Even though each grandchild will have to include her or his pro rata share of the trust's taxable income in his or her taxable income, unequal distributions may be made due to the differing needs of the beneficiaries from time to time. For instance, if one of the six beneficiaries has a disability requiring long-term care, and all of the trust distributions are diverted to that beneficiary, the other five (and their spouses) may be unhappy having to pay income taxes on trust income that does not benefit her or him.

For gift and estate tax purposes, contributions to the trust will be free of gift tax because they will be limited to the annual gift tax exclusion amount and will be considered present interests due to the *Crummey* withdrawal right.[35] However, the lapse of the withdrawal right will be a gift from each grandchild to the trust for contribution amounts exceeding the 5 and 5 amount because the retained interest in the trust is not determinable.[36] Because none of the grandchildren has a power of appointment, the excess above the 5 and 5 amount will be a completed gift by each grandchild and she or he will have an obligation to report it on her or his Federal Gift Tax Return. Further, if a grandchild were to die while holding a *Crummey* withdrawal right prior to its lapse, then the amount subject to the withdrawal right would be included in her or his estate.[37] If, as in Example 1, each grandchild were given a power of appointment, this would keep the gifts caused by the *Crummey* withdrawal right's lapse from being complete.[38] However, a portion of each such gift will later be complete each time the trust makes a distribution to someone other than the grandchild whose *Crummey* right lapsed, probably resulting in multiple gifts to report that will likely be complicated to track.

For GST tax purposes, each contribution to the trust will be subject to GST tax (with Grant being the transferor). The gift will not qualify for the GST tax annual exclusion for two independent reasons: (i) the trust has multiple current beneficiaries who can receive distributions of corpus and income and (ii) the trust corpus is not necessarily includable in any one grandchild's estates.[39] Accordingly, Grant will have to either use some of his GST tax exemption or pay GST tax. In addition, although it is unlikely there will be a transfer to a skip person from the trust, if a grandchild dies during the term of the trust, the trust corpus will be subject to GST tax because the grandchild's respective *Crummey* withdrawal right will cause her or him to be the transferor. In such case, Grant's GST tax exemption would be of no further benefit.

For state law purposes, the result is the same as the above examples.

IV. WHEN TO USE 678 TRUSTS

There are times to use 678 trusts and times to carefully avoid doing so. An example of the former is when you want the trust income to be taxed at the beneficiary's marginal income tax rates and the trust funds are expected ultimately to go to that beneficiary. This is often the case with annual exclusion gifts that are made in trust to a single current beneficiary. An example of the latter is when the planning is dynastic, with the trust funds expected to hopefully go to that beneficiary's descendants, with the grantor having planned carefully to avoid transfer taxes. The reason for this distinction is that triggering the application of section 678 requires a withdrawal power, and that is also a general power of appointment. General powers of appointment, at least in excess of a 5 and 5 power, will result in the imposition of a transfer tax during and at the end of the powerholder's life. This can also result in the loss of the donor's GST tax exemption allocated to the trust because the powerholder becomes the transferor for GST tax purposes. General powers of appointment can also give rise to the loss of spendthrift protections.

V. RELEASES, LAPSES, ETC.

A careful reader will notice that subsection 678(a)(2) applies (a) if a person who had a power exercisable solely by herself to vest the corpus or the income of any portion of a trust therefrom in herself has (b) previously partially *released or otherwise modified* such a power and afterwards retains control in the way specified. This is in contrast to subsections 2041(b)(2) and 2514(e), which are clear that a lapse of a power of appointment is considered a release except to the extent a *lapsed power* does not exceed the 5 and 5 power.[40] This gives rise to whether a lapse of a withdrawal right can trigger subsection 678(a)(2). There is currently no

[34] §§671 and 678(a).

[35] §2503(b)(1); Rev. Rul. 73-405.

[36] §§2041(b)(2) and 2514(e).

[37] §2041(a)(2).

[38] Treas. Reg. §25.2511-2(b) and (c).

[39] §2642(c).

[40] A release may qualify as a 5 and 5 power, but the statutes and the related regulations expressly provide that the 5 and 5 power applies if there is a lapse. So, lapsing the withdrawal power is the conservative position, and also easier to administer because a lapse, unlike a release, can occur without any action being taken by the powerholder.

authority for this on which a taxpayer can rely, such as a statute, regulation, revenue ruling, or case.[41] Instead, the position that a lapse is a partial release or modification for purposes of subsection 678(a)(2) depends largely on legal analysis that (a) sections 2041 and 2514 treat all lapses as being a release for gift and estate tax purposes and (b) there is no reason why a lapse should not be within the scope of subsection 678(a)(2)'s "partial[42] release or other modification," a lapse being an "other modification." One well regarded commentator's logical argument in support of the lapse triggering subsection 678(a)(2) is that, if the lapse does not trigger subsection 678(a)(2), then similarly situated taxpayers will be treated differently if one simply acts to partially release her withdrawal power while another allows hers to lapse.[43] This analysis is also supported by the IRS consistently ruling this way in any number of private letter rulings, which, of course, can only be relied on by the letter's recipient.[44] In the private letter rulings, the IRS provided little reasoning for its position, suggesting that it does not think the question deserves much thought. Nonetheless, one commentator claims that this may be "the weakest link in the chain" as to how BDITs may be challenged; however, in evaluating his opinion, it should be kept in mind that he is the creator and leading advocate for the Beneficiary Deemed Owner Trust, which he views is a superior alternative to BDITs.[45]

VI. THE BENEFICIARY DEFECTIVE INHERITOR'S TRUST[46] ("BDIT")

The above discussion and examples all relate the use of trusts in making gifts. Unlike some other states, Texas does not permit self-settled spendthrift trusts, with limited exceptions.[47] This severely limits Texans' ability to use trusts to protect their own assets. The Beneficiary Defective Inheritor's Trust (the "BDIT") is promoted as a vehicle to place one's assets beyond the reach of one's creditors and also transfer taxes.[48] The BDIT begins as a 678 trust set up for the beneficiary of the trust by a third person, such as a parent or someone else (other than a spouse) who is willing to establish the 678 trust and fund it with $5,000. The $5,000 must be a true gift, and not money that the beneficiary directly or indirectly provides.

A. Example 3: BDIT

Grant's father creates an irrevocable trust for the benefit of Grant and appoints Grant as trustee. During Grant's life, the trustee can distribute to him so much of the net income and corpus of the trust as the trustee deems necessary for Grant's health, education, maintenance, and support. Additionally, an independent trustee (or any trustee at a trust consultant's direction) can distribute the trust's net income and corpus to Grant for any reason. Following Grant's death, the remaining trust assets are allocated and added to trusts for his descendants. Further, Grant and any future beneficiaries are granted a testamentary broad special power of appointment over the trust corpus (*i.e.*, he can appoint to any person other than himself, his creditors, his estate, or creditors of his estate).

Grant's father contributes $5,000 to the trust at its creation. So that the gift is a present interest for purposes of qualifying for the annual gift tax exclusion, the trust instrument grants Grant the right to withdraw the contribution for a 30-day period after he receives notice of the contribution. If Grant does not exercise his withdrawal right during the 30-day period, the contribution will remain a part of the trust corpus.

The trust instrument includes no provision that would cause the trust to be a grantor trust as to Grant's father.

Prior to the filing deadline, Grant's father will file a gift tax return to report the $5,000 gift and allocate $5,000 of GST exemption to it.

Consequences: For income tax purposes, the trust is a 678 trust and as such Grant will be treated as its owner beginning when the withdrawal period starts and continuing after the withdrawal right lapses.[49] *See* the discussion in the section titled Releases, Lapses, Etc. above.

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[41] Although there are two Revenue Rulings where the IRS has stated that a beneficiary holding a *Crummey* power was the trust's deemed owner, in each case they did not address what the effect of the *Crummey* power's lapse was. Rev. Rul. 67-241; Rev. Rul. 81-6.

[42] The release or modification is "partial" because if it were complete, the beneficiary would no longer have an interest in the trust to which §678 would apply. *But cf.* Blattmachr, Jonathan G., Gans, Mitchell M., and Lo, Alvina H., *A Beneficiary as Trust Owner: Decoding Section 678*, 35 ACTEC Journal 106, 116 (2009).

[43] See Blattmachr at 116.

[44] PLR 201216034; PLR 200104005; PLR 200147044; PLR 200022035.

[45] Morrow, Edwin P., IRC Section 678 and the Beneficiary Deemed Owner Trust (BDOT), 148 (April 19, 2018).

[46] Sometimes called a Beneficiary Defective *Irrevocable* Trust.

[47] Tex. Prop. Code §112.035.

[48] The BDIT might also protect one's assets in the event of a failed marriage, at least if it is only funded with one's separate property.

[49] §678(a).

For gift and estate tax purposes, the $5,000 contribution to the trust will be free of gift tax because it is considered a present interest due to the withdrawal right and will be below the maximum annual gift tax exclusion amount.[50] Further, the lapse of the withdrawal right will not cause a taxable gift from Grant to the trust because the $5,000 contribution does not exceed the 5 and 5 amount.[51] If Grant were to die while holding the withdrawal right prior to its lapse, then the amount subject to the withdrawal right would be included in his taxable estate.[52]

For GST tax purposes, the $5,000 contribution to the trust will not be subject to GST tax because Grant is not a skip person as to his father (the transferor).[53] Further, at Grant's death, no GST tax will be triggered because the withdrawal right's lapse will not be a release due to the $5,000 being within the 5 and 5 amount, meaning that Grant's father will still be treated as the transferor at such time.[54] Accordingly, the GST exemption allocated by Grant's father will apply when a later taxable termination or distribution occurs, causing no GST tax to be incurred.

For state law purposes, the trust qualifies as a spendthrift trust because the contribution to the trust, and thus the amount subject to the withdrawal right, will be limited to the applicable 5 and 5 amount of $5,000.[55]

A moment of reflection will reveal that the trust in Example 3 (the "BDIT") is simply like the other 678 trusts discussed above except that limiting the funding of the trust to $5,000 does not lead to the incomplete gift and other transfer tax complications that arise with a withdrawal right for a larger amount. That's nice, but it leaves the beneficiary with a trust of limited utility and is probably not worth the effort to create if more is not done with it.

B. Example 3A: Sale to the BDIT

After the BDIT described in Example 3 is in place and Grant's withdrawal right has lapsed, Grant enters into a bona fide installment sale with the BDIT structured as the asset freeze technique commonly called a sale to an IDGT (except the beneficiary is the seller rather than the grantor). Specifically, Grant, as seller, will sell to the BDIT, as buyer, $45,000 of assets desired to be transferred to the trust (and out of the beneficiary's estate), which amount is the fair market value of the assets as determined by a qualified appraiser or other reliable means.[56] The size of the sale is limited to nine times the then value of the corpus of the trust so that the trust's debt will be no more than ninety percent of the value of the BDITs assets. As consideration for the sale, the BDIT will execute a secured promissory note for $45,000 payable to Grant evidencing indebtedness in the amount of the sales price plus interest at the applicable federal rate for the term of the note. This sale transaction "freezes" the value of the transferred assets at the point in time of the sale (*i.e.*, the value of the promissory note plus interest), leaving all subsequent appreciation of the assets to grow outside of the beneficiary's estate.

Consequences: For income tax purposes, the installment sale to the BDIT will be ignored because the beneficiary, being the trust's deemed owner, and the BDIT should be treated as the same person.[57]

For transfer tax purposes, as long as the sale is recognized as being a bona fide sale for such purposes, there will be no transfer tax consequences, and thus the sale will not be treated as a gift or incomplete gift that would cause gift tax or estate inclusion as to the beneficiary.

The sale will be recognized for state law purposes, including spendthrift protections.

The sale in Example 3A will result in the BDIT having $50,000 of assets, subject to $45,000 of debt. That's ten times the assets in Example 3, but it still leaves the beneficiary with a trust of limited utility. Even with an additional $45,000 of assets, subject to a like debt, it is still probably not worth the effort to create it unless more can be done with it.

Some "more" things that might be done with a $50,000 trust are to give it an interest in a promising business opportunity that requires a small amount of capital to invest that is commercially reasonable. For example, a beneficiary who was a real estate developer might be permitted to invest her BDIT in a new project undertaken with other partners who are providing the

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[50] §2503(b)(1); Rev. Rul. 73-405.

[51] §§2041(b)(2) and 2514(e); the trustee will want to hold the $5,000 in a non-interest-bearing account until the withdrawal power lapses so that the lapse will not exceed $5,000 and will also apply to all of the assets in the trust so that the powerholder will be the owner of all of the trust assets for purposes of §678(a)(2).

[52] §2041(a)(2).

[53] §2613(a).

[54] §2652(c).

[55] TEX. PROP. CODE § 112.035(e)(2) and (f)(3).

[56] Grant might sell a limited partnership interest in his family limited partnership that is worth $45,000, which would convey an interest that has a materially higher liquidation value.

[57] Rev. Rul. 85-13, but if, as discussed in the section titled Releases, Lapses, Etc. above, the BDIT is not a grantor trust as to the beneficiary under §678(a)(2), then the beneficiary would be liable for any capital gains from the sale and the resulting interest, and potentially penalties.

capital and even guaranties for the project loans.[58] Or the BDIT might buy common interests in an entity whose equity has been recapitalized in a preferred interest freeze. In both cases, the BDIT's opportunity might arise because of the beneficiary's personal participation. There is no tax law requirement that such a beneficiary be compensated if she is willing to work for free.

C. Example 3B: Overleveraged Sale to the BDIT

The facts are the same as in Example 3A except that the amount of assets sold is $1 million and the promissory note is for $1 million.

Change in Consequences: The BDIT, as so leveraged, would have trust corpus of less than 0.5 percent of the value of the BDIT's assets. With such extreme leverage, it is doubtful that the sale to the BDIT would be recognized for any tax purpose. The conveyance of the assets might well be viewed as a contribution to the trust or the note might be viewed as a nonqualified retained interest under section 2702, which would result in the conveyance being taxed in full as a gift (although it might be an incomplete gift). For state law purposes, the conveyance of the assets might result in the BDIT being viewed as a self-settled spendthrift trust, except as to $5,000.

D. Example 3C: Sale to the BDIT with Guaranty

The facts are the same as in Example 3B except that the $1 million sale is financed with a bank loan, paying interest at the rate the bank demands. In order to get the bank to make the loan, Grant provides his personal guaranty without compensation, which the bank accepts because Grant has more than enough other liquid assets to satisfy the guaranty if the BDIT defaults.

Change in Consequences: This transaction may well be analyzed as being a circuitous route to implementing what is in essence the same transaction as described in Example 3B as the ultimate risk of default is borne by Grant in both Example 3B and Example 3C.

E. Example 3D: Sale to the BDIT with Third-Party Guaranty

The facts are the same as in Example 3C except that the guaranty is provided by a third-party.

Change in Consequences: In theory, this should have the same consequences as Example 3A.

Example 3D sounds promising, but there is reason for serious doubt as to whether a third-party would provide such a guaranty. If, however, a third-party guarantor could be found, what would the guaranty fee be? This question is especially relevant if the guarantor is a related trust.

Some years ago, when discussing sales to BDITs with other practitioners, one of the authors was told that the annual guaranty fee was two percent of the amount guaranteed. For these transactions, the guarantor was *always* a related party. When the author pressed what the evidence was for such a low fee, he was told it was what "everyone" was doing and common knowledge. Perhaps a well-known Texas estate planning firm should be commended for being more conservative and using a "rule of thumb" for the annual guaranty fee that is 50% higher, three percent.[59] They typically have the guaranty fee paid on 15 to 20 percent of the note amount.[60] Further, they note, "The size of the guaranty impacts the amount of LP interests the Client can sell, as the guaranty must be at least 10% of the note amount."[61]

If this really is "market," one has to ask why we are practicing law instead of setting up two thinly capitalized LLCs that each obtain a $2.5 million loan that is credit-enhanced with a guaranty of 20 percent of the loan amount that costs three percent a year and then having the one LLC go long in the stock market and the other go short. Regardless of how the market does, odds are that at the end of the year one of the LLC's with $2.5 million invested will have done quite well and the other will be broke, sticking the guarantor with the obligation to pay back 20 percent of the $2.5 million, which is $500,000.[62] This seems like a reasonable place to start because the annual three percent guaranty fees on 20 percent of the loan amount would only be $30,000 on loans totaling $5 million, and $30,000 is probably within the reach of most of us to capitalize on such a promising opportunity. It might well be possible to then take the profits and do another set of transactions, but the second time bigger. Repeating this series of transactions several years in a row, or at least as long as

[58] Is it problematic for the beneficiary to provide her own guaranty with the other investors when she does not personally have an equity interest? What if she personally is also an investor in the project and the guaranties all provide for joint and several liability?

[59] *See* The Blum Firm, P.C., *678 Trusts: Fundamentals and Drafting Strategies*, 5 (Oct. 2016)("typically guarantees 15% to 20% of the note amount in exchange for a 3% annual fee"); *see* also Blum, Marvin E., *Squeeze, Freeze, & Burn: Estate Planning with 678 Trusts*, Slides 30 – 32 (Oct. 2018) ("The rule of thumb we use to value the guaranty fee is 3% of the amount of assets pledged"; however, with the example given, it says the "guarantor of 20% of the promissory note amounts" paid annual fees equal to 3% of the amount guaranteed.).

[60] Id.

[61] *Id*.

[62] A 1.2% market move on a $2.5 million portfolio will return a profit of $30,000, getting one to breakeven, with any larger market move in a year being profit. Note that the lender will bear any loss in excess of $500,000.

the "market" for guaranty fees is so accommodating, would provide a series of larger, can't lose transactions.

Careful reflection will lead a serious practitioner to recognize that the guaranty fee should not be set based on a rule of thumb but should be based on the nature of the assets that are held in the BDIT and its balance sheet. The business track-record of the trustee might also be relevant. When a business valuation firm was asked about how such a guaranty fee might be reasonably determined, one appraiser, thinking out loud, suggested that if the assets in trust were marketable securities, perhaps it might be valued using a Black-Scholes model. Wikipedia defines this as "a mathematical model for the dynamics of a financial market containing derivative investment instruments." That is not a simple fixed percentage of the amount guaranteed.

As this outline is being written, it is reported that Donald Trump cannot find anyone to take his real estate interests as security for an appellate bond approaching a half billion dollars. This suggests that there is a strong reluctance in the marketplace to take illiquid assets as security for an obligation that might require the guarantor to put up cash. Query if the same reality exists when you ask a guarantor to provide a guaranty where default will result in the guarantor taking a limited partnership interest in a family limited partnership after paying off the trust's note.

If the guarantor is a related party, paying an arm's length guaranty fee is not an academic question – it can be the difference between having a successful transaction as set out in Example 3D, and a disaster of a transaction, as set out in Example 3C.

F. Example 3E: Sale to the BDIT with Related Party Guaranty

The facts are the same as in Example 3D above, except the guaranty is provided by an irrevocable trust settled by Grant for his descendants, with the BDIT paying what is reasonably believed to be an arm's length annual guaranty fee to the guaranteeing trust.

Change in Consequences: In theory, this should have the same consequences as Example 3A, but that assumes that the trustee of the BDIT can prove that the guaranty fee is an arm's length amount. Even if the trustee can do so, she might still be subject to fiduciary liability for guaranteeing a loan to the uncreditworthy BDIT, and imprudently putting the assets of the guaranteeing trust at risk.

Given that the principal benefit of the BDIT is to move value out of the beneficiary's taxable estate and to protect those assets from creditors, it is unsettling to realize that getting the statute of limitations to run on any gift tax liability does not bar the IRS from adding the assets back into the beneficiary's taxable estate under sections 2036 and 2038 after the beneficiary's death, which may be decades later. Remember that the beneficiary's executor may be pressed to prove the bona fides of the original sale to the BDIT many years in the future. It also does not bar creditors from going after the BDIT assets on a fraud on the creditors theory.

VII. BENEFICIARY DEEMED OWNER TRUSTS ("BDOTS")

One author with impressive credentials has argued that what he calls the Beneficiary Deemed Owner Trust ("BDOT") is another type of 678 trust, one that he (the "Proponent") argues is superior to the BDIT[63] and can be more widely used to make all manner of trusts, such as marital trusts, into 678 trusts. The BDOT beneficiary's withdrawal power covers only the trust's *taxable* income (as distinguished from accounting income). The Proponent correctly notes that the Treasury Regulations for grantor trusts generally define "income" for grantor trust purposes to include both ordinary income and capital gains. The BDOT does not provide a power to withdraw the trust's corpus, other than corpus that comes from net taxable capital gains realized during the term of the trust.

The Proponent argues that Treasury Regulation section 1.678-1(a), which tracks subsection 678(a)(1), should be read as follows. "Where a person other than the grantor of a trust has a power exercisable solely by himself to vest the corpus **or** the income [remember, 'income' here means taxable income not accounting income] of any portion of a testamentary or inter vivos trust in himself, **he is treated** under section 678(a) **as the owner of that portion**." (Emphasis and bracketed language added by the Proponent).[64] That is, to again quote the Proponent, "a §678 beneficiary '**shall be treated as the owner**' for income tax purposes 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.'"[65] To be clear, he is asserting that the beneficiary of the trust is treated as the income tax owner of the entire trust if the beneficiary has *either* a power to vest *corpus or the income* therefrom in himself.[66] He then asserts that

[63] The proponent of the BDOT notes that the BDIT relies on both §678(a)(1) (during the withdrawal period) and §678(a)(2) (after the withdrawal power lapses) to cause the beneficiary to be the trust's deemed owner; however, he asserts that the BDOT relies only on §678(a)(1) to reach the same result. He goes on to assert that by relying only on the §678(a)(1) trigger, for which he asserts that the law is more certain, the BDOT avoids what he sees as the main issues with the BDIT – the uncertainty of the effect of the lapsing withdrawal right and the limited seed gift to the BDIT.

[64] *Morrow* at 96.

[65] *Id*.

[66] *Id* at 96-97.

since a power of the beneficiary to vest income in himself is sufficient to make the beneficiary deemed owner of the entire trust for income tax purposes, there is no need for the beneficiary to have a power to withdraw the trust's corpus to produce that result. If the Proponent is correct, the BDOT would be superior to the BDIT because 678 treatment is not limited to the $5,000 that the beneficiary can withdraw under a 5 and 5 power.

A. Clifford Trusts

The Proponent's arguments are best analyzed in light of long settled grantor trust law applicable when different persons have interests in the income and the corpus. A clear example is found in how *Clifford* trusts were treated before Congress abolished them in the Tax Reform Act of 1986.[67] *Clifford* trusts took their name from the famous case of *Helvering v. Clifford*.[68] In that case, the Supreme Court approved the Bureau of Internal Revenue's (the predecessor of the IRS) extension of the then statutory grantor trust rules to a 1934 short-term (five-year) irrevocable trust of which the grantor was the trustee and the grantor's spouse was the income beneficiary. At the end of the trust term, the corpus was returned to the grantor. Meanwhile, the Treasury Department issued regulations under those statutes that arguably extended those statutory provisions, including extension to irrevocable trusts with a reversion to the grantor within 15 years. The regulations were commonly referred to as the "Clifford Regulations."[69] After expanding the grantor trust rules to cover additional situations, they were largely codified in sections 671 – 678 of the Internal Revenue Code of 1954, with Clifford trusts permitted if they had a term of at least ten years or, if shorter, the life of the income beneficiary.[70]

B. Example 4: Typical *Clifford* Trust

In 1981, son created a *Clifford* trust for his mother. The trust instrument[71] provided that the trustee shall pay to the mother "all of the net income of the trust during her lifetime; all of such income shall be distributed during each taxable year or within 30 days after the end of the taxable year." "Upon the death of [the mother], this trust shall terminate. Within a reasonable period of time after termination of the trust, the Trustee shall distribute all accumulated income to the estate of [the mother] and the Trustee shall distribute the principal of the trust to" the son. The trust instrument contained typical language regarding trust accounting income and trust principal.

Clifford trusts typically gave the current beneficiary the right to all of the trust accounting income, on which she was taxable, pursuant to the non-grantor trust rules in Subchapter J of the IRC. In a *Clifford* trust, the grantor retained the right to the return of the corpus at the end of the trust term, making him taxable on the capital gains, pursuant to subsection 673(a). With such a trust, it was clear that the income beneficiary had the income interest in the trust while the corpus remained with the grantor, making the trust a grantor trust with respect to only corpus. When the trust realized a capital gain or loss, it was reported by grantor on his income tax return because those items were charged by the trust to the corpus.[72]

Thus, you can think about a typical *Clifford* trust as providing for a horizontal slice of the interests in the trust, with the income interest in the non-grantor trust slice and the corpus in the grantor trust slice.

C. Example 4A: 678-Style *Clifford* Trust

The facts are the same as in Example 4 except instead of providing for mandatory income distributions to the mother, the trust instrument gives her the right to withdraw the trust accounting income of the trust from time to time as she requested.

With this change, the mother is taxable on the trust's accounting income under subsection 678(a)(1) because she is able to withdraw accounting income. Thus, the income interest is a grantor trust as to her, and the corpus is a grantor trust slice. The trust is thus a wholly grantor trust with two different persons owning different interests and each reporting her or his portion of the trust's income on her or his income tax return.

D. Example 4B: Three-Slice 678-Style *Clifford* Trust

The facts are the same as in Example 4A except the son also provides in the trust instrument that his sister had the power to withdraw the net capital gains from the trust, which are to be paid to her, if at any time during

[67] To the objection that the long-gone *Clifford* trust is not relevant to the issue, the answer is that §678 has not been amended in material aspect since sometime before 1976, if ever. The §678 Treas. Regs. were issued in 1956 and have never been amended.

[68] 309 U.S. 331 (1940), *rev'g* 105 F.2d 586 (8th Cir. 1939) and *aff'g* B.T.A. Memo. 1938-335.

[69] *See* Ronald D. Aucutt, *Shall We Dance? Celebrating Seventy-Five Years of ACTEC by Looking at Ten Decades of Tax Law Changes* which was the Seventy-Fifth Anniversary Presentation at the 2024 ACTEC Annual Meeting (March 8, 2024).

[70] Mr. Clifford's failed attempt to split his income with his wife was effectively permitted when The Revenue Act of 1948 introduced joint income tax returns for married couples.

[71] The quoted language is from a 1981 *Clifford* trust instrument.

[72] *See* Treas. Reg. §1.677(a)-1(g) Ex. 2.

the taxable year she so requests, as promptly as reasonably possible after such net capital gains can be computed after the close of the taxable year.

With this change, the sister is taxable on the trust's net capital gains under subsection 678(a)(1) because she is able to withdraw net capital gains. The change thus carves off a portion of the corpus horizontal slice, thus creating a third horizontal slice. Each of the three slices is taxed under the grantor trust rules, and the trust would thus be a wholly grantor trust with three different persons owning different interests and each reporting her or his portion of the trust's income on her or his income tax return.

E. Example 4C: BDOT / *Clifford* Trust

The facts are the same as in Example 4B except the mother has the power to withdraw *taxable* income from the trust (in the manner the Proponent suggests). The change simply takes the portion of the corpus horizontal slice carved off for the sister in Example 4B and combines it with the mother's interest.

With this change, the mother is taxable on the trust's accounting income and on the net capital gains under subsection 678(a)(1) because she is able to withdraw those portions of the trust. As in Example 4A, there are two horizonal slices – an income interest and a corpus interest – and both slices are grantor trusts as to their respective holders. The only difference is that the horizontal slice is carved a little differently, with a portion of the corpus slice instead being a part of the income slice. The trust is still a wholly grantor trust with two different persons owning different interests and each reporting her or his portion of the trust's income on her or his income tax return; however, the mother's slice (and not the son's) now includes the net capital gains. Note that a net capital loss from the trust would still be allocated to the son.

F. Conclusions About BDOTs

The analyses of Examples 4A, 4B, and 4C above all follow the same long standing grantor trust rules and showing there is no logical reason to think that in Example 4C the mother would be deemed to own the entirety of the trust simply because her income horizontal slice is defined in terms of *taxable* income instead of accounting income. Likewise, there is no logical reason why a different definition of the mother's horizontal slice would make her deemed owner of the entire trust since the son would remain owner of his own horizontal slice (i.e., that portion of the corpus retained by him, including net capital loss and any unrealized capital gain).

Furthermore, what would happen in Example 4C if there was a net capital loss? It is not logical to "withdraw" a loss.[73] In his paper, the Proponent has given considerable thought to whether the capital loss would be passed through to the person who can withdraw the taxable income. However, while conceding the question is by no means clear, the Proponent, continuing to misread section 678(a)(1), concludes the net capital loss probably would be deductible by the mother.[74] Taking a step back, it is clear that the son would be the person who would have suffered the net capital loss, which would reduce the amount of capital that would be returned to him. It follows that the net capital loss deduction should be taken on his income tax return, calling into doubt the Proponent's reading of subsection 678(a)(1).

Subsection 678(a)(1) should be read the way it has long been read and consistent with its threshold test that the powerholder have a general power of appointment. If subsection 678(a)(1) were restated twice to clearly articulate this rule with respect to the trust's income and the rule with respect to the trust's corpus, it would look as follows (quoting the subsection in full twice, striking "corpus" in one quotation and "income" in the other, and removing unneeded punctuation):

> "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."
> "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."

This understanding of subsection 678(a)(1) restores the important role of the word "portion" in correctly understanding the provision and the requirement that the powerholder have a general power of appointment over the portion of the trust over which he will be treated as the owner. Also, there is nothing that requires the word "portion" to refer to a vertical slice of the trust, *i.e.*, a slice in every trust interest that exists with respect to a separate share of the trust or an undivided interest in the trust.

The Proponent's interpretation of this language means that, so long as the withdrawal power adequately covers all of the trust's taxable income, it is unnecessary that it also cover the trust's corpus in order for the powerholder to be the deemed owner of the entire trust

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[73] It brings to memory a major accounting firm's tax opinion that began with the suggestion that the client "donate" their short position and then proceeded to analyze the charitable gift of what is a liability, not an asset. When a credit card bill arrives, it would be nice to "donate" it and be done with the matter. One could even pick their least favorite charity.

[74] *Morrow* at 59-65.

(including all of its ordinary income and income attributable to corpus) for income tax purposes.[75] But as we know from how *Clifford* trusts worked, this is not how the grantor trust rules are to be read.

The Proponent's 195-page paper (updated as of September 2022) analyzes what seems like a limitless number of aspects of the BDOT. Despite the impressive amount of work, the BDOT is built on a misreading of subsection 678(a)(1). There is no authority or even a nonbinding ruling that supports his specific reading of this subsection, and it requires one to take two steps past the authority that does exist. The first step is that one can be deemed to own the entirety of a trust for income tax purposes when she did not create the trust or have a general power of appointment over all of the beneficial interests in the trust (or in a vertical slice of the trust). The second step is that if one did not create the trust, or have a general power of appointment over all of the beneficial interests in the trust (or in a vertical slice of the trust), that the trust will be ignored for income tax purposes and the powerholder treated as if she owned all of the assets and owed all of the liabilities of the trust (or of a vertical slice).

With respect to the first step, the Proponent's misreading of subsection 678(a)(1) has led him to totally disregard to whom the corpus of the trust belongs. If the corpus without a right to net capital gains does not belong to the powerholder, there must be rights in property that belong to someone else, either to someone who is the "owner" under the grantor trust rules or to a trust taxed under the regular IRC Subchapter J provisions. His over-attribution of the entire trust as being deemed to be owned by those who only have a right to withdraw taxable income also leads to a conundrum if, for instance, his deemed owner purchases an asset from the trust which has $20,000 of unrealized appreciation. If the Proponent is correct, the trust is a grantor trust as to the powerholder, the gain is not recognized, and the powerholder will not be able to withdraw the $20,000 of gain. In contrast, if the asset were sold to a third-party, the powerholder could withdraw the $20,000 of realized gain. Note that the powerholder and a third-party would pay the same amount for the asset, so the $20,000 stays in the trust, with the corpus, if the powerholder buys the asset but the gain is not taxed. This makes no sense. After discussing the issue, the Proponent suggests a best practice would be to "simply avoid it."[76] When one comes to such a conclusion, it is appropriate to reconsider how one has analyzed the applicable tax law.

Further, if the Proponent were correct, the taxable income beneficiary would be able to exchange her low basis assets for the trust's high basis assets without income tax recognition even though she is not entitled to the trust's corpus.[77] Likewise, the taxable income beneficiary would be able to exchange her assets with a short-term holding period for the trust's assets with a long-term holding period without income tax recognition even though she is not entitled to the trust's corpus. It makes sense to allow the grantor of a trust to exchange assets without income tax recognition with the trust. But why should this result be extended to the taxable income beneficiary of a BDOT, who never had any right to the original corpus of the trust? Indeed, if the Proponent were correct, the sale of residential property deemed under the grantor trust rules to be the principal residence of the taxable income beneficiary would be excluded from taxable income under section 121, meaning the gain would be added to corpus and retained by the trust, which would benefit the trust's remainder beneficiaries when the trust terminated. Why this should be so?

With respect to the second step, under section 671 a trust may be treated as owned by its grantor, with the trust's income, deductions, and credits against tax attributed for income tax purposes to its grantor, essentially as though the trust does not exist or, in other words, as if its grantor owned the assets of the trust. But it does not necessarily follow that that the existence of a grantor trust is ignored for all income tax purposes.[78] In Revenue Ruling 64-302, the IRS dealt with a contribution by a grantor to a *Clifford* trust of his United States savings bond on which the interest had been deferred. The trust instrument provided that the unreported interest income on the contributed bond was to be allocated to corpus and upon the occurrence of a taxable event with respect to that interest income during the term of the trust, the interest income was to be taxable to the grantor pursuant to 677(a)(2). The Proponent's analysis ignores the corpus horizontal slice of the trust that the grantor had retained; however, it is clear that the result in the ruling turned on the fact the grantor had retained the unreported interest income as a part of the corpus horizontal slice.

It is the well-established position of the IRS and at least one court that the existence of a grantor trust is ignored for all income tax purposes, but that position has only been taken in cases with respect to the trust's

[75] *Morrow* at 17-18.

[76] *Morrow* at 105-106.

[77] The BDOT structure assumes the powerholder is also the trustee. Such an exchange might be a breach of the trustee's fiduciary duty owed to the trust's beneficiaries entitled to the corpus, who will exist.

[78] *See Rothstein v. United States.*, 735 F.2d 704 (2d Cir. 1984) (ruling a trust owned by a grantor must be regarded as a separate taxpayer capable of engaging in sales transaction with the grantor).

grantor.[79] It might be reasonable to extend that tax treatment to someone who holds or held a general power of appointment over *all* of the beneficial interests in the trust, or at least a vertical slice of all of those beneficial interests. But not extending this rule to BDOTs, where a powerholder held a general power of appointment over either income or corpus (but not both) would resolve several of the anomalies discussed above and by the Proponent otherwise.

[79] *Madorin v. Commissioner*, 84 T.C. 667 (1985) (ruling that the sole grantor should be treated as the owner of partnership interests the grantor transferred to his grantor trusts over which he had retained the power to add beneficiaries); Rev. Rul. 85-13 (grantor received the entire corpus of the trust in exchange for a promissory note given to the trust, which caused the grantor to be the owner of the entire trust (or a vertical slice portion of the trust) and IRS announced it would not follow *Rothstein*); Rev Rul. 58-2 (grantor established trust and had power of revocation and contribution to trust did not trigger gain); Rev. Rul. 66-159 (grantor created trust and qualified for nonrecognition of gain under then §1034 for residence used by grantor as his principal residence).