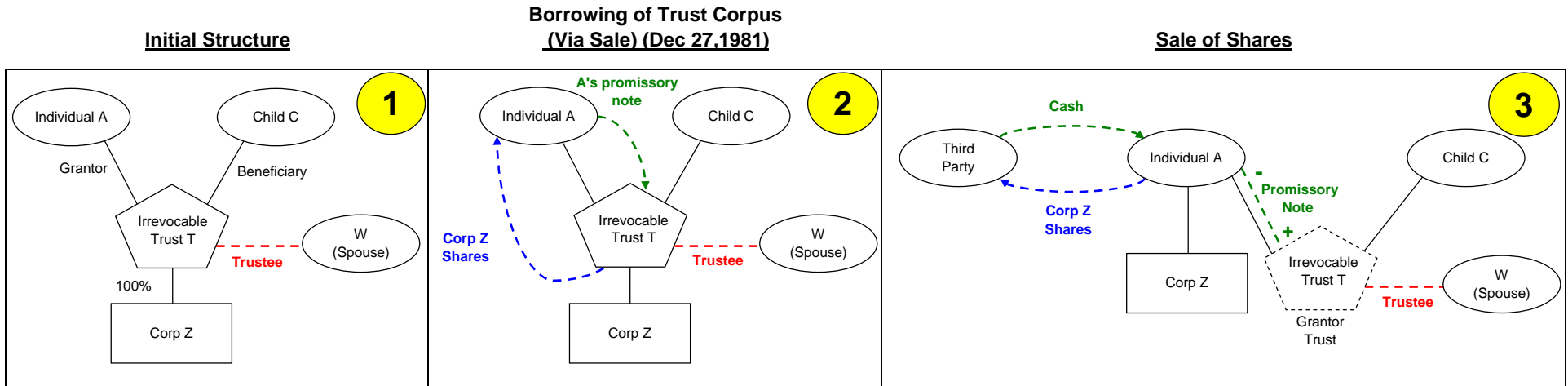


**Grantor Trust Not
Treated as Separate Entity**



In 1980, A, an individual, created an irrevocable trust, T. W, A's spouse, is the trustee of T. The trust instrument of T provides that all income of T is to be paid semiannually to C, A's child, for a term of 15 years. Upon expiration of the trust term, or if C dies before the trust term expires, the corpus of T will be distributed to C's child or to the estate of C's child. Neither A nor any other person has a power over or an interest in T that would cause A to be treated as the owner of T under the grantor trust provisions of the Code, section 671 and following. A funded T with a contribution of 100 shares of stock in Corporation Z. The 100 shares represented all of the outstanding stock of Corporation Z. When A funded T, A's basis in the shares was \$20x. On December 27, 1981, when the fair market value of the Corporation Z shares was \$40x, W, as trustee, transferred the 100 shares to A. In exchange, A gave W A's unsecured promissory note with a face amount of \$40x, bearing an adequate annual rate of interest, payable semiannually, beginning six months following the date on which the shares were transferred to A. Principal payments on the note were scheduled to be paid in 10 equal annual installments, the first installment being due 3 years following the date on which the 100 shares were transferred to A, December 27, 1984. On January 20, 1984, A sold the 100 shares to an unrelated party for \$50x. Corporation Z did not make any distributions with respect to the 100 shares at any time before the sale of those shares to the unrelated party.

Under section 675(3), a grantor will be treated as the owner of any portion of a trust in respect of which the grantor has directly or indirectly borrowed the trust corpus or income and has not completely repaid the loan, including any interest, before the beginning of the taxable year, unless the loan (1) provides for adequate interest, (2) is adequately secured, and (3) is not made by the grantor or by a related or subordinate trustee who is subservient to the grantor. Section 675 in effect treats the grantor as the owner of a trust if under the terms of the trust instrument, or the circumstances attendant to its operation, administrative control is exercisable primarily for the benefit of the grantor rather than the beneficiaries of the trust. Section 675(3) differs from the other provisions of section 675 which provide rules for determining grantor ownership of a trust, because it requires an affirmative act (borrowing) rather than a retained power, before it applies. Nevertheless, the same theme underlies section 675(3) as underlies the other provisions of section 675 which treat the grantor as owning the trust. Reg. 1.671-3(a)(1) states that if a grantor is treated as the owner of an entire trust, the grantor takes into account in computing the grantor's income tax liability all items of income, deduction, and credit to which the grantor would have been entitled had the trust not been in existence during the period the grantor is treated as the owner. If the grantor is treated as the owner of a portion of a trust and that portion consists of specific trust property and its income, Reg. 1.671-3(a)(2) provides that all items directly related to that property or apportioned to that property are to be taken into account in computing the grantor's income tax liability.

In this case, A has acquired control over and use of the entire trust corpus, the 100 shares of Corporation Z stock, in exchange for A's unsecured note. If A, instead of giving W a note in exchange for the 100 shares, had made a cash payment of \$40x to W and subsequently borrowed that cash, giving W the unsecured note to evidence the borrowing, section 675(3) would be applicable and A would be the owner of T. Although A did not engage in this kind of direct borrowing, A's acquisition of the entire corpus of T in exchange for an unsecured note was, in substance, the economic equivalent of borrowing trust corpus. Accordingly, under section 675(3), A is treated as the owner of the portion of T represented by A's promissory note. Further, because the promissory note is T's only asset, A is treated as the owner of the entire trust. Because A is treated as the owner of the entire trust, A is considered to be the owner of the trust assets for federal income tax purposes. A is considered to be the owner of the promissory note held by the trust. Therefore, the transfer of the Corporation Z shares by T to A is not recognized as a sale for federal income tax purposes because A is both the maker and the owner of the promissory note. A transaction cannot be recognized as a sale for federal income tax purposes if the same person is treated as owning the purported consideration both before and after the transaction.