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THE AMERICAN COLLEGE OF TRUST AND ESTATE COUNSEL

Please Address Reply to:

Executive Director
DEBORAH O. MCKINNON

April 2, 2012

CC:PA:LPD:PR (Notice 2011-101)
Internal Revenue Service
Room 5203
Post Office Box 7604
Ben Franklin Station
Washington, DC 20044

Via Electronic Mail:

Notice.Comments@irscounsel.treas.gov

Re: Comments of The American College of Trust and Estate Counsel on Transfers by a Trustee from an Irrevocable Trust to Another Irrevocable Trust (Sometimes called "Decanting")(Notice 2011-101) Released December 21, 2011

Dear Ladies and Gentlemen:

The American College of Trust and Estate Counsel (the "College") is pleased to submit these comments pursuant to Notice 2011-101, 2011-52 I.R.B. 932, released on December 21, 2011, which requested comments regarding when (and under what circumstances) transfers by a trustee of all or a part of the principal of an irrevocable trust ("Distributing Trust") to another irrevocable trust ("Receiving Trust"), sometimes called "decanting," that result in a change in the beneficial interests in the trust are not subject to income, gift, estate, or generation-skipping transfer ("GST") taxes. The initial draft of these comments was prepared prior to the issuance of Notice 2011-101. We believe that our comments respond to substantially all the issues raised by the Notice, but in the interest of completeness the format of the initial draft has been retained.

The College is also pleased to submit a proposed Revenue Ruling which would provide a series of safe harbors in the situation where a trustee with absolute discretion to distribute the corpus of a trust to its beneficiaries is granted the authority under state law to exercise that authority to transfer the corpus of the Distributing Trust to a Receiving Trust for the benefit of one or more of the beneficiaries of the Distributing Trust. The College believes that the proposed Revenue Ruling would cover the most common uses of such decanting authority and would provide helpful and much needed guidance to taxpayers.

The College is a professional organization of approximately 2,600 lawyers from throughout the United States. Fellows of the College are elected to membership by their peers on the basis of professional reputation and ability in the fields of trusts and estates and on the basis of having made substantial contributions to those fields through lecturing, writing, teaching, and bar activities. Fellows of the College have extensive experience in providing advice to taxpayers on matters of federal taxes, with a focus on estate, gift, and GST tax planning, fiduciary income tax planning, and compliance. The College offers technical comments about the law and its effective administration, but does not take positions on matters of policy or political objectives.

Introduction

Distributions of assets from one trust to another trust can occur as a result of the exercise by trustees of a statutory power, a power under the common law, or a power in the governing instrument to make such distributions or as the result of the exercise by the holder of a power of appointment to make such distributions (each, a "decanting power"). For purposes of this letter, we generally define decanting to mean the discretionary authority to distribute some or all the assets of a Distributing Trust to a Receiving Trust pursuant to a power of appointment, authority in the governing instrument, or authority under applicable state law without the need for prior court approval or the prior consent of any beneficiary of the trust. Notice 2011-101 requests comments on decanting in other contexts, such as in the context of discretionary or mandatory beneficiary consent or court approval. We offer such commentary but point out that beneficiary consent or court approval is not typically sought or required under the state decanting statutes currently in effect. Decanting does not include any required interim or final distribution from a trust by the terms of its governing instrument. We assume, unless stated to the contrary, that decanting authority exercisable by a trustee is subject to fiduciary duties, which are discussed more fully herein. We assume that decanting authority exercisable by a power of appointment not held in a fiduciary capacity is not subject to fiduciary duties. We further assume, unless stated to the contrary, that the person with decanting authority has no beneficial interest in either the Distributing Trust or the Receiving Trust as a result of the decanting. Accordingly, we assume that the decanting power itself is not a general power of appointment. We believe, however, that the tax consequences of decanting cannot conveniently be limited by a definition, but should be limited by the specific factual contexts in which decanting is employed, as in the accompanying proposed Revenue Ruling.

Decanting powers have become increasingly popular over the past twenty years as state legislatures as well as estate planning counsel have turned to such powers as a means of ensuring, particularly for long-term trusts, a method of dealing with changes in circumstances not anticipated by the drafters of original trust instruments. For example, thirteen states have adopted decanting statutes that permit trustees who have distribution powers under the Distributing Trust exercisable in favor of beneficiaries to distribute trust property to a Receiving Trust for the benefit of one or more such beneficiaries that has terms that differ from the terms of the Distributing Trust.[1] A common theme running through the professional literature discussing long term trusts is the need to provide for flexibility through the use of decanting provisions in trust instruments.[2]

The existence of decanting powers and their exercise present a number of complex income and transfer tax issues. The frequency with which these powers are being conferred on trustees and power holders and the frequency with which they are being exercised makes the resolution of these issues significant. This letter discusses these issues and provides analysis to assist in determining the most appropriate resolution.

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[1] Alaska Stat. §13.36.157; Arizona Rev. Stat. §14-10819; Delaware Code Ann. Tit. 12, §3528; Florida Stat. Ann. §736.04117; Indiana Code §30-4-3-36; Missouri Revised Statutes §456.4-419; Nevada Revised Stat. 163.556; New Hampshire Rev. Stat. §564-B:4-418; New York EPTL 10-6.6(b)-(s); North Carolina Gen. Stat. §36C-8-816.1; Ohio Revised Code §5808.18; South Dakota Codified Law §55-2-15-55-2-21; Tennessee Code Ann. §35-15-816(b)(27).

[2] *See* Halperin & O'Donnell, "Modifying Irrevocable Trusts: State Law and Tax Considerations in Trust Decanting," 2008 University of Miami School of Law 42nd Annual Heckerling Institute; Levin & Flubacher, "Put Decanting to Work to Give Breath to Trust Purpose," 38 ESTPLN 3 (2011); Culp & Bennett, "Use of Trust Decanting to Extend the Term of Irrevocable Trusts," 37 ESTPLN 3 (2010); Zeydel & Blattmachr, "Tax Effects of Decanting -- Obtaining and Preserving the Benefits," 111 JTAX 288 (2009).

Background

The first recognition by an American court of a trustee decanting power appeared in *Phipps v. Palm Beach Trust Co.*[3] In that case, the Supreme Court of Florida (the highest court of the state) held that a trustee could invade trust property by paying it over to another trust for the beneficiary of the original trust. That decision was based on the Florida Supreme Court's interpretation of the common law, rather than on any specific statutory authority or decanting authority in the trust instrument.

In *Phipps,* the court concluded that a trustee's discretionary distribution authority is comparable to a special power of appointment in favor of the beneficiaries of the trust. The Florida court cited the Restatement of Trusts, section 17, for the proposition that if a trustee has a special power of appointment, that is, a power to appoint among the members of a specified class, then whether the trustee can effectively appoint a trustee for members of the class depends on the terms of the power vested in him. The court concluded that:

> The general rule gleaned from the foregoing and other cases of similar import is that the power vested in a trustee to create an estate in fee includes the power to create or appoint any estate less than a fee unless the donor clearly indicates a contrary intent.[4]

If the reasoning in *Phipps* is sound, there is reason to believe that the common law of every other jurisdiction throughout the United States confers a decanting power on all trustees who have the power to invade trusts for the benefit of their beneficiaries.[5] No court has held to the contrary.

Nevertheless, because of the importance of the decanting power and a reluctance among estate planning counsel to advise their trustees to exercise such a power without specific statutory authority, states began in 1992 to authorize such powers by statute. New York was the first state to enact decanting legislation.[6] The legislative history of the New York act provides that it is consistent with and declaratory of existing common law.[7]

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[3] 142 Fla. 782, 196 So. 299 (1940).
[4] *Id.* at 786.
[5] See also Wiedenmayer v. Johnson, 106 N.J. Super. 161, 254 A.2d 534 (App. Div., 1968). Wiedenmayer concerned an indirect decanting, however, in that the trustees exercised their power of invasion in favor of the beneficiary contingent on the beneficiary's agreeing to transfer the property in further trust. The court concluded that the transfer was in the beneficiary's best interests, describing "best interests" as follows: "The expression is not limited to a finding that distribution must be to the son's best 'pecuniary' interests. His best interests might be served without regard to his personal financial gain. They may be served by the peace of mind, already much disturbed by matrimonial problems, divorce, and the consequences thereof, which the new trust, rather than the old contingencies provided for in his father's trust indenture, will engender. Of what avail is it to rest one's 'best interests' on a purely financial basis, and without regard to the effect upon a man's mind, heart and soul, if the end result would produce a wealthier man, but a sufferer from mental anguish?"
[6] See N.Y.E.P.T.L. section 10-6.6. See also Halperin and O'Donnell, supra note 2.
[7] See Scott on Trusts §3.1.2 at 143-44 (Aspen 5th ed. 2008). Memorandum in Support of Legislation, Governor's Bill Jacket, 1992 Chapter 591, page 4.

Legislation somewhat similar to that in New York now has been enacted in Alaska, Arizona, Delaware, Florida, Indiana, Missouri, Nevada, New Hampshire, North Carolina, Ohio, South Dakota, and Tennessee.[8] We understand that the legislatures of several other states are considering similar legislation.

A power held by a trustee to invade the corpus of a trust is analogous to a power of appointment for property law purposes.[9] As a general rule, the holder of a power of appointment may appoint the property in further trust.[10] If the power to decant is held by a trustee, however, it is by definition a fiduciary power. The *Comments* to Restatement (Third) of Trusts, section 75, draw a distinction between powers held in a fiduciary capacity and those that are held for the power holder's personal benefit (meaning without regard to any fiduciary obligation to the beneficiaries of the trust or the permissible appointees). The discussion echoes the Reporter's Notes on section 64, which also draw a distinction between a personal power that may be exercised for the personal benefit of the donee of the power and a fiduciary power that must be exercised for the purpose for which the settlor created it. The Reporter's Notes on section 64 indicate that if the power holder's power is personal, then the trustee's only duty is to ascertain whether the attempted exercise is or is not within the terms of the trust.

The donee of a personal power of appointment seems to have no affirmative duty to act in good faith, and appears to be able to exercise a power of appointment to exclude a person from beneficial enjoyment for personal reasons.[11] A fiduciary, on the other hand, would be precluded by fiduciary duties from acting in a similar manner. Instead, a fiduciary will always be held to a minimum standard of good faith, with an obligation to act consistently with the terms of the trust and the interests of the beneficiaries.[12]

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[8] See supra note 1.

[9] See Restatement (Third) of Property (Wills & Don. Trans.) §17.1 (2011) *Comment g* ("A fiduciary distributive power is a power of appointment (a nongeneral power), but it is not a discretionary power of appointment"). If the trustee can invade for his or her own benefit, then the power of invasion may constitute a general (estate taxable) power of appointment under Code sections 2514(c) and 2041(b). The power to invade for one's own benefit (that is, to withdraw property from the trust) may cause the power holder to be the owner of the trust for purposes of Code section 671 so that the income, deductions, and credits against tax of the trust are attributed to the power holder. See Code section 678(a). If the power is held in a fiduciary capacity, however, Code section 678 may not apply. See Blattmachr, Gans, and Lo, "A Beneficiary as Trust Owner: Decoding Section 678," ACTEC Journal (2009).

[10] See, generally, Scott on Trusts, supra note 6 §3.1.2 at pages 144-45 (the trend is to construe the language conferring a power of appointment with increasing liberality, and to hold that the donee of the power has broad discretion as to the manner in which the power may be exercised). See, e.g., Restatement (Third) of Property: Wills & Other Transfers (Tentative Draft No. 5), §19.14 (except to the extent the donor has manifested a contrary intention, the donee of a nongeneral power is authorized to make an appointment, including an appointment in trust and an appointment that creates a power of appointment in another, that solely benefits permissible appointees of the power).

[11] See Restatement (Third) of Trusts, section 50 (2003), Comment a ("A trustee's discretionary power with respect to trust benefits is to be distinguished from a power of appointment. The latter is not subject to fiduciary obligations and may be exercised arbitrarily within the scope of the power").

[12] See section 105 of the Uniform Trust Code, adopted in 2003 by the National Conference of Commissioners on Uniform State Laws, which prohibits a trust instrument from waiving a trustee's duty to act in good faith and in accordance with the terms and purposes of the trust and the interests of the beneficiaries.

Uses of Decanting

Trustees exercise their decanting powers for a variety of reasons, including to separate the beneficial interests of different beneficiaries and to modify certain provisions of the initial trust. Although we have defined decanting as a power exercisable without prior court approval or beneficiary consent, the original New York statute required court approval prior to the exercise of a decanting power. Accordingly, there is a body of case law under the original New York statute that provides guidance as to the permissible purposes for which a fiduciary may exercise a decanting power. The New York courts, for example, have permitted the use of trustees' decanting powers for the following reasons:

1. Protecting the tax treatment of a trust.[13]
2. Granting a beneficiary a power of appointment, presently exercisable or otherwise.[14]
3. Reducing administrative costs.[15]
4. Altering trusteeship provisions such as the identity or manner of appointing fiduciaries.[16]
5. Extending the termination date of a trust.[17]
6. Converting a nongrantor trust to a grantor trust or the reverse.[18]
7. Changing a trust's governing law.[19]
8. Dividing trust property to create separate trusts.
9. Reducing potential liability.[20]

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[13] Matter of Ould, N.Y.L.J., 11/28/01, page 21, col. 5 (Surr. Ct., N.Y. County), in which the trustees were permitted to appoint the trust estate consisting of a second-to-die insurance policy to a new trust, thereby eliminating the Crummey power of withdrawal of one of the insureds.

[14] See Phipps v. Palm Beach Trust Co., 142 Fla. 782, 196 So. 299 (1940). It seems quite apparent that granting a beneficiary a power of appointment is consistent with a trustee's decanting power. Because the trustee could pay the principal of the trust directly to the beneficiary who could then give or bequeath the property to anyone in the world or expend it for his or her own benefit, granting the beneficiary a special or general power of appointment gives the beneficiary the same type of disposition or expenditure authority.

[15] Matter of Vetlesen, N.Y.L.J., 6/29/99, page 27, col. 3 (Surr. Ct., N.Y. County), in which a sole trustee appointed principal of an inter vivos trust to himself and another as trustees of a testamentary trust and the trustees agreed to share one commission.

[16] Matter of Klingenstein, N.Y.L.J., 4/20/00, page 33, col. 6 (Surr. Ct. Westchester County), in which limitations on number of individual trustees, powers to remove and replace trustees, requirement for a corporate trustee, designation of successor trustees, and ability of corporate trustee to appoint a successor were changed.

[17] In re Alfred Hazan, N.Y.L.J., 4/11/00 (Surr. Ct. Nassau County), in which a trustee was permitted to extend a trust for a beneficiary's lifetime. See also Matter of Dornbush (Riese), 164 Misc.2d 1028, 627 N.Y.S.2d 232 (Surr. Ct. N.Y. County, 1995), in which the corpus of an irrevocable trust subject to New York law, which was to end at the death of the first to die of the grantor and the beneficiary, was paid to a new Florida trust for the beneficiary's lifetime in order to protect the trust assets from the beneficiary's potential creditors.

[18] See CCA 200923024, discussed below.

[19] Matter of Dornbush (Riese), 164 Misc.2d 1028, 627 N.Y.S.2d 232 (Surr. Ct. N.Y. County, 1995) supra note 19, in which the trustees of two irrevocable trusts subject to New York law were allowed to pay over assets to substantially identical Florida trusts in order to protect the trusts' assets from New York real property transfer gains taxes.

[20] Matter of Kaskel, 163 Misc.2d 203, 620 N.Y.S.2d 217 (Surr. Ct. N.Y. County, 1994), in which the trustees of several family trusts, which included spendthrift provisions, were allowed to terminate the existing trusts and pay over assets to new trusts without spendthrift provisions so that the beneficiaries could assign their interests in distressed real estate properties from the trusts to corporations, followed by an invasion of the principal of the trusts in favor of the corporations.

10. Converting a trust into a supplemental needs trust to permit a beneficiary to qualify for certain governmental benefits.[21]
11. Making trust interests spendthrift or the reverse.[22]

Other common uses of decanting include (1) addressing changed circumstances, such as changes in applicable fiduciary law or changes in family circumstances or dynamics; (2) modifying administrative provisions, such as to change restrictions on investment powers or to create a "directed trust"; (3) correcting a drafting error without the necessity of going to court.

Common Statutory Decanting Provisions

Not all state decanting statutes are alike. However, there are common or parallel provisions. Some allow decanting only if the trustee's power to invade the trust is "absolute."[23] Others permit invasions even if there is a fixed (e.g., ascertainable) standard for invasion,[24] and at least one of the statutes requires that the invasion standard be the same in the trust to which the trust assets are decanted as it was in the invaded trust.[25] Most expressly require that an income interest cannot be eliminated[26] and must be preserved in decanting. Some but not all statutes provide that the decanting power cannot be used to extend the term of the trust beyond the rule against perpetuities applicable to the original trust.[27]

A decanting power generally cannot be exercised to add to the class of beneficiaries of a trust.[28] Instead, decanting authority derives from the trustee's authority to make distributions to or for the benefit of current beneficiaries of the trust as described by the Florida Supreme Court in *Phipps*. And if a trustee may distribute property to or for the benefit of a beneficiary free of trust the beneficiary would be able thereafter to transfer the property to a non-beneficiary. Accordingly, the *Phipps* court permitted the trustee to grant a beneficiary a power of appointment by decanting whereby the beneficiary was authorized to appoint the trust estate to a non-beneficiary.

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[21] Estate of Grosjean, N.Y.L.J., 12/10/97, page 35, col. 6 (Surr. Ct. Nassau County). See also In re Estate of Alfred Hazan, supra note 19; Estate of Barkman, N.Y.L.J., 5/20/03, page 23, col. 3 (Surr. Ct., Nassau County), in which the court permitted the conversion even though the beneficiary had a fixed income interest.
[22] Matter of Rockefeller, N.Y.L.J., 8/24/99, page 28, col. 2 (Surr. Ct. Nassau County), in which a committee of individuals with discretionary distribution authority over a trust was permitted to pay trust assets to a new trust to protect the trust principal by providing a spendthrift restraint.
[23] See, e.g., Florida Stat. Ann. §736.04117.
[24] See, e.g., Delaware Code Ann. Tit. 12 §3528.
[25] Alaska Stat. §13.36.157.
[26] See, e.g., Alaska Stat. §13.36.157; New York EPTL 10-6.6, and Florida Stat. Ann. §736.04117.
[27] Cf., e.g., New York EPTL §10-6.6 and Florida Stat. Ann. §736.04117 with Alaska Stat. §13.36.157.
[28] See, e.g., Florida Statutes §736.04117(1)(a):

> Unless the trust instrument expressly provides otherwise, a trustee who has absolute power under the terms of a trust to invade the principal of the trust, referred to in this section as the "first trust," to make distributions to or for the benefit of one or more persons may instead exercise the power by appointing all or part of the principal of the trust subject to the power in favor of a trustee of another trust, referred to in this section as the "second trust," for the current benefit of one or more of such persons under the same trust instrument or under a different trust instrument; provided: ... The beneficiaries of the second trust may include only beneficiaries of the first trust ....

Income and Transfer Tax Issues

The existence of and use of decanting powers, whether held in a fiduciary or non-fiduciary capacity, and whether held as a result of local common or statutory law or as a result of a provision in the original instrument, present a number of tax issues, including:

Income Tax Issues

1. Whether the existence of a decanting power causes the trust to be treated as a grantor trust under Code section 671 if the decanting power permits decanting from a non-grantor Distributing Trust to a grantor Receiving Trust.[29]

2. Whether decanting a trust that is treated as owned partially or wholly by a person under Code sections 671 through 678 (a "grantor trust") to one which is not a grantor trust is an income tax realization event.

3. Whether the distribution of property from one trust to another should be treated as a distribution for purposes of Code sections 661 and 662.

4. Whether the distribution of appreciated assets from one trust to another will cause the Distributing Trust to recognize gain under Code section 1001.

5. Whether the distribution of appreciated assets from one trust to another will cause any beneficiary of the Distributing Trust to recognize gain under Code section 1001.

6. Whether a trust that receives all of the assets of a decanted trust receives the tax attributes of that trust such as, for example, its capital loss and net operating loss carryovers, its deductions in excess of gross income for its last year, its accumulated gross income for purposes of determining permissible future deductions for distributions to charity, its passive loss carryforwards, and its carryforward of disallowed investment interest.

7. Whether the grantor of the Distributing Trust continues to be the grantor of the Receiving Trust following a decanting.

8. Whether the existence of a decanting power with regard to a qualified subchapter S trust ("QSST") results in loss of QSST status.

Gift and Estate Tax Issues

1. Whether a beneficiary whose interests are diminished as a result of the decanting has made a taxable gift.

2. Whether a beneficiary whose interests are diminished as a result of the decanting has made a transfer for purposes of Code section 2036 or 2038.

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[29] All references to a "section" or "§" of the Code refer to the Internal Revenue Code of 1986, as amended.

3. Whether the existence of a decanting power in a trust that is required to have certain provisions to qualify for an estate or gift tax marital deduction under Code section 2056 or 2523 or for a gift tax exclusion under Code section 2503(c) will cause the trust to fail to qualify for the marital deduction or the gift tax exclusion.

4. Whether a requirement that beneficiary consent, court approval, or approval by the State Attorney General be obtained prior to the exercise of a decanting power will result in different gift tax consequences to a beneficiary than a decanting that does not require such approval.

5. Whether the donor of the Distributing Trust continues to be the donor of the Receiving Trust following a decanting.

Generation-Skipping Transfer Tax Issues

1. Whether a trust that has, by a decanting, received property from another trust that is protected from the GST tax by reason of the effective date rule of Chapter 13 or by reason of an allocation of GST exemption continues to enjoy that protection.

2. Whether decanted trust property that has an inclusion ratio of more than zero but less than one by reason of an allocation of GST exemption under Code section 2631 to the Distributing Trust will have that same inclusion ratio in the Receiving Trust.

3. Whether decanted trust property of a Distributing Trust that is not subject to Chapter 13 by reason of Code section 2663 retains that status following a decanting to a Receiving Trust.

4. Whether decanted trust property continues to have the same transferor for purposes of Chapter 13 following a decanting from a Distributing Trust to a Receiving Trust.

5. Whether a trust that is not exempt from generation-skipping transfer tax may be decanted so as to permit effective allocation of GST exemption to only a portion of the original trust.

There is little developed law to assist taxpayers in answering these questions. Detailed guidance is important both for taxpayers and the Internal Revenue Service. Each of these issues is discussed more fully below in the form of questions and our proposed answers. The accompanying proposed Revenue Ruling does not attempt to propose guidance on each of these issues, but instead covers what we perceive to be the most common forms of decanting.

Income Tax Issues

1. Q. Code section 674(a) causes a trust to be treated as owned by its grantor while the grantor is living if any portion of the income or principal of the trust is subject to a power of disposition by any person without the consent of an adverse party. There are a number of exceptions to this rule, but none of the exceptions applies if any person has the power to add a beneficiary to the trust (other than afterborns or adopteds). When a trustee or other power holder has the power to decant to a Receiving Trust, should the Receiving Trust be treated as a "beneficiary"? If the Receiving Trust is treated as a beneficiary, would the Receiving Trust fail to qualify for the exceptions under Code section 674 because the trustee of the Distributing Trust would in effect be treated as having a power to add a

beneficiary to the original trust? Code section 677 causes a trust to be treated as owned by its grantor while the grantor is living if any portion of the income or principal of the trust may be distributed to or accumulated for future distribution to its grantor. If a Distributing Trust that is not a grantor trust may be distributed to a Receiving Trust that is a grantor trust, would that power cause the Distributing Trust to be treated as having a power to distribute income and principal to its grantor?

A. Trusts are held for the benefit of beneficiaries; but it seems inappropriate that trusts be treated as if they were beneficiaries for purposes of Code section 674 or Code section 677. The treatment of a trust as a person is a convenient fiction for income tax purposes.[30] It enables the Code to impose income tax on them as if they were entities separate from the persons for whose benefit they are held. The term "beneficiary" or "beneficiaries" for purposes of Code section 674 and Code section 677 is best limited to the person or persons for whose benefit a trust is held. The power to distribute trust property to another trust, so long as that power does not permit the Receiving Trust to include persons as beneficiaries who were not beneficiaries of the Distributing Trust, ought not to disqualify a trust from the exceptions to Code section 674(a). Similarly, while a grantor trust is treated as identical with its grantor for some purposes (so that, for example, a partnership interest held by a grantor trust is treated as owned by its grantor [31]), that does not mean that a grantor trust is identical to its grantor for all purposes or that every grantor trust should be treated as providing a beneficial interest to the grantor. If, for purposes of decanting, a grantor trust is treated as identical to its grantor, the decanting to a grantor trust might be viewed as identical to a distribution to the grantor, and under Code section 677 every trust would therefore be a grantor trust by reason of the grantor's beneficial interest, particularly if the authority to decant can be found within the common law authority of a trustee to distribute property "for the benefit of" the beneficiaries of a trust. It seems inappropriate to cause such a significant and unexpected consequence with respect to the income tax treatment of irrevocable trusts. Accordingly, it seems most appropriate that the authority to decant not be treated as the authority to add a beneficiary to the original trust so long as the Receiving Trust resulting from the decanting is not permitted to include any beneficiary who was not also a beneficiary of the Distributing Trust. Similarly, it seems appropriate that the authority to decant from a Distributing Trust that is not a grantor trust to a Receiving Trust that is a grantor trust not be treated, by itself, as authority to make distributions to or accumulate property for future distribution to the grantor of the Distributing Trust.

2. Q. A trust may be treated as owned partially or wholly by a person under Code sections 671 through 678 (a "grantor trust") and that person will be treated for Federal income tax purposes, in whole or in part, as the owner of the assets held in trust. As a result, to the extent the trust is a grantor trust, items of income, deduction, and credit will be attributed to the owner and reportable by the owner on the owner's Federal income tax return. A grantor may be treated as the owner of a trust under the following provisions of the Code:

   (1) If the grantor has retained a reversionary interest under Code section 673.
   (2) If the grantor or a non-adverse party has certain powers over the beneficial interests in the trust under Code section 674.
   (3) If certain administrative powers over the trust exist under which the grantor can or does benefit under Code section 675.

[30] Code section 7701(a)(1).
[31] See *Madorin v. Commissioner*, 84 T.C. 667 (1985). See also Rev. Rul. 2007-13, 2007-1 C.B. 684.

(4) If the grantor or a nonadverse party has a power to revoke the trust or return the corpus to the grantor under Code section 676.

(5) If the grantor or a nonadverse party has the power to distribute income to or for the benefit of the grantor or the grantor's spouse under Code section 677.

In addition, a person other than the grantor may be treated as the owner of a trust under Code section 678 if that person possesses a power exercisable solely by himself to vest the income or corpus in himself or 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 Code sections 671 to 677, inclusive, subject a grantor of a trust to treatment as the owner thereof. A trust may be changed from a grantor trust to a non-grantor trust or the reverse if the power or powers over the trust causing the trust to be a grantor trust are eliminated or introduced. If the power or powers are eliminated or introduced by decanting, would that cause the Distributing Trust or the Receiving Trust to realize income for income tax purposes?

A. As a general rule, it seems that the conversion of a nongrantor trust to a grantor trust is not a income tax realization event. In Revenue Ruling 85-13, 1985-1 C.B. 184, the grantor of a trust acquires the corpus of a trust in exchange for the grantor's unsecured promissory note. The Revenue Ruling concludes that the transaction constitutes an indirect borrowing within the meaning of Code section 675(3), causing the borrower to be treated as the owner of the entire trust. The Revenue Ruling concludes further that the borrower becomes the owner of the trust and the owner of the property. But the Revenue Ruling concludes that the transition from nonowner to owner is not a sale for income tax purposes; therefore, no income tax realization event occurs. Rather, the conversion from a nongrantor trust to a grantor trust is treated as a mere gratuitous transfer of the property to the borrower, such that the borrower has a carryover basis rather than a cost basis in the property. On the other hand, Revenue Ruling 77-402, 1977-2 C.B. 222, holds that when a grantor and owner of a trust which holds a partnership interest subject to liabilities renounces all the grantor trust powers over the trust during the grantor's lifetime, the grantor is treated as having transferred the interest in a sale that results in the recognition of gain or loss. That result, however, derives from a particular rule applicable to the transfer of an interest in a partnership under Code section 752(d) requiring realization if a partner's share of partnership liabilities is reduced or eliminated by reason of a transfer or deemed transfer of a partnership interest. The result does not appear to apply generally except in the particular context of a trust holding a partnership interest subject to liabilities. The result follows from *Crane v. Commissioner*,[32] which requires a taxpayer to include in the amount realized upon disposition of a property liabilities previously included in basis to the extent the transferee takes the property subject to those liabilities. Consistently with the foregoing authorities, Chief Counsel Advice 200923024[33] concludes that "the Service should not take the position that the mere conversion of a nongrantor trust to a grantor trust results in taxable income to the grantor." And it seems that the same result should apply in the case of a mere conversion of a grantor trust to a nongrantor trust, except to the extent that a special income tax rule overrides that result, as in the case of a trust that holds an asset with debt in excess of basis. For example, if the Distributing Trust were a grantor trust holding a partnership interest, and the partner/grantor's share of partnership liabilities exceeded basis

[32] 331 U.S. 1 (1947).
[33] CCA 200923024 (December 31, 2008).

in the partnership interest, then a decanting to a Receiving Trust that is not a grantor trust would result in an income tax realization event.[34]

3. Q. Code section 661 allows a trust to deduct in the calculation of its taxable income, with certain limitations, distributions the trust is required to make and distributions actually made that are permitted distributions. Code section 662 requires the beneficiaries who receive or are required to receive such distributions, again with certain limitations, to include such amounts in their gross incomes for the year. Should a distribution from one trust to another be subject to Code sections 661 and 662?

   A. Although the Code does not specifically include a trust that can receive distributions from another trust within its definition of "beneficiary,"[35] case law suggests that one trust can be a beneficiary of another trust for purposes of Code sections 661 and 662 (in contrast, for example, to sections 674 and 677 discussed above).[36] If a Distributing Trust distributes less than all of its assets to a Receiving Trust, it seems most appropriate that the distribution be treated as a distribution to a beneficiary for purposes of Code sections 661 and 662.

   If, however, a Distributing Trust distributes all of its assets to a Receiving Trust, a better approach would be to treat the distribution as a mere recasting of the Distributing Trust and to treat the Receiving Trust as a continuation of the Distributing Trust. This seems to be the position the Internal Revenue Service took in PLR 200607015.[37]

4. Q. Should the distribution of appreciated assets from a Distributing Trust to a Receiving Trust cause the Distributing Trust to recognize gain under Code section 1001?

   A. If the distribution of appreciated assets from a Distributing Trust to a Receiving Trust is not made in satisfaction of an obligation (under the terms of the trust instrument of the Distributing Trust or otherwise) to distribute a fixed amount, Code section 643(e) would protect the Distributing Trust from gain recognition unless the trustee of the Distributing Trust elects to recognize gain under Code section 643(e)(3).

   A more difficult question arises if the property distributed from a Distributing Trust to a Receiving Trust is subject to a liability in excess of its income tax basis (i.e., a "negative basis" asset). Under these circumstances, whether gain will be recognized under *Crane v. United States*[38] is uncertain. In this case, we assume that neither the Distributing Trust nor the Receiving Trust is a grantor trust. Under the *Crane* doctrine, the amount realized, which will be used to determine tax profit or loss,

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[34] See *Madorin v. Commissioner*, 84 T.C. 667 (1985). See, e.g. PLRs 200011005 (November 23, 1999), 200010010 (November 23, 1999), 9838017 (June 19, 1998), 9710006 (November 8, 1996), 9709001 (November 8, 1996), and 9304017 (October 30, 1992).

[35] The Code does not contain a full definition of the term "beneficiary." The closest thing to a statutory definition is Code section 643(c), which provides that the term "beneficiary" includes "heir, legatee, devisee." The regulations provide further guidance by stating that "[a]n heir, legatee, or devisee (including an estate or trust) is a beneficiary. A trust created under a decedent's will is a beneficiary of the decedent's estate." Treas. Reg. §1.643(c)-1

[36] *Lynchburg Trust & Savings Bank v. Commissioner,* 68 F. 2d 356 (4th Cir. 1934); *Duke v. Commissioner,* 38 BTA 1265 (1938).

[37] PLR 200607015 (November 4, 2005). See also PLR 200736002 (May 22, 2007).

[38] 331 U.S. 1 (1947).

includes recourse and nonrecourse indebtedness discharged. There is no developed law as to whether Code section 643(e) overrides the *Crane* doctrine. Code section 643(e) provides that a Distributing Trust's basis in distributed property carries over to the beneficiary and that the amount of the distribution is limited to the beneficiary's basis in the distributed property. The argument that the Receiving Trust should receive a carryover basis is weakened, however, by the requirement in Code section 643(e) that the basis of the property distributed by the fiduciary to the beneficiary is "adjusted for ... any gain ... recognized to the ... trust on the distribution."[39] And in the case of a distribution of a "negative basis" asset, it appears that under the *Crane* doctrine the trust would recognize gain if the Receiving Trust is considered a different taxpayer for income tax purposes.

Regardless of how the negative basis issue is resolved in connection with a partial decanting of assets, in the case of a distribution of all (or substantially all) of the Distributing Trust's assets to one or more Receiving Trusts, where there is no opportunity to select assets with reference to their bases, the better approach would be to treat the Receiving Trust or Trusts as continuations of the Distributing Trust. The result would be no gain recognition for the Distributing Trust and a carryover basis for the Receiving Trust or Trusts.

5. Q. Should the distribution of appreciated assets from one trust to another cause any beneficiary of the Distributing Trust to recognize gain under Code section 1001?

   A. Normally, under Code section 662(a), a beneficiary may realize income by reason of a trust distribution only to the extent of the trust's DNI. It is conceivable, however, that a "change" in a beneficiary's interest in a trust could cause the beneficiary to realize income.

   In *Cottage Savings Assn. v. United States*,[40] the Supreme Court held that a company realized a loss when it exchanged certain mortgage note interests for other such notes that were "materially different." The Internal Revenue Service has indicated that it may treat a beneficiary as having realized gain under *Cottage Savings* where, for example, the beneficiary's income interest is "converted" into a unitrust interest unless the conversion is pursuant to a state statute (or opinion of the highest court of the state).[41] Also, Treas. Reg. §1.643(b)-1 provides in part that a "switch" or conversion from an income interest to a unitrust interest, if "not specifically authorized by state statute but valid under state law (including a switch via judicial decision or a binding non-judicial settlement), may constitute a realization event to the trust or its beneficiaries for purposes of section 1001 [of the Code]...."

   Nevertheless, it seems that if the trustee were expressly authorized under the terms of the governing instrument or under applicable state law to change the beneficiary's interest from an income interest

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[39] Code section 643(e)(1). Cf. Treas. Reg. §1.661(a)-2(f).
[40] 499 U.S. 554, 61 AFTR2d 91-808 (1991)
[41] See PLR 200013015 (December 22, 1999) in which the Internal Revenue Service held that the partition of the trust and changes in administrative provisions pursuant to New York EPTL §10-6.6 would not cause the beneficiaries, whose interests remained the same in the "new" trusts as in the old, to realize gain under Cottage Savings Assn., supra. But see PLR 200736002 (May 22, 2007), in which the IRS indicated that a beneficiary might realize gain if the beneficiary's interest in a successor trust, pursuant to a pro rata division of a trust, was "materially" different than in the original trust, and PLR 200231011 (May 6, 2002), in which the IRS held, under Cottage Savings, that a court-approved settlement under which an annuitant received a unitrust interest instead of the annuity stream constituted an income-taxable exchange.

to a unitrust interest, the beneficiary would not realize gain when this occurs because the beneficiary's interest in the trust was always subject to that potential conversion.[42]

A partial answer also may be found in Treas. Reg. §1.1001-1(h), which deals with the severance of a trust (including without limitation a severance that meets the requirements of Treas. Reg. §26.2642-6 [the qualified severance Regulation] or of Treas. Reg. §26.2654-1(b) [retroactive severances at death]). It provides that a severance is not an exchange of property for other property differing materially either in kind or extent if an applicable state statute or the governing instrument authorizes or directs the trustee to sever the trust and any non-pro-rata funding, whether mandatory or in the discretion of the trustee, is authorized by an applicable state statute or the governing instrument.

"Severance" for this purpose is not defined by the Code. It seems, however, that the term would include an action by the trustee, without judicial intervention or beneficiary consent, which is authorized by the governing instrument or applicable state law. Accordingly, if a complete decanting to a Receiving Trust may be treated as a continuation of the Distributing Trust, it seems most appropriate that a decanting to create more than one Receiving Trust be treated as a severance likewise having no gain realization consequences. Certainly, the qualified severance regulations treat certain divisions of a trust that produce new trusts with different beneficiaries as a severance.[43] And Treas. Reg. §1.1001-1(h) does not appear to require a "qualified severance." Instead, the result seems to turn on the ability of the trustee to take the action under the terms of the governing instrument or under state law.

Therefore, it seems that the exercise by a trustee of a decanting power, whether conferred under the instrument itself or pursuant to state law, would not result in any beneficiary realizing any gain or loss for Federal income tax purposes. It seems necessary to this conclusion that beneficiary consent, and possibly court approval—which indirectly may require that the beneficiary consent or at least acquiesce—not be required prior to the exercise of the decanting authority so that the beneficiary would not have the legal right to prevent the exercise of the decanting power.

6. Q. Does a Receiving Trust that receives all of the assets of a Distributing Trust succeed to the tax attributes of the Distributing Trust such as, for example, its capital loss and net operating loss carryovers, its deductions in excess of gross income for its last year, its accumulated gross income for purposes of determining permissible future deductions for distributions to charity, its passive loss carryforwards, and its carryforward of disallowed investment interest?

A. The answer to some of these issues can be found in Code section 642(h). This section provides that in the final year of a trust, its capital loss and net operating loss carryforwards and its deductions in excess of gross income for the year will be allowed as deductions to the beneficiaries who receive the trust property. There is no specific authority dealing with the balance of the issues. We believe that the simplest and most appropriate way to resolve these issues is to treat the Receiving Trust as a continuation of the Distributing Trust and to treat it as having received all of its tax attributes as well as its assets. This is the position the private foundation regulations take in connection with the

[42] PLR 200810019 (November 20, 2007).

[43] See, e.g., Treas. Reg. §26.2642-6(j), Example 2 (the trustee of a discretionary trust for T's children, A and B, and their descendants, divides the trust pursuant to state law into two trusts, one for A and A's descendants and one for B and B's descendants; the "severance" constitutes a "qualified severance").

distribution of all of the assets of a private foundation to another private foundation controlled directly or indirectly by the same persons.[44]

In the case of a decanting to more than one Receiving Trust, it seems most consistent that the tax attributes be divided proportionately among the Receiving Trusts. This would appear to avoid any unfair income tax advantage or disadvantage to taxpayers as a consequence of decanting. Nevertheless, where a decanting involves less than all the assets of the Distributing Trust, or involves a decanting to multiple Receiving Trusts, we believe that the subject requires further study, and if there is such further study, the College would welcome the opportunity to supplement the analysis in this letter.

7. Q. Does the grantor of a Distributing Trust continue to be the grantor of each Receiving Trust following a decanting?

   A. Treasury Regulation §1.671-2(e)(5) provides that if a trustee transfers property from one trust to another trust, the grantor of the recipient trust generally remains the same as the grantor of the original trust. This appears to be true whether the transfer to the Receiving Trust occurs as a result of a requirement under the terms of the Distributing Trust to make a distribution to the Receiving Trust or pursuant to an exercise of discretion by the trustee of the Distributing Trust to make a distribution to a Receiving Trust. Treasury Regulation §1.671-2(e)(5) provides that in the case where the distribution to the Receiving Trust is pursuant to the exercise of a general power of appointment within the meaning of Code section 2041, then the holder of the general power of appointment will become the grantor of the Receiving Trust, even if the Distributing Trust was a grantor trust with respect to another person. This shift in the identity of the grantor is consistent with the gift tax law, which treats a person who exercises a general power of appointment as the donor of the property transferred by the exercise under Code section 2514.

8. Q. Code section 1361(d) permits certain trusts to qualify as owners of Subchapter S stock (a so-called "qualified subchapter S trust" or "QSST"). Does the existence of a decanting power cause a trust to fail to qualify as a QSST?

   A. Code section 1361(d)(3) sets forth the requirements for a trust to be a QSST. Those requirements include that there be only a single income beneficiary of the trust and that during the lifetime of the current income beneficiary corpus may be distributed only to that income beneficiary and any termination of the trust may occur only in favor of the current income beneficiary. If pursuant to applicable state law or the governing instrument the trustee of a QSST has decanting authority, the question arises whether that authority, by itself, disqualifies the trust as a QSST. If the Distributing Trust is a QSST, then the Distributing Trust would have fulfilled the requirements of Code section 1361(d)(3). As a general matter, decanting authority may be exercised only in furtherance of a trustee's power to invade corpus of the Distributing Trust. Accordingly, it appears that a trustee's authority to decant a Distributing Trust that is a QSST would be limited to a Receiving Trust for the exclusive benefit of the income beneficiary of the Distributing Trust. In addition, most state decanting statutes do not permit the reduction or elimination of an income interest in a trust. But even if the income interest could be reduced or eliminated, that possibility alone would not appear to violate the requirements for a QSST. Code section 1361(d)(3)(A)(i) requires simply that a QSST

[44] Treas. Reg. §1.507-3(a)(9).

have only 1 income beneficiary. It does not require that the income beneficiary have a mandatory income interest. Instead, Code section 1361(d)(3)(B) requires that all of the income (within the meaning of Code section 643(b)) is distributed currently to the sole income beneficiary who is a U.S. citizen or resident. Accordingly, the mere possibility of reducing a mandatory income interest to a discretionary interest should not disqualify a Distributing Trust that is a QSST.

It is possible that by decanting or other means under applicable state law a provision in the Receiving Trust would disqualify the trust as a QSST. For example, in the Receiving Trust the current income beneficiary might be granted a lifetime power of appointment in favor of persons other than the current income beneficiary. It is not clear whether that possibility ought to disqualify a QSST from inception, rather than only at the time the power is in fact granted. The terms of the Distributing Trust would have met the requirements of a QSST. Indeed, strictly construing those requirements in the Distributing Trust may prohibit the trustee from decanting to a Receiving Trust that is not also a QSST. It also seems that a trustee of a Distributing Trust may be constrained from exercising its authority in a manner that conflicts with the tax purposes of the settlor under state law, if those purposes are expressed in or otherwise apparent from the governing instrument of the trust. In that case, state law would appear to prohibit the trustee from decanting a Distributing Trust to a Receiving Trust that is not also a QSST.

Gift and Estate Tax Issues

1. Q. Does the reduction of a beneficiary's interests in a Distributing Trust caused by a decanting of some or all of the assets of the Distributing Trust to a Receiving Trust result in a taxable gift by the beneficiary, whether the reduction occurs by granting another beneficiary a power of appointment, extending the duration of the trust, or excluding that beneficiary from the Receiving Trust?

   A. An individual makes a gift for federal tax purposes to the extent she transfers property worth more than what she receives, in money or money's worth, in exchange.[45] A beneficiary who neither created the Distributing Trust nor holds an immediately exercisable general power of appointment described in Code section 2514(b) would not normally be treated as making a gift when a trustee exercises distribution authority over the Distributing Trust, such as the power to invade principal for another trust beneficiary. It therefore seems appropriate that if the trustee distributes trust property in further trust pursuant to a decanting power, a beneficiary similarly not be treated as making a gift, regardless of whether the beneficiary's interest is diminished and regardless of the means by which the interest is diminished. Instead, it seems appropriate that such a decanting be treated no differently for gift tax purposes than a distribution to an individual beneficiary of a multiple beneficiary discretionary trust.

   The gift tax is imposed on the act of transfer of an interest in property by the donor.[46] Treas. Reg. §25.2511-2(a) provides:

   > The gift tax is not imposed upon the receipt of property by the donee, nor is it necessarily determined by the measure of enrichment resulting to the donee from the transfer, nor is it conditioned upon ability to identify the donee at the time of the

[45] Code section 2512.
[46] See Estate of DiMarco v. Commissioner, 87 T.C. 653 (1986).

> transfer. On the contrary, the tax is a primary and personal liability of the donor, is measured by the value of the property passing from the donor, and attaches regardless of the fact that the identity of the donee may not then be known or ascertainable.

The regulation requires an act of transfer. If the act of transfer is not voluntary, ordinarily no taxable gift would be deemed to occur.

It therefore seems appropriate that a beneficiary not be treated as having made a taxable gift when a trustee exercises a decanting power in a manner adverse to his or her beneficial interest unless the beneficiary has a legal right to object to the exercise of the authority to decant. It seems appropriate that this result occur only if it is reasonable for the beneficiary to believe that such an objection would be sufficient to prevent such exercise, and only if the costs of pursuing such an objection are not unreasonable in light of the expected outcome of the objection.[47]

The grounds for objecting to the exercise of discretionary authority by a fiduciary under state law are generally quite narrow. Restatement (Third) of Trusts §50 (2003) provides as follows:

> (1) A discretionary power conferred upon the trustee to determine the benefits of a trust beneficiary is subject to judicial control only to prevent misinterpretation or abuse of the discretion by the trustee.
>
> (2) The benefits to which a beneficiary of a discretionary interest is entitled, and what may constitute an abuse of discretion by the trustee, depend on the terms of the discretion, including the proper construction of any accompanying standards, and on the settlor's purposes in granting the discretionary power and in creating the trust.

As indicated, in general, a court will interpose on the exercise of a trustee's discretion only in the case of an abuse of discretion.[48] Accordingly, it appears that if a trustee exercises a decanting power consistently with state law, a beneficiary would be unable to prevent the exercise of the trustee's discretion.

In addition, a trustee who is also a beneficiary and who is not permitted to make distributions to himself or herself, but is permitted to make distributions to other beneficiaries, might be treated as making a taxable gift on the exercise of such authority.[49] Accordingly, a trustee who is also a beneficiary typically would be afforded tax protection either by a provision in the governing

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[47] Revenue Ruling 81-264, 1981-2 C.B. 185, confirms that a taxable gift can occur by permitting legal rights to expire. GCM 38584 relating to Revenue Ruling 81-264, acknowledges, however, that there may be circumstances where the taxpayer is able to show that the statute of limitations lapsed "in the ordinary course of business" based on the prospects of succeeding in litigation. See Treas. Reg. §25.2512-8.

[48] See Commentary to Article 8, Section 814, of the Uniform Trust Code (last amended and revised in 2010) drafted by the National Conference of Commissioners on Uniform State Laws, approved and recommended for enactment by all States at its 113th year meeting (July 30 - August 6, 2004), citing Scott on Trusts, section 187.2 (4th Ed. 1988) (generally a court will not interfere with a trustee's exercise of discretion if the trustee acts in good faith and does not act capriciously).

[49] PLR 9811044 (December 11, 1997); cf. Rev. Rul. 67-370, 1967-1 C.B. 324.

instrument, or by means of a state statute,[50] that restricts distributions by a beneficiary who is also a trustee to an ascertainable standard of health, education, maintenance, and support within the meaning of Code section 2041(b)(2). Treas. Reg. §2511-1(g)(2) provides that if a trustee has a beneficial interest in trust property, the transfer of the property by the trustee is not a taxable transfer if it is made pursuant to a fiduciary power the exercise or nonexercise of which is limited by a reasonably fixed or ascertainable standard which is set forth in the trust instrument. If the beneficiary/trustee's power is not so limited, her exercise of the power in a manner that diminishes her interest in the trust property would be treated as a taxable gift unless the beneficiary/trustee has sufficient control over the Receiving Trust to render the gift incomplete for gift tax purposes.

If the Receiving Trust confers on any beneficiary a power of appointment, and the trustee has the authority under applicable state law or the governing instrument to confer such a power, then consistent with the foregoing analysis, the grant of a nongeneral power of appointment to a beneficiary of the Receiving Trust would appear not to have gift tax consequences to any beneficiary of the Distributing Trust. As previously discussed, in *Phipps,* the Florida Supreme Court held that a trustee with "absolute discretion" has the authority to decant to a Receiving Trust that confers on a beneficiary a nongeneral power of appointment. Similarly, if the trustee of the Distributing Trust has the authority under state law or the governing instrument to decant so as to delay the termination date of the Distributing Trust (whether this is accomplished by the terms of the Receiving Trust or a change to the governing law or situs of administration of the Distributing Trust), then consistent with the foregoing analysis, doing so would not appear to have gift tax consequences.

2. Q. Does the reduction of a beneficiary's interests in a trust caused by decanting result in a transfer by the beneficiary for purposes of Code sections 2036 or 2038?

   A. Rev. Rul. 95-58, 1995-2 C.B. 191, implies that powers described in Code sections 2036 or 2038 held by a trustee are attributed to the trust's settlor (causing estate tax inclusion in the settlor's estate) if the settlor may remove the trustee and name another as trustee, unless the settlor may not appoint herself or anyone who is related or subordinate to the settlor within the meaning of Code section 672(c) (sometimes referred to as an "independent trustee"). The Revenue Ruling provides a "safe harbor" avoiding the attribution of the trustee's powers to the settlor if the settlor's power to remove and replace a trustee is limited to the appointment of an independent trustee. This possibility of attribution of the trustee's powers has been extended, unofficially, by the Internal Revenue Service to beneficiaries acting as trustees, potentially causing them to be deemed to hold a general power of appointment.[51] But it seems appropriate that attribution not occur if the beneficiary is not deemed to have indirect control over the actions of the trustee by means of a removal and replacement power. Accordingly, it would appear consistent with existing principles that a beneficiary's control over the identity of the trustee who has a decanting power be treated similarly to a beneficiary's control over a trustee with distribution powers. Thus, if the power to remove and replace the trustee is constrained consistently with Revenue Ruling 95-58, a beneficiary should not be treated as making a transfer

[50] See, e.g., New York EPTL 10-10.1 and Florida Statutes §736.0814(2) (formerly Florida Statutes §737.402(4)); see also, Rev. Proc. 94-44, 1994-2 C.B. 683 (holding that the enactment of the Florida statute curtailing the powers of a beneficiary/trustee to make distribution to himself to an ascertainable standard would not be treated as causing a lapse of a power of appointment for purposes of Code sections 2041(b)(2) and 2514(e).
[51] See, e.g., PLR 200551020 (September 21, 2005).

within the meaning of Code section 2036 or 2038 when a trustee possesses or exercises a decanting power.

If a beneficiary is acting as a co-trustee such that the beneficiary can participate in the decanting authority, then the tax consequences to the beneficiary will depend upon the permissible terms of the Receiving Trust. If the authority of a beneficiary/trustee to exercise a decanting power preserves an ascertainable standard of invasion in the Receiving Trust such that Code section 2041 is not implicated, then, even if the beneficial interest of the beneficiary/trustee is reduced, it seems appropriate that such reduction not be construed as a transfer by the beneficiary for purposes of Code sections 2036 or 2038.

It also seems that the statement in many of the decanting statutes or a determination under the common law that the power to decant is to be construed as a nongeneral power of appointment would be enough to prohibit a beneficiary/trustee from participating in a decanting that would confer on the beneficiary/trustee an interest in the trust that could be tantamount to a general power of appointment.

The Delaware statute states that if the trust contains a standard, the exercise of the power to decant must be in furtherance of the standard. Other statutes simply permit a beneficiary/trustee to participate in the decanting only if distributions are limited to a standard. It seems appropriate that such a limitation on a beneficiary/trustee be inferred if the beneficiary/trustee is so limited in the Distributing Trust. Any contrary construction would appear to be an exercise of distribution authority by the beneficiary/trustee beyond the scope of the beneficiary/trustee's authority in the Distributing Trust.

3. Q. Does the existence of a decanting power in a trust that otherwise qualifies for a gift or estate tax marital deduction under Code sections 2523 or 2056 or a gift tax exclusion under Code section 2503(c) cause the trust to fail to qualify for a marital deduction or a gift tax exclusion?

   A. To the extent the authority to decant is held in a fiduciary capacity such that the terms of the trust or applicable law governing the trust would prohibit a fiduciary from exercising any authority over the original trust in a manner that would be adverse to the best interests of the beneficiaries or violate a material purpose of the trust, it appears that the authority to decant would not permit a trustee to alter the terms of the trust in a manner that could disqualify the trust for its intended tax benefits. Accordingly, if the trustee's authority to decant is subject to a duty to act consistently with the purposes of the trust and the best interests of the beneficiaries under applicable state law, then it appears that the trustee would be precluded from exercising the authority to decant in a manner that could alter the terms of the trust necessary to qualify for a marital deduction or gift tax exclusion such that the decanting authority, by itself, would disqualify a trust for such tax treatment. We believe it is appropriate that restrictions under the governing instrument or applicable state law be considered for purposes of determining whether the authority to decant may be exercised in a manner that could disqualify a tax sensitive trust from its original tax benefits. It also appears appropriate to consider whether language in the original trust instrument setting forth the intended purposes of the original trust is sufficient as a matter of state law to preclude a decanting power from being exercised in a manner that could disqualify the original trust. We believe that it would be a rare circumstance when decanting would be considered with respect to a marital deduction trust or a gift tax exclusion trust; accordingly, the accompanying proposed Revenue Ruling does not propose guidance with respect to such trusts.

4. Q. Does a requirement that beneficiary consent, court approval, or approval by the State Attorney General be obtained prior to the exercise of a decanting power result in different gift tax consequences to a beneficiary of the trust than a decanting that does not require such approval?

   A. As previously explained, as a general rule, an individual makes a taxable gift only by engaging in a voluntary gratuitous transfer of property. If an individual permits legal rights to expire, a taxable gift can also occur.[52] The question thus becomes whether the requirement of beneficiary consent, court approval, or the approval of the State Attorney General amounts to a legal right on the part of a beneficiary to avoid the decanting. In this regard, the approval of the State Attorney General would appear distinguishable because no beneficiary can control whether the State Attorney General approves of the decanting or not. Instead, the requirement for approval of the State Attorney General would appear to represent an approval by an independent party that ought not to cause any tax consequence to a beneficiary. The requirement for beneficiary consent or court approval to the extent court approval cannot be obtained without beneficiary consent, has the potential to have gift tax consequences to a beneficiary. If a beneficiary can in effect block the decanting, then whether or not failing to exercise that right has tax consequences will depend on the effect of the decanting on the beneficiary's interest in the Distributing Trust. If the beneficiary's interest in the Distributing Trust is reduced, then it would appear that the beneficiary has made a taxable gift.[53]

   The tax consequences of reformations and modifications of trusts both of which require court approval seem relevant to the analysis. As a general matter, the law on reformation and modification of trusts is governed by the U.S. Supreme Court's holding in *Commissioner v. Bosch.*[54] In *Bosch,* the Supreme Court concluded that federal authorities, including the Internal Revenue Service, are not conclusively bound by a determination of a property interest made by a state trial court in a proceeding to which the United States is not a party. The Supreme Court determined to follow *Erie Railroad Co. v. Tompkins*[55] to the effect that the state law as announced by the highest court of the state is to be followed. But "[i]f there is no decision by that court then federal authorities must apply what they find to be the state law after giving 'proper regard' to the relevant rulings of other courts of the State." Accordingly, if the decanting being sought is consistent with the law of the state whose law governs the trust, as declared by the highest court of that state, then it appears that the decanting would have no gift tax consequences to any beneficiary under *Bosch.* This would appear true even if beneficiary consent is obtained without being required to the extent the trustee's authority to decant exists independently of the requirement for beneficiary consent.

   It also seems relevant that a decanting by a trustee can have only prospective effect. Accordingly, a decanting, even if obtained with beneficiary consent and/or court approval, that extinguishes an interest or power prior to the time it becomes effective, would appear not to have tax consequences to any beneficiary. In Revenue Ruling 73-142,[56] the decedent made substantial gifts of property to a trust for his wife and children. Under the terms of the instrument, the decedent reserved an unrestricted power to remove or discharge the trustee and appoint a new trustee, with no express

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[52] Rev. Rul. 81-264, 1981-2 C.B. 185 (a taxpayer who permits his legal rights to collect a debt to expire makes a taxable gift to the borrower).
[53] Treas. Reg. §25.2512-8.
[54] 387 U.S. 456 (1967).
[55] 304 U.S. 64 (1938).
[56] 1973-1 C.B. 205.

limitation on so appointing himself. The trustee had an unrestricted power to withhold distributions and to apportion income and principal. The state court construed the decedent's power to permit only one removal and appointment and to exclude the power to appoint himself a trustee. It appeared that the decree was contrary to the decisions of the highest court of the state. The Revenue Ruling concludes that *Bosch* does not void a lower court decree that is binding on the parties. Once the time for appeal elapses such that the decree is binding on the parties, the property rights of the parties are determined by the decree. Accordingly, the Code section 2036 and 2038 powers that might otherwise have attracted estate tax were extinguished prior to the taxing event, namely the death of the decedent. The decree extinguishing the powers would therefore be binding on the Internal Revenue Service, because the decedent did not possess the powers after the decree.

Accordingly, to the extent a court approved decanting does not itself have tax consequences, because, for example, a current property interest is thereby surrendered, a court approved decanting with prospective effect to eliminate a power with future tax consequences appears to avoid gift and future estate tax consequences so long as the court decree is thereafter binding on the taxpayer and cannot be undone.

5. Q. Does the donor of the Distributing Trust continue to be the donor of the Receiving Trust following a decanting?

   A. We believe that the answer to this question turns on whether a beneficiary or trustee is deemed to make a taxable gift as a result of the decanting. As previously explained, if a beneficiary could not prevent the exercise of decanting authority by the trustee, it would not appear possible for a beneficiary to have made a taxable gift. Accordingly, unless the exercise of decanting authority is deemed the exercise of a general power of appointment under Code sections 2041 and 2514 because the person with the authority to decant may exercise that authority in favor of himself, his creditors, his estate, or the creditors of his estate, the donor of the Receiving Trust should be the same as the donor of the Distributing Trust.

Generation-Skipping Transfer Tax Issues

1. Q. Does a Distributing Trust that is protected from generation-skipping transfer tax by reason of being irrevocable on September 25, 1985 lose that protection as to property decanted to a Receiving Trust? Does a Distributing Trust exempt by reason of an allocation of GST exemption lose that protection as to property decanted to a Receiving Trust under the same circumstances as an effective date trust?

   A. Treas. Reg. §26.2601-1(b)(4)(i)(A) provides that a distribution of trust principal from a trust that was irrevocable on September 25, 1985 to a new trust will not cause loss of exempt status if the terms of the governing instrument or applicable state law at the time the trust became irrevocable authorizes the distribution to the new trust without the consent or approval of any beneficiary or court, and the terms of the governing instrument of the new trust will not extend the time for vesting beyond any life in being at the date the original trust became irrevocable plus a period of 21 years. Accordingly, so long as the decanting authority existed in the original trust and can be exercised without prior court approval or beneficiary consent, it appears under the regulation that the exercise of that authority has no effect on the exempt status of a trust protected from the generation-skipping transfer tax by the effective date rule provided the new trust must terminate within the period set forth in the regulation.

None of the decanting statutes was in effect when the GST tax took effect. Thus, the requirement that state law authorize the distribution when the trust became irrevocable would not be met on the basis of such state statutes for trusts that are exempt by reason of the effective date rule.[57] Nevertheless, as discussed above, it is at least arguable that a decanting power existed under the common law of all states.

A separate rule applies if decanting authority is exercised in a manner such that the vesting of interests is not postponed. Treas. Reg. §26.2601-1(b)(4)(i)(D)(*1*) provides as follows:

> A modification of the governing instrument of an exempt trust (including a trustee distribution, settlement, or construction that does not satisfy paragraph (b)(4)(i)(A), (B), or (C) of this section) by judicial reformation, or nonjudicial reformation that is valid under applicable state law, will not cause an exempt trust to be subject to the provisions of chapter 13, if the modification does not shift a beneficial interest in the trust to any beneficiary who occupies a lower generation (as defined in section 2651) than the person or persons who held the beneficial interest prior to the modification, and the modification does not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust.

Accordingly, changes that do not shift beneficial interests to lower generations should not cause loss of exempt status, even if done pursuant to a decanting statute enacted after the trust became irrevocable.[58]

In addition, if decanting is accomplished by the exercise of a non-general power of appointment over the trust estate that existed at the time the trust became irrevocable, the new trust may continue for a standard rule against perpetuities period of lives in being when the original trust became irrevocable plus a 21 year term.[59] Alternatively, the trust may continue for a period not to exceed 90 years from the date of creation of the original trust. Treas. Reg. §26.2601-1(b)(1)(v)(D), *Example 4* provides that the exercise of a non-general power of appointment granted in a trust exempt from GST tax by reason of the effective date rule does not cause the trust to lose its exempt status if the exercise of the power

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[57] Certain trusts created after the initial effective date of the GST tax are exempted (e.g., where the settlor was incompetent); see Treas. Reg. §26.2601-1(b)(3). It is possible that one of the state decanting statutes might have been enacted for such special-date grandfathered trusts by the time such a trust became irrevocable.

[58] See PLR 9737024 (June 17, 1997) (no loss of grandfathering where no change in quality, value, or timing of any beneficiary's interest or power pursuant to decanting under New York EPTL 10-6.6); PLR 9804046 (October 28, 1997) (no loss of grandfathering where spendthrift provision changed by decanting under New York EPTL 10-6.6); PLR 200227020 (April 1, 2002) (no loss of grandfathering where situs of trust changed from New York pursuant to decanting under New York EPTL 10-6.6 where the trust would end at the same time); PLR 9438023 (June 17, 1994) (same).

[59] In PLR 200227020 (April 1, 2002), the IRS ruled that grandfathering would not be lost in decanting a trust and explicitly noted that the new trust "will provide that, notwithstanding any other provision, no exercise of a power of appointment granted in the trust shall result in a termination date for a trust or a share thereunder or created pursuant to a power of appointment granted thereunder which is later than the date twenty-one years after the death of the survivor of all of Sister's descendants living at Decedent's death."

does not suspend the vesting, absolute ownership, or power of alienation of an interest in the trust principal for a period, measured from the date of creation of the trust, beyond lives in being at the time the trust became irrevocable plus 21 years.

A generation-skipping trust may be exempt, in whole or in part, from GST tax not just by reason of the effective date rule but also by reason of an allocation of GST exemption to transfers to the trust.[60] The Internal Revenue Service in private rulings has applied certain of the grandfathering rules to trusts that are exempt by reason of an allocation of GST exemption.[61] Nevertheless, it remains uncertain under what circumstances the exercise of a state decanting power would cause such exemption from taxation to be lost.[62] Many of the rulings addressing trusts exempt by reason of an allocation of GST exemption include the following language: "No guidance has been issued concerning changes that may affect the status of trusts that are exempt from GST tax because sufficient GST exemption was allocated to the trust to result in an inclusion ratio of zero. At a minimum, it seems appropriate to conclude that a change that would not affect the GST status of a trust that was irrevocable on September 25, 1985, would similarly not affect the exempt status of such a trust."[63] Guidance confirming this principle would be beneficial to provide clarity and certainty to trustees acting under a trust that is exempt by reason of an allocation of GST exemption who propose to exercise a decanting power.

A question remains as to whether the limitation on the duration of a trust that receives the proceeds of an effective date trust under Treas. Reg. §26.2601-1(b)(4)(i)(A) (sometimes referred to as the "GST RAP") should also apply to a trust that is GST tax exempt by reason of an allocation of GST exemption. The GST RAP reflects the common law rule against perpetuities that was in effect in most states at the time Chapter 13 was enacted, although Wisconsin and South Dakota had already permitted the unlimited duration of trusts. Under the law of many states, the common law rule has since been abolished in favor of permitting longer duration trusts.[64] Suppose that at the time a trust that is exempt by reason of an allocation of GST exemption becomes irrevocable applicable state law permits the trust to continue for 360 years, but the governing instrument of the trust provides for an earlier termination date. Suppose that under a state decanting statute in effect at the time the trust became irrevocable the trustee has authority to extend the duration of the trust to 360 years from the date it became irrevocable. In that case, by analogy to Treas. Reg. §26.2601-1(b)(4)(i)(A)(*2*), it could be argued that even a *valid postponement* of vesting beyond lives in being when the Distributing Trust became irrevocable plus 21 years (or, alternatively, 90 years from the time the Distributing Trust became irrevocable) would still cause the Receiving Trust to lose its GST tax exemption. On the other hand, because the governing law at the time the Distributing Trust became irrevocable allowed *both* a 360-year term and decanting into a trust with a 360-year term, it could be argued that in the context of a comprehensive treatment of such issues in published guidance it is most consistent with the principles informing that guidance that the Receiving Trust would also be GST exempt. In either case, guidance on this point would be most helpful.

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[60] Code section 2631(a).
[61] See, e.g., PLR 200551020 (September 21, 2005).
[62] See PLR 9849005 (September 1, 1998) (holding that GST exemption allocation to a trust that made it exempt from the tax would continue if the trust were to use New York EPTL 10-6.6 to pay the corpus over to a trust with 'identical' terms).
[63] See, e.g., PLR 200839025 (May 30, 2005).
[64] See R.H. Sitkoff & M. Schanzenbach, *Jurisdictional Competition for Trust Funds: An Empirical Analysis of Perpetuities and Taxes,* 115 Yale L.J. 356, 410 (2005).

In general, however, it appears appropriate to construe the existence of a decanting power applicable at the time the trust became irrevocable with respect to a trust exempt from GST tax by reason of an allocation of GST exemption as having no effect, by itself, on the exempt status of the trust. Similarly, it seems that the exercise of such a decanting power should also have no effect on the exempt status of the trust unless the decanting power itself constitutes a general power of appointment.

2. Q. Does a trust formed by decanting from a trust that has an inclusion ratio of more than zero but less than one have the same inclusion ratio as the original trust?

   A. As a general matter, a division of a trust, other than by means of a qualified severance, will not cause a trust that is wholly or partially exempt from GST tax to be treated as a separate trust for GST tax purposes.[65] Under Treas. Reg. §26.2642-6(h), however, trusts resulting from a severance that does not meet the requirements of a qualified severance will be treated, after the date of severance, as separate trusts for GST tax purposes, provided that the trusts resulting from such severance are recognized as separate trusts under applicable state law. Each trust resulting from a non-qualified severance will have the same inclusion ratio as that of the original trust immediately before the severance under Treas. Reg. §26.2642-6(h). Accordingly, it would be consistent with existing law that the consequences of a decanting be the same as a division of the trust under applicable state law, such that both the Distributing Trust and the portion of the Receiving Trust consisting of the decanted property would have the same inclusion ratio as the Distributing Trust.

3. Q. Does decanted trust property from a Distributing Trust that is not subject to Chapter 13 by reason of Code section 2663(2) relating to transferors who are nonresident aliens continue not to be subject to Chapter 13 if it is decanted to a Receiving Trust?

   A. Code section 2663(2) and the Treasury Regulations promulgated thereunder contain special rules dealing with the application of GST tax to transfer by a nonresident not a citizen of the United States. As a general rule, Chapter 13 applies to such individuals only to the extent the transfer of property was subject to Chapter 11 or Chapter 12. Accordingly, it seems appropriate that a trustee's power to decant property from a Distributing Trust created by a nonresident not a citizen of the United States to a Receiving Trust have an effect on the application of Chapter 13 to the Receiving Trust only if the exercise of the trustee's power to decant was subject to Chapter 11 or Chapter 12 with respect to any person under the principles described above.

4. Q. Does decanted trust property have the same transferor for GST purposes following a decanting from a Distributing Trust to a Receiving Trust?

   A. We believe that the answer to this question turns on whether a beneficiary or trustee is deemed to make a taxable gift or experience estate tax inclusion as a result of the decanting. As previously explained, if a beneficiary has no legal right to prevent the exercise of decanting authority, it would not appear possible for a beneficiary to have made a taxable gift. Accordingly, unless the exercise of decanting authority is deemed the exercise of a general power of appointment under Code sections 2041 and 2514 because the person with the authority to decant may exercise that authority in favor of himself, his creditors, his estate, or the creditors of his estate, the donor of the Receiving Trust should

[65] See Code section 2654(b).

be the same as the donor of the Distributing Trust. If no taxable gift has occurred by reason of the exercise of decanting authority, then it appears that no shift in the identity of the transferor can occur for GST tax purposes. Similarly, unless decanting authority causes the value of any portion of the Distributing Trust to be included in the gross estate of any person, it would not appear that a shift in the identity of the transferor of the Distributing Trust can occur and the transferor of both the Distributing Trust and the Receiving Trust should be the same for GST tax purposes with respect to the decanted trust property.

5. Q. Can a trust that is not exempt from GST tax be decanted to permit effective allocation of GST exemption to only a portion of the original trust?

   A. It is possible that the decanting of a trust pursuant to applicable state law might be construed as a severance that does not meet the requirements of a qualified severance.[66] In that event, even though the severance is not qualified, after the date of severance the trusts will be recognized as separate trusts under state law.

   Assuming the trusts are treated as separate trusts under state law, it seems appropriate that it be possible to allocate GST exemption to less than all of the trusts without being treated as having allocated GST exemption ratably to all the trusts. There would appear to be no tax abuse in permitting such an effective late allocation, as only the portion of the trust to which GST exemption is allocated would thereafter be treated as GST exempt. Indeed, GST exemption could be effectively allocated to the entire original trust, immediately followed by a qualified severance under Code section 2642(a)(3) such that one trust would be wholly exempt from GST tax and the other would be wholly subject to GST tax. Accordingly, there appears to be no reason not to permit a division of the trust by decanting, followed by an allocation of GST exemption only to one of the trusts so as to make that trust wholly exempt from GST tax.

   If the severance results in a taxable termination or a taxable distribution as to a portion of the trust, for example because one of the trusts is a skip person, it would appear appropriate that the taxable event be deemed to occur only with regard to that particular resulting trust, with no GST tax impact on any other trust resulting from the severance. Each trust resulting from such a severance (prior to the allocation of any additional GST exemption) would have the same inclusion ratio as the original trust.

* * *

In addition to the comments in this letter, the College also submits a proposed Revenue Ruling setting forth a number of safe harbors covering the situation where decanting authority is conferred by state law upon a trustee with absolute discretion to distribute trust corpus of the original trust. The College believes that the situations covered in the proposed Revenue Ruling address the most common uses of decanting, not necessarily all issues discussed in this letter. The College believes that the issuance of such a Revenue Ruling would be a great assistance to taxpayers and their advisors in clarifying the federal tax consequences of the existence and exercise of decanting authority conferred under state law.

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[66] See Treas. Reg. §26.2642-6(h).

Conclusion

These comments were prepared by Diana S.C. Zeydel (305-579-0575) (the principal author), Mary Ann Mancini (202-508-6263), and members of the College's Estate and Gift Tax Committee and Fiduciary Income Tax Committee, and were reviewed and approved by Ronald D. Aucutt (703-712-5497) on behalf of the College's Washington Affairs Committee. We appreciate this opportunity to comment with respect to Notice 2011-101 and would be pleased to offer additional comments if desired.

Respectfully submitted,

Louis A. Mezzullo

Enclosure: Proposed Decanting Revenue Ruling

<u>PROPOSED DECANTING REVENUE RULING</u>

Rev. Rul. 2012-XX

ISSUE

What are some of the estate, gift, income, and generation-skipping transfer (GST) tax effects of the exercise by an independent trustee of a power granted under state law to transfer property held in one trust to another trust for the benefit of one or more of the beneficiaries of the original trust, which power is exercisable without prior court approval or beneficiary consent?

FACTS

The trustee of an irrevocable trust (the "first trust"), created under the law of state X by will or other instrument, is authorized, under an express grant of authority under the governing instrument, to pay corpus of the first trust directly to the beneficiaries of the first trust. A statute of state X expressly authorizes the trustee of the first trust to transfer a portion or all of the corpus of the first trust to another trust (a "second trust") for the benefit of one or more or all of those beneficiaries to whom the trustee could directly distribute the corpus of the first trust. The trustee's authority under the statute of state X is exercisable without prior court approval and without the prior consent of any beneficiary of the first trust. The trustee's authority to transfer corpus from the first trust to the second trust is exercisable notwithstanding any spendthrift or similar provision in the governing instrument or state law applicable to the first trust. No beneficiary has made a transfer for gift or estate tax purposes to the first trust and no beneficiary holds a general power of appointment over the first trust. In each situation, (i) no asset of the first trust consists of a policy of insurance on the life of any trust beneficiary, (ii) no beneficiary is a trustee of either the first trust or the second trust, and (iii) no beneficiary holds a power to remove any trustee of the first trust. In no situation do the terms of the governing instrument of the first trust authorize distributions to another trust.

Situation 1: The first trust authorizes the trustee, under an express grant of authority in its governing instrument, to pay corpus of the first trust to one or more or all of the descendants of the settlor living from time to time in the trustee's absolute discretion. The first trust terminates in 2015, whereupon the entire corpus and undistributed income will then be distributed to the settlor's then living descendants, per stirpes. The trustee of the first trust, pursuant to the authority granted under a statute of state X, transfers the entire corpus of the first trust to a second trust declared by the trustee of the first trust for the benefit of some, but not all, of the settlor's descendants. The second trust will terminate 21 years after the date of death of the survivor of the settlor's descendants who were alive when the first trust became irrevocable. Upon its termination, the second trust will be distributed to the settlor's then living descendants.

Situation 2: The first trust authorizes the trustee, under an express grant of authority in its governing instrument, to pay corpus of the first trust to the sole life income beneficiary. The beneficiary does not hold a power of appointment with respect to the property of the first trust. The trustee of the first trust, pursuant to the authority granted under a statute of state X, transfers one-half of the corpus of the first trust to a second trust declared by the trustee under which the beneficiary of the first trust is entitled to all the income for life. The second trust grants the beneficiary a power to appoint the property of the second trust upon the beneficiary's death among a class consisting of the descendants of the beneficiary living at the death of the beneficiary.

Situation 3: The first trust authorizes the trustee, under an express grant of authority in its governing instrument, to pay corpus of the first trust to one or more or all of the descendants of the settlor living from time to time in the trustee's absolute discretion. The trustee of the first trust, pursuant to the authority granted under a statute of state X, pays the entire corpus of the first trust to a second trust funded by someone other than the settlor of the first trust. Under the terms of the second trust, the trustee may pay the corpus of the second trust to one or more or all of the descendants of the first trust's settlor in the trustee's absolute discretion. The second trust grants one of the descendants of the settlor of the first trust a presently exercisable power to pay the corpus of the second trust at any time and from time to time to one or more of the spouses of the descendants of the settlor of the first trust, including the widow or widower of any descendant of the settlor of the first trust who has died.

Situation 4: The first trust authorizes the trustee, under an express grant of authority in its governing instrument, to pay corpus of the first trust to the sole life income beneficiary. The trustee of the first trust, pursuant to the authority granted under a statute of state X, transfers the entire corpus of the first trust to a second trust declared by the trustee of the first trust and governed by the law of another state. The law of the state governing the second trust, unlike the law of state X, permits the trustee to convert the beneficiary's income interest into a unitrust interest paying 5% per year of the annual value of the second trust's corpus to the income beneficiary instead of the second trust's fiduciary accounting income.

Situation 5: The first trust authorizes the trustee, under an express grant of authority in its governing instrument, to pay corpus of the first trust to the sole life income beneficiary. The first trust requires that all investments be in publicly traded securities. The trustee of the first trust, pursuant to the authority granted under a statute of state X, transfers the entire corpus of the first trust to a second trust governed by the law of another state. The law of the state governing the second trust, unlike the law of state X, (i) permits the current beneficiary to remove the trustee and appoint another as trustee (other than the beneficiary so removing the trustee and other than anyone related or subordinate to the beneficiary within the meaning of Section 672(c)), (ii) permits the trustee of the second trust to make any prudent investment, and (iii) permits a trustee's compensation to be greater than or less than a trustee's compensation under the law of state X.

LAW AND ANALYSIS

In general, a trust (other than a trust that is considered owned by another under Subpart E of Part 1 of Subchapter J of Chapter 1 of the Internal Revenue Code commonly referred to as a "grantor trust"), is entitled to a deduction under Section 661(a) for the amount of property properly paid or distributed to a beneficiary, but not in excess of the trust's distributable net income (DNI) defined in Section 643(a). Any amount so paid or distributed is included under Section 662(a) in the gross income of the beneficiary, but not in excess of the DNI. A trust may be treated as a beneficiary for purposes of Section 661(a) and Section 662(a). See Reg. § 1.643(c)-1.

Distributions from a trust (other than a grantor trust) are governed by Sections 651 and 652 if the trust is required to distribute all of its income as defined in Section 643(b), does not provide for any payment to charity, and makes no other distributions for the year. Such a trust is known as a "simple trust." Distributions from a trust (other than a grantor trust) are governed by Sections 661 and 662 if the trust is not required to distribute all of its income as defined in Section 643(b) or, if the trust is required to distribute all of such income and the trust makes another distribution for the year or provides for a payment to charity. Such a trust is known as a "complex trust."

Reg. § 1.643(b)-1 provides, in part,

> For purposes of subparts A through D, part I, subchapter J, chapter 1 of the Internal Revenue Code, "income," when not preceded by the words "taxable," "distributable net," "undistributed net," or "gross," means the amount of income of an estate or trust for the taxable year determined under the terms of the governing instrument and applicable local law. Trust provisions that depart fundamentally from traditional principles of income and principal will generally not be recognized. For example, if a trust instrument directs that all the trust income shall be paid to the income beneficiary but defines ordinary dividends and interest as principal, the trust will not be considered one that under its governing instrument is required to distribute all its income currently for purposes of section 642(b) (relating to the personal exemption) and section 651 (relating to simple trusts). Thus, items such as dividends, interest, and rents are generally allocated to income and proceeds from the sale or exchange of trust assets are generally allocated to principal. However, an allocation of amounts between income and principal pursuant to applicable local law will be respected if local law provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust for the year, including ordinary and tax-exempt income, capital gains, and appreciation. For example, a state statute providing that income is a unitrust amount of no less than 3% and no more than 5% of the fair market value of the trust assets, whether determined annually or averaged on a multiple year basis, is a reasonable apportionment of the total return of the trust. ... A switch between methods of determining trust income

authorized by state statute will not constitute a recognition event for purposes of section 1001 and will not result in a taxable gift from the trust's grantor or any of the trust's beneficiaries.

Section 2501 imposes a tax on the transfer of property by gift by an individual, resident or nonresident. Section 2511(a) provides that the gift tax applies whether the transfer is in trust or otherwise, whether the gift is direct or indirect, and whether the property is real or personal, tangible or intangible.

Section 2033 causes the value of property to be included in the gross estate of a decedent only to the extent the decedent had an interest in the property at the time of the decedent's death. Sections 2036, 2037, and 2038 cause the value of property to be included in the gross estate of a decedent only to the extent the decedent during lifetime transferred the property. Section 2039 causes the value of an annuity or other payment receivable to be included in the gross estate of a decedent only as to such part of the annuity or other payment as is proportionate to that part of the purchase price therefor contributed by the decedent. Section 2040 causes the value of property to be included in the gross estate of a decedent only if the property was owned by the decedent with another as joint tenants with right of survivorship. Section 2041 causes the value of property to be included in the gross estate of a decedent only to the extent the decedent held a general power of appointment over the property. Section 2042 causes the value of proceeds of a policy of insurance on the life of a decedent to be included in the gross estate of the decedent to the extent the decedent possessed an incident of ownership in the policy or its proceeds are payable to the estate of the decedent.

In general, the value of a trust of which the decedent was a beneficiary but to which the decedent made no transfer during life is not included in the decedent's gross estate unless the decedent held a general power of appointment over the trust at death within the meaning of Section 2041.

Chapter 13 of Subtitle B of the Internal Revenue Code imposes a generation-skipping transfer (GST) tax on any generation-skipping transfer as defined in Section 2611(a) of that chapter. In general, Chapter 13 does not apply to a generation-skipping transfer under a trust that was irrevocable on September 25, 1985 (referred to herein as a "GST exempt trust"). Reg. § 26.2601-1(b)(1)(i). The distribution of trust principal from a GST exempt trust to a new trust may cause the new trust to be subject to the provisions of Chapter 13 if the terms of the governing instrument of the GST exempt trust do not authorize distributions to the new trust without the consent or approval of any beneficiary or court and, at the time the GST exempt trust became irrevocable, state law did not authorize distributions to the new trust. Reg. § 26.2601-1(b)(4)(i)(A).

Reg. § 26.2601-1(b)(4)(i)(D)(*1*) provides, in part,

> A modification of the governing instrument of [a GST exempt trust] (including a trustee distribution…) by judicial reformation, or nonjudicial reformation that is valid under applicable state law, will not cause an exempt trust to be subject to the provisions of chapter 13, if the modification does not shift a beneficial interest in the trust to any beneficiary who occupies a lower generation ... than the person or persons who held the beneficial interest prior to the modification, and the modification does not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust.

In Situation 1, no beneficiary will be treated as making a gift and no beneficiary will be treated as recognizing gain or other income by reason of the transfer by the trustee of the corpus of the first trust to the second trust. Because the entire corpus of the first trust is paid to the second trust, no one other than the trustee, acting as such, has made a contribution to the second trust. Accordingly, the second trust will be considered for all income tax purposes to be the same trust as the first trust, if neither the first trust nor the second trust is a grantor trust with respect to any taxpayer. The taxpayer identification number of the first trust may be used by the second trust. The transfer of corpus from the first trust to the second trust will extend the time for vesting of a beneficial interest in the first trust. Accordingly, the transfer of corpus from the first trust to the second trust will cause the second trust to lose any grandfathering from GST tax under Reg. § 26.2601-1(b)(4)(i)(A).

In Situation 2, the transfer by the trustee of one-half the corpus of the first trust to a second trust under which the beneficiary holds a power to appoint the property upon the beneficiary's death among a class consisting of the then living descendants of the beneficiary will cause the amount so distributed, not in excess of the DNI of the first trust, to be included in the gross income of the second trust, if neither the first trust nor the second trust is a grantor trust with respect to any taxpayer. The second trust is treated as a separate taxpayer and must obtain and use a taxpayer identification number different from the taxpayer identification number of the first trust. No beneficiary will be treated as making a gift and no beneficiary will be treated as recognizing gain or other income by reason of the transfer to the second trust, whether or not the first trust was a grantor trust with respect to any taxpayer. No generation-skipping transfer will be deemed to have occurred by reason of the transfer to the second trust if at least one of the current beneficiaries of the second trust is a non-skip person for GST tax purposes with respect to the first trust. The inclusion ratio for GST purposes of both trusts will be the same as the inclusion ratio of the first trust. The value of the second trust will not be included in the gross estate of the beneficiary who has been granted the special power of appointment exercisable at death by reason of the grant of the power. Any exercise of the special power of appointment in further trust with respect to a grandfathered trust should be analyzed under the principles illustrated in Situation 1.

In Situation 3, the transfer by the trustee of the corpus of the first trust to a second trust will cause all of the DNI of the first trust to be included in the gross income of the second trust if neither the first trust nor the second trust is a grantor trust with respect to any taxpayer. The second trust is treated as a taxpayer separate from the first trust. The second trust must obtain and use a taxpayer identification number different from the taxpayer identification number of the first trust. No trust beneficiary will be treated as making a gift and no beneficiary will be treated as recognizing gain or other income by reason of the transfer to the second trust whether or not the first trust or the second trust is a grantor trust with respect to any taxpayer. In particular, the grant of a presently exercisable power of appointment to one of the descendants of the settlor of the first trust will not by itself cause any beneficiary to have made a taxable gift to any other beneficiary. The exercise of the power of appointment may result in a taxable gift by the descendant holding the power of appointment under Revenue Ruling 75-550, 1975-2 C.B. 357, if that descendant is also a beneficiary of the second trust. No generation-skipping transfer will be deemed to have occurred by reason of the transfer to the second trust if at least one of the current beneficiaries of the second trust is a non-skip person for GST tax purposes with respect to the first trust. The inclusion ratio for GST tax purposes of the second trust will be the same as the inclusion ratio of the first trust with respect to the portion of the second trust that consists of the transfer, and the settlor of the first trust will be treated as the transferor for GST tax purposes with respect to such portion. The portion of the second trust attributable to the transfer from the first trust will not be included in the gross estate of any of the trust beneficiaries by reason of the transfer.

In Situation 4, the transfer by the trustee of the corpus of the first trust to a second trust which is governed by the law of another state that has a statute that permits a trustee to convert an income interest in a trust to a 5% unitrust will not cause the beneficiary to recognize income or gain and no generation-skipping transfer will be deemed to have occurred. The inclusion ratio for GST purposes of the second trust will be the same as the inclusion ratio of the first trust. The value of the second trust will not be included in the gross estate of any trust beneficiary. The results would be the same if the income interest in the second trust is thereafter converted to a unitrust.

In Situation 5, the transfer by the trustee of the corpus of the first trust to the second trust which is governed by the law of another state that permits the current beneficiary to remove the trustee and appoint another as trustee, permits the trustee to make any prudent investment, and provides a method of fiduciary compensation so that the trustee's compensation may be greater than or less than a trustee's compensation under the law of state X will not cause any beneficiary to recognize income or gain, and no generation-skipping transfer will be deemed to have occurred. The inclusion ratio for GST purposes of the second trust will be the same as the inclusion ratio of the first trust. The value of the second trust will not be included in the gross estate of any trust beneficiary.

In each Situation, the trustee is neither the donor nor a beneficiary. It would not change the tax consequences if (i) decanting authority were conferred under applicable state law in effect at the time the first trust became irrevocable rather that in the governing instrument of the first trust, (ii) the trustee were a beneficiary so long as the beneficiary/trustee has no authority to participate in the decanting, or (iii) the second trust were declared by someone other than the trustee of the first trust.

HOLDINGS

When the trustee of a trust, who is not a beneficiary of the trust and to which no trust beneficiary has made a transfer for estate or gift tax purposes, may, under applicable state law, exercise the trustee's absolute discretion to distribute trust corpus directly to any one or more beneficiaries so as to transfer trust corpus to a second trust for one, some, or all of the trust beneficiaries of the first trust, such transfer is treated as a distribution to a beneficiary under whichever of subpart B or subpart C of part I of Subchapter J of the Code is applicable if neither the first trust nor the second trust is a grantor trust with respect to any taxpayer. Such a transfer will not cause any beneficiary to be treated as making a gift for Federal gift tax purposes, will not cause the value of the any of the trust property to be included in the gross estate of any beneficiary (except to the extent, if any, the beneficiary holds a general power of appointment over the trust property), and will not be treated as a generation-skipping transfer if at least one of the current beneficiaries of the second trust is a non-skip person with respect to the first trust. However, if the first trust was irrevocable on September 25, 1986 and the time for vesting of any beneficial interest in the first trust is extended, either the first trust or the second trust or both may become subject to Chapter 13.

DRAFTING INFORMATION