NEW YORK STATE BAR ASSOCIATION TAX SECTION
NEW YORK STATE BAR ASSOCIATION TRUSTS AND ESTATES LAW SECTION

REPORT ON NOTICE 2011-101:

REQUEST FOR COMMENTS REGARDING THE INCOME, GIFT, ESTATE AND GENERATION-SKIPPING TRANSFER TAX CONSEQUENCES OF TRUST DECANTING

April 26, 2012

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Report No. 1265

New York State Bar Association Tax Section
New York State Bar Association Trusts and Estates Law Section

Report On Notice 2011-101

This report (the "Report")[1] responds to the request from the Office of Associate Chief Counsel, Passthroughs & Special Industries, in Notice 2011-101 (the "Notice"),[2] for comments regarding the income, gift, estate, and generation-skipping transfer (or GST) tax consequences arising when the trustee of one irrevocable trust transfers part or all of the trust principal to another irrevocable trust, frequently referred to as "decanting."

As requested in the Notice, this Report specifically addresses the tax consequences where the decanting results in a change in the beneficial interests in the trust.[3] In addition, we consider the specific circumstances identified in the Notice which may affect the tax analysis.

I. OVERVIEW OF TRUST DECANTING

A. Definition of Decanting

Decanting refers to the trustee's payment of part or all of the principal of an irrevocable trust (the "Distributing Trust") to another irrevocable trust (the "Receiving Trust") for the benefit of one or more of the beneficiaries of the Distributing Trust. A trustee's authority to decant may derive from the terms of the document governing the Distributing Trust (that is, the trust instrument or Will) or, as discussed below, applicable state law. Authority under state law, in turn, may derive from common law principles or a specific decanting statute.

B. Purposes of Decanting

Trust decanting may be employed by a trustee for numerous reasons to ensure that the grantor's objectives are achieved, to protect the interests of the beneficiaries and/or preserve the trust assets. In addition, decanting can be used to correct drafting errors in an irrevocable instrument.[4] In recent years, decanting has gained recognition as a potent strategy for trustees to

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[2] 2011-52 I.R.B. 932 (Dec. 20, 2011).

[3] The Notice indicates that there will be a "change in beneficial interest" when the interests of one or more of the beneficiaries are changed or terminated and/or when another beneficiary who did not have an interest in the Distributing Trust may receive an interest in Receiving Trust.

[4] *See* McCaffrey, "Fixing Estate Planning Documents: Part II," NYSBA Trusts and Estates Law Section Newsletter, Winter 2011, Vol. 44, No.4; Halperin and O'Donnell, "Modifying Irrevocable Trusts: State Law and Tax Considerations in Trust Decanting," 42nd Ann. Heckerling Inst, on Est. Plan. (2008), Ch. 13.

address a variety of issues and changed circumstances. Indeed, many practitioners include specific decanting authorization in the trust instrument to provide flexibility. In addition, many states recently have introduced or modified their decanting statutes to take into account the increased utility of trust decanting.

1. Addressing Changed Circumstances

Irrevocable trusts often provide for mandatory distributions of trust principal to a beneficiary at specified times, such as the beneficiary attaining a certain age. However, circumstances at that time may warrant retaining the assets in trust to address unanticipated changes, such as a beneficiary's other available wealth or significant appreciation in the trust property. In addition, the trustee may wish to retain assets in trust if the beneficiary lacks the maturity necessary to handle the funds, has creditor problems, suffers from addiction or exhibits other negative behavior.[5] A trustee also may wish to withhold distributions to a beneficiary so he or she may qualify for government or other public benefits.[6] Decanting also has been relied on to provide or eliminate a trust's spendthrift provisions, either to protect the trust's assets from a beneficiary's creditors, or conversely, to facilitate an assignment of the trust property.[7] When used in this context, decanting may result in a change in beneficial interest.

Decanting further may provide a means to address changes in the law governing the administration or taxation of the trust.

2. Implementing Administrative Changes

A trustee may determine to decant in order to modify the administrative provisions of the trust, such as to provide for the succession, appointment or compensation of trustees[8] or to expand or limit investment powers. A trustee also may decant in favor of another trust in order to change a trust's governing law[9] and to modify the trust instrument to conform to the new applicable law. Changes in administrative provisions are not likely to affect the beneficial interests of the beneficiaries.

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[5] *See, e.g.,* Matter of Riese,164 Misc.2d 1028, 627 N.Y.S.2d 232 (Sur. Ct. New York County, 1995). In that case, the decanting extended the term of the trust to provide creditor protection for the beneficiary.

[6] *See, e.g.,* Estate of Grosjean, NYLJ December 10, 1997, p. 35, col. 6 (Sur. Ct. Nassau County), where a trustee was permitted to decant into a supplemental needs trust so that the beneficiary could qualify for government assistance.

[7] *See, e.g.,* Matter of Rockefeller. N.Y.L.J., 8/24/99, page 28, col. 2 (Sur. Ct. Nassau County) (decanting to a new trust to provide spendthrift protection); Matter of Kaskel 163 Misc.2d 203, 620 N.Y.S.2d 217 (Sur. Ct. N.Y. County, 1994) (decanting to a new trust without a spendthrift clause so as to permit a transfer of trust property).

[8] *See, e.g.,* Matter of Klingenstein, N.Y.L.J., 4/20/00, page 33, col. 6 (Sur. Ct. Westchester County) (decanting to modify the terms regarding trustees, including limitations on number of individual trustees, powers to remove and replace trustees, requirement for a corporate trustee and the designation of successor trustees).

[9] *See* Matter of Riese,164 Misc.2d 1028 (the trustees of irrevocable trusts subject to New York law were permitted to pay the trusts' assets to other trusts governed by Florida law).

3. Dividing and Combining Trusts

Decanting may enable a trustee to divide or segregate assets into separate trusts to address the different needs of each beneficiary, to employ different investment strategies[10] or to facilitate tax planning.[11] A trustee may decant assets from one trust to another to combine the assets and consolidate investments for ease of administration and to lower administrative costs.[12]

4. Modifying Tax Status

Decanting may result in a change of the income tax status of the trust, from a grantor trust governed by Subpart E of Subchapter J of Chapter 1 the Code,[13] to a complex trust, governed by Subparts B and C of Subchapter J.[14] The opposite result also may occur: the Distributing Trust may be a complex trust, while the Receiving Trust may be a grantor trust. A trustee also may decant so that a trust may qualify as an S corporation shareholder.[15]

C. Authority

1. Common Law

There are two possible bases, under common law principles, supporting the proposition that, under certain circumstances, a trustee has decanting power, even absent express authority granted in the governing trust instrument. One rationale is that a trustee with discretionary authority to make distributions of trust principal for the benefit of a trust beneficiary may exercise that authority by distributing trust principal in further trust for the benefit of that beneficiary.[16]

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[10] *See, e.g.*, In re Estate of Scheuer, NYLJ July 10, 2000 (Sur. Ct. N.Y. County.) (the trustees distributed the trust property to separate trusts for each beneficiary so that each beneficiary's trust could be managed separately, in accordance with the beneficiary's financial needs and investment objectives).

[11] For example, a trustee may wish to divide trust property into GST exempt and non-exempt shares if a trust has an inclusion ratio between zero and one. *See* IRC § 2642(a)(3) and Treas. Reg. § 26.2642-6, relating to qualified severances for GST tax purposes. In that case, the trustee may implement different investment and distribution strategies based on the anticipated estate or GST tax consequences for each trust.

[12] *See, e.g.*, Matter of Vetlesen, N.Y.L.J., 6/29/99, page 27, col. 3 (Sur. Ct., N.Y. County) (the trustee was permitted to combine two trusts and reduce trustee commissions).

[13] Unless indicated otherwise, all "Section" references are to the Internal Revenue Code of 1986, as amended (the "Code"), and all "Treas. Reg. §" references are to the Treasury regulations promulgated under the Code, both as in effect on the date of this Report.

[14] *See* IRC §§ 671-679 and IRC §§ 652 and 662. *See also* CCA 200923024, (conversion of non-grantor trust to grantor trust not a transfer for income tax purposes).

[15] *See* IRC § 1361(c)(2).

[16] *See* Priv. Ltr. Rul. 200530012 (Mar. 24, 2005) (the facts of the Private Letter Ruling disclose that a state court confirmed that a trustee's authority to distribute "to or for the benefit of" a beneficiary permitted a distribution to another trust for the same beneficiary).

The other rationale under common law is based, in part, on the theory that a trustee's power to distribute principal is akin to a special power of appointment.[17] It generally is accepted that a person holding a power of appointment may appoint to the fullest extent of the authority or to a lesser extent absent express prohibition in the trust instrument.[18] In other words, if there is authority to make an outright distribution to a beneficiary, there is authority to distribute in further trust for the benefit of such beneficiary. Admittedly, a trustee's distribution power is distinguishable from a traditional power of appointment: Powers of appointment generally are not subject to fiduciary duties, while the trustee's discretionary power to distribute is subject to fiduciary duties.[19] Nevertheless, the same rationale – a power that may be exercised to the fullest extent (outright) also may be exercised to a lesser degree (in further trust) – has been cited in support of the common law right to decant.[20]

Two reported cases have applied these principles in a fashion to support a trust decanting absent statutory authority. In *Phipps v. Palm Beach Trust Company*,[21] the trustee had sole discretion to sprinkle income and principal among the donor's descendants. The trustee exercised the power by distributing the trust property to a new trust. The Supreme Court of Florida approved the distribution, stating that "[a]n examination of the trust indenture in this case leaves no doubt of the power of the individual trustee to create the second trust provided one or more of the descendants of the donor of the original trust are made the beneficiaries."[22] In reaching this conclusion, the Florida Supreme Court relied on case law and the general rule that a "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."[23]

In *Wiedenmayer v. Johnson*,[24] the trustees of a trust for the settlor's son were directed "from time to time and whenever in their absolute and uncontrolled discretion they deem it to be for his best interests, to use for or to distribute and pay over to [the son] . . . to be his absolutely, outright and forever, any or all of the Trust Property."[25] The New Jersey court concluded that the trustees' "absolute and uncontrolled discretion" to distribute the Trust

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[17] RESTATEMENT (SECOND) OF PROP.: DONATIVE TRANSFERS § 11.1 cmt. d (1986).

[18] *See, e.g.,* In re Hart's Will, 262 A.D. 190, 28 N.Y.S.2d 781 (1941), In re Nicholas' Will, 284 A.D. 971, 134 N.Y.S.2d 809 (1954), aff'd 308 N.Y. 971, 127 N.E.2d 337 (1955); In re Reynal's Will, 58 Misc.2d 518, 296 N.Y.S.2d 158 (Sur.Ct.1968); In Re: the Trust for the Benefit of Elaine Johnson Wold 310 N.J. Super. 382, 708 A.2d 787 (1998).

[19] RESTATEMENT (THIRD) OF TRUSTS, § 50 ("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"). *See also* RESTATEMENT (THIRD) OF TRUSTS §§ 64 and 75.

[20] *See generally* William R. Culp, Jr. & Briani Bennett Mellen, *Trust Decanting: An Overview and Introduction to Creative Planning Opportunities*, 45 REAL PROP. TR. & EST. L. J. 1, 46 (2010); Halperin and O'Donnell *supra* note 4 at ¶ 1302.2.

[21] 142 Fla. 782 (1940).

[22] *Id*. at 786.

[23] *Id*. at 786.

[24] 254 A.2d 534 (N.J. Super. Ct. App. Div. 1969).

[25] *Id*. at 535.

Property to the son was limited solely by the trustees' determination that such distribution was for the son's "best interests."[26] Accordingly, in the face of opposition from the remaindermen of the son's original trust, the court stated: "If [the trustees] could make [a distribution for the son's best interests] to the end, as the trust indenture expressly stated, that the trust property would be the son's 'absolutely, outright and forever,' it seems logical to conclude that the trustees could, to safeguard the son's best interests, condition the distribution upon his setting up a substituted trust."[27]

2. Statutory Authority

Fifteen states have enacted decanting statutes. They are Alaska, Arizona, Delaware, Florida, Indiana, Kentucky, Missouri, Nevada, New Hampshire, New York, North Carolina, Ohio, South Dakota, Tennessee and Virginia.[28] In addition, in just the past few months, several other states have introduced decanting legislation, including Colorado, Illinois, Michigan and Rhode Island.

While the state statutes vary, they have common elements. The statutory provisions that may have relevance to the tax consequences of decanting are set forth below.

(a) Who May Exercise a Decanting Power

Each decanting statute specifies that the authority to decant is exercisable only by a trustee who has the authority to invade principal for the benefit of a trust beneficiary.[29] Certain states limit which trustees may exercise the decanting power. For example, under New York law, only an "authorized trustee" may exercise the power to decant. An authorized trustee is any trustee other than the grantor and any beneficiary to whom income or principal must be paid currently or in the future, or who is or will become eligible to receive a distribution of income or principal in the discretion of the trustee (other than by the exercise of a power of appointment held by another in a non-fiduciary capacity).[30] Most state decanting statutes further prohibit a trustee from exercising the decanting power in a fashion that would give rise to a general power of appointment.[31]

Under the South Dakota statute, restrictions also are placed on the ability to decant held by any trustee who is a beneficiary of the Distributing Trust or who has a power to

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[26] *Id*. at 535-36.

[27] *Id*. at 536.

[28] Virginia's decanting legislation was passed by the state senate on January 19, 2012 and signed into law by the Governor on April 4, 2012. *See* PROP. § 55-548.16:1 CODE OF VA SB 110. The Kentucky legislation was signed into law on April 11, 2012. *See* PROP. § 386 . KRS; HB 155.

[29] *See* AK STAT. § 13.36.157(a); A.R.S. § 14-10819; 12 DEL. C. § 3528(a); FLA. STAT. § 736.04117(1)(a); IC § 30-4-3-36; MO REV. STAT. § 456.4-419(1).

[30] *See, e.g.,* N.Y. EPTL ("EPTL") § 10-6.6(s)(2).

[31] *See, e.g.,* AK STAT. § 13.36.157(c); A.R.S. § 14-10819(C); 12 DEL. C. § 3528(c); EPTL § 10-6.6(s)(2); FLA. STAT. § 736.04117(3); IC § 30-4-3-36(d); MO REV. STAT. § 456.4-419(2)(a); N.C. GEN. STAT. § 36C-8-816.1(d); NEV. REV. STAT. § 163.556(3); NH REV. STAT. § 564-B:4-418(c); O.R.C. § 5808.18(E); S.D. CODIFIED LAWS § 55-2-15(2)(a). *See also* IRC §§ 2041 and 2518 (regarding general powers of appointment).

change the Trustees.[32] Similarly, Missouri law prohibits the following trustees from participating in a decanting: any trustee who is a beneficiary or who may remove any other trustee and designate as a successor trustee a person who is related or subordinate to him or her, within the meaning of Section 672(c).[33]

(b) Fiduciary Duties

While all decanting powers are exercised by trustees, and therefore are presumably subject to fiduciary duties, some states expressly set forth a standard of care governing the trustee's exercise of the decanting power.[34] The New York statute, for example, provides that the trustee has a "fiduciary duty to exercise the power in the best interests of one or more proper objects of the exercise of the power and as a prudent person would exercise the power under the prevailing circumstances."[35] Additionally, Ohio provides that a trustee "who acts reasonably and in good faith in exercising [the decanting power] is presumed to have acted in accordance with the terms and purposes of the [Distributing Trust] and the interests of the beneficiaries."[36]

(c) Authority to Invade Principal

Under all decanting statutes, in order to decant, the trustee must have discretion to invade principal in favor of one or more of the trust beneficiaries. Certain states permit decanting only if the trustee has unlimited authority to invade principal.[37] Alaska, Delaware and Tennessee permit a trustee to decant even if the principal invasion power is limited by a standard.[38] Similarly, under the New York statute, a trustee with unlimited discretion to invade principal can decant in favor of one, more than one or all of the trust beneficiaries and may exclude one or more beneficiaries.[39] A trustee who does not have unlimited discretion also may decant, so long as the Receiving Trust has the same beneficiaries and the same restrictions on distributions.[40]

[32] S.D. CODIFIED LAWS § 55-2-15.

[33] MO REV. STAT. § 456.4-419(2).

[34] *See, e.g.*, EPTL § 10-6.6(h); 12 DEL. C. § 3528(e).

[35] EPTL § 10-6.6(h).

[36] O.R.C. § 5808.18(I).

[37] *See, e.g.,* FLA. STAT § 736.04117(1)(a). Under the Florida statute, a power to invade principal for the "best interests, welfare, comfort or happiness" of a beneficiary qualifies as an "absolute power," so long as it is not limited to specific or ascertainable purposes.

[38] *See* AK STAT. § 13.36.157; 12 DEL. C. § 3528; TENN. CODE ANN. § 35-15-816(b)(27). Under Delaware's decanting statute, the trustee's exercise of the decanting power must conform with any standard imposed by the Distributing Trust. 12 DEL. C. § 3528(a)(5).

[39] EPTL § 10-6.6(b) and (c). For purposes of the statute, the term "unlimited discretion" means the authority to distribute principal that is not modified in any way. Terms directing that distributions be made for the beneficiary's best interests, welfare, comfort or happiness are not considered modifications on the trustee's authority to distribute principal.

[40] If the Receiving Trust extends the term of the trust beyond the term of the Distributing Trust, the Receiving Trust may grant the trustee unlimited discretion to invade principal during the extended period of the term. EPTL § 10-6.6(c)(2).

South Dakota law permits a trustee to decant income or principal in favor of one or more of the trust beneficiaries.[41] While the trustee may decant even if the trustee's discretion to pay income and/or principal is limited to a standard, the trustee must take into account various factors, including: whether the appointment is necessary or desirable after taking into account the purposes of the Distributing Trust, the terms and conditions of the Receiving Trust, and the consequences of the distribution.[42]

(d) Adding or Excluding Beneficiaries

All of the state statutes require that the authority to decant be exercised in favor of one or more of the beneficiaries of the Distributing Trust. As a result, in no event may a trustee decant in favor of a person who is not a beneficiary of the Distributing Trust.[43] The New York statute specifies that a trustee with unlimited power to invade principal may exclude one or more beneficiaries of the Distributing Trust and although other statutes do not refer specifically to exclusion, the ability to decant in favor of one or more (but not all) of the permissible beneficiaries necessarily includes a power to exclude.[44]

(e) Preserving Fixed Income Rights and Withdrawal Powers

New York, Alaska, Arizona, Florida, Indiana, Nevada and Tennessee do not permit a trustee to reduce a beneficiary's fixed income interest in the Distributing Trust.[45] The Delaware, Missouri, and South Dakota statutes provide similar protection but only in the case of certain trusts, such as a trust for which a marital deduction had been taken for federal estate or gift tax purposes, a charitable remainder trust or a grantor retained annuity trust.[46]

Certain states such as Delaware, Nevada, New York, North Carolina and South Dakota have specific provisions that address a beneficiary's withdrawal power over the Distributing Trust. Under Delaware, Nevada and South Dakota law, a decanting may eliminate a beneficiary's right of withdrawal over trust property as long as the right of withdrawal is not presently exercisable.[47] North Carolina law, however, provides that if a beneficiary has a power of withdrawal over trust property in the Distributing Trust, the terms of the Receiving Trust must provide the beneficiary with an identical right of withdrawal.[48]

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[41] S.D. CODIFIED LAWS § 55-2-15.

[42] *Id.*

[43] A trustee's ability to decant in favor of a trust that grants a beneficiary a power of appointment does not constitute a power to add beneficiaries. *See infra*, Section I(C)(2)(h) of this Report.

[44] EPTL § 10-6.6(b).

[45] AK STAT. §13.36.157(a)(1); A.R.S. § 14-10819(A)(1); EPTL § 10-6.6(n)(1); FLA. STAT. § 736.04117(1)(a)(2); IC § 30-4-3-36; NEV. REV. STAT. 163.556; TENN. CODE ANN. § 35-15-816(B)(27)(a).

[46] 12 DEL. C. § 3528(3); MO REV. STAT. § 456.4-419(1); S.D. CODIFIED LAWS § 55-2-15(6). *See* IRC §§ 2056, 2523, 664 and 2702.

[47] *See, e.g.,* 12 DEL. C. § 3528(a)(4).

[48] N.C. GEN. STAT. § 36C-8-816.1.

(f) Preserving Other Tax Benefits

Many state statutes prohibit the exercise of the decanting power in a manner that will jeopardize tax benefits inherent in the Distributing Trust. For example, the Arizona statute contains a broad limitation.[49] Under Arizona law, the decanting power may not be exercised if the decanting adversely affects the tax treatment of the trust, the trustee, the settlor or the beneficiaries.[50] Other state statutes are more specific. For example, under the Florida statute, a decanting power may be exercised with respect to a Distributing Trust that qualified for the marital or charitable deduction for federal tax purposes only if the Receiving Trust does not contain any provision that would have prevented the Distributing Trust from qualifying for such deduction or would have reduced such deduction if such provision were included in the Distributing Trust.[51]

In addition, many of the state decanting statutes require that, if contributions to the Distributing Trust qualified for the annual gift tax exclusion under Section 2503(b) based on the trust's qualification under Section 2503(c), the Receiving Trust must provide that the beneficiary's remainder interest in the trust must vest no later than the date upon which such interest would have vested under the terms of the Distributing Trust.[52]

Some state statutes have similar savings language to preserve the tax status of the Distributing Trust as a qualified S corporation shareholder under Section 1361,[53] and the qualification of a transfer as a direct skip under Section 2642(c).[54]

(g) Extending the Term of the Trust

Some state statutes expressly authorize extending the trust term by decanting.[55] In most cases, the exercise of the decanting power may not violate the rule against perpetuities as measured by reference to the Distributing Trust.[56] Although decanting in a manner that extends the trust term may be prohibited, decanting from a perpetual Distributing Trust to a perpetual Receiving Trust is permitted, so long as the law governing the Receiving Trust authorizes perpetual trusts.

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[49] A.R.S. § 14-10819(A)(5).

[50] *Id.*

[51] FLA. STAT. § 736.04117(1)(a)(3). Similar provisions exist under the decanting statutes in Delaware, Indiana, Missouri, Nevada, New Hampshire, New York, North Carolina, Ohio and South Dakota. *See* 12 DEL. C. § 3528(3); EPTL § 10-6.6(n)(5); IC § 30-4-3-36(a)(3); MO REV. STAT. § 456.4-419.2(5); NEV. REV. STAT. 163.556(2)(c); NH Rev. Stat.§ 564-B:4-418(b)(3); N.C. GEN. STAT. § 36C-8-816.1(c)(4); O.R.C. § 5808.18(C)(2); S.D. CODIFIED LAWS § 55-2-15(6)(a).

[52] *See, e.g.*, 12 DEL. C. § 3528(a)(2); MO REV. STAT. § 456.4-419.2(4);); NEV. REV. STAT. 163.556(2)(h).

[53] *See, e.g.*, O.R.C. § 5808.18(C)(4);

[54] *See, e.g.*, EPTL § 10-6.6(n)(5).

[55] *See, e.g.*, EPTL § 10-6.6(e).

[56] *See, e.g.*, AK STAT. 13.36.157(a)(3); FLA. STAT. § 736.04117(1)(b)(3); N.C. GEN. STAT. § 36C-8-816.1(e)(2).

(h) Granting Powers of Appointment

Absent a prohibition under state law or the governing instrument of the Distributing Trust, a trustee with decanting authority generally may decant in favor of a Receiving Trust that grants a beneficiary a power of appointment, whether presently exercisable or in the future, and regardless of whether such a power existed in the Distributing Trust. In addition, the class of appointees in the Receiving Trust may extend beyond the class of permissible beneficiaries of the Distributing Trust. Since the decanting power itself is treated as a power of appointment under state statutory law (and under analogous common law principles), the same rules applicable to powers of appointment provide a framework for the legal analysis.

The donee of a power of appointment may exercise the power only within the permitted scope and may not exercise the power in favor of someone who is not within the class of permissible appointees. For example, the power to appoint among the grantor's descendants does not authorize appointment in trust for the life of a child, with the remainder to charity, because charity is not included in the permissible class of appointees.[57] Nevertheless, since a donee of a power of appointment may appoint the trust property outright to a beneficiary (who is within the permissible class), the donee also may exercise the power of appointment in a more limited fashion. For example, if the power is limited in favor of the grantor's descendants, the donee of the power of appointment may appoint in further trust for the life of a child, while granting the child with a testamentary power of appointment exercisable in favor of descendants and charity.[58] The reason is that, if the donee could have appointed the property outright in favor of the child, the child could be given rights that fall short of outright ownership.

In light of the foregoing, if the trustee has broad discretion to distribute outright to a beneficiary, such trustee should have the authority to decant in favor of a trust for the beneficiary, while granting that beneficiary a power of appointment (even if the class of permissible appointees extends beyond the beneficiaries of the Distributing Trust). To be clear, the decanting (with the grant of a power of appointment) is not the equivalent of expanding the class of beneficiaries of the Distributing Trust. Rather it is consistent with the exercise of the decanting power in favor of the beneficiary (who is granted the power of appointment).

Several statutes recognize this principle.[59] New York's statute distinguishes between the scope of the power of appointment which may be granted by a trustee of a Distributing Trust who has unlimited discretion to invade trust principal, and a trustee who has limited discretion. A trustee with unlimited discretion may grant either (i) a broad power of appointment in favor of a virtually unlimited class of appointees, which may exclude as permissible appointees one or more of the beneficiary, the grantor, the grantor's spouse, or the estates, creditors or creditors of the estates of the beneficiary, grantor or grantor's spouse or (ii) a power of appointment identical to any power of appointment held by the beneficiary under the

[57] *See* In re Fiske, 88 N.Y.S. 2d 446 (Sur. Ct. N.Y. County 1949); Halperin and O'Donnell, *supra* note 4, at ¶1303.1.

[58] *See* In re Hatch (Moore), 493 N.Y.S.2d 924 (N.Y. Sup. Ct. 1985); Halperin and O'Donnell, *supra* note 4, at ¶1303.1.

[59] *See* EPTL § 10-6.6(b)(1); N.C. GEN. STAT. § 36C-8-816.1(c)(8); NEV. REV. STAT. § 163.556.5; 12 DEL. C. § 3528(a); O.R.C. § 5808.28(A)(3)(a).

Distributing Trust.[60] In the case of a decanting by a trustee with limited discretion, if a beneficiary holds a power of appointment under the Distributing Trust, an identical power of appointment must be provided for the beneficiary under the Receiving Trust.[61]

(i) Accelerating Interests

State statutes generally prohibit against the acceleration of remainder interests as a result of decanting.[62] The South Dakota statute, in contrast, authorizes a trustee to exercise the decanting power in favor of one or more beneficiaries of the Distributing Trust "to or for whom a distribution of income or principal may be made in the future from the [Distributing Trust] or at a time or upon the happening of an event specified under the [Distributing Trust]."[63] Therefore, the trustee presumably may include a beneficiary with no current beneficial interest in the Distributing Trust as a current beneficiary of the Receiving Trust.[64] Accelerating the interests of a future beneficiary would constitute a shift in the trust's beneficial interests.

(j) Judicial Authorization and Beneficiary Consent

Some states such as Arizona, Nevada, New York and North Carolina permit, but do not require, a trustee to seek judicial approval for a decanting.[65] With one exception, no decanting statute requires prior court or beneficiary consent. The one exception is Nevada, which requires a trustee to secure a beneficiary's consent in circumstances where the trustee eliminates or limits a beneficiary's interest in the Distributing Trust.[66]

(k) Notice Requirements

New York, Florida, Indiana, Missouri, North Carolina and Ohio require that notice of the decanting be given to the persons interested in the trust. The New York and Ohio statutes require that the interested parties be given 30 days' notice,[67] while Florida, Indiana, Missouri and North Carolina require 60 days' notice.[68] The notice period gives beneficiaries an opportunity to object to the trustee's exercise of its power to decant.

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[60] *See* EPTL § 10-6.6(b)(2) and (3).

[61] *See* EPTL § 10-6.6(c)(4).

[62] *See* N.C. GEN. STAT. § 36C-8-816.1(c)(2). *See also*12 DEL. C. § 3528(a)(1); EPTL § 10-6.6(h); TENN. CODE ANN. § 35-15-816(B)(27)(a).

[63] S.D. CODIFIED LAWS § 55-2-15(1).

[64] If the grantor is living, the power to accelerate an individual's beneficial interest may render the trust a grantor trust for income tax purposes. *See* IRC § 674.

[65] A.R.S. 1.10819(D); NEV. REV. STAT. § 163.556(4) (2009); EPTL §10-6.6(j)(1); N.C. GEN. STAT. § 36C-8-816.1(b).

[66] NEV. REV. STAT. § 163.556(2)(e).

[67] EPTL § 10-6.6(j)(2); O.R.C. § 5808.18(F).

[68] FLA. STAT. § 736.04117(1)(b)(4); IC § 30-4-3-36 (e); MO REV. STAT. § 456.4-419(3); N.C. GEN. STAT. § 36C-8-816.1(f)(2).

New York also requires notice be given to the grantor of the Distributing Trust and any person with the right to remove or replace the trustee of the Distributing Trust.[69]

D. Existing Treasury Regulations Dealing With Trust Decanting

Existing regulations and Code provisions, in limited instances, deal expressly with decanting. For example, the GST regulations provide that, under certain circumstances (discussed in greater detail below), the distribution of trust principal "from an exempt trust to a new trust or retention of trust principal in a continuing trust" will not cause the new or continuing trust to be subject to the provisions of chapter 13.[70] Section 2653(b), which provides the rule for determining the inclusion ratio of property transferred in trust, includes a special rule for transfers from one trust to another trust (referred to therein as the "pour over trust").[71]

Another example is found in the Treasury Regulations under Section 671, with respect to the identity of the grantor of a trust for income tax purposes. Under that regulation, if a trust makes a transfer to another trust, the grantor of the first trust generally will be treated as the grantor of the Receiving Trust.[72]

II. SUMMARY OF RECOMMENDATIONS

Given the increasing authority to decant, both in trust documents and under state statutes, we offer this Report to suggest a comprehensive, consistent analysis of the tax consequences. While the focus of our analysis (as requested by the Notice) is on situations where the beneficial interests in the Distributing and Receiving Trusts are different, we also address situations where the beneficial interests remain the same. This Section of the Report summarizes our recommendations.

A. Income Tax

Regardless of whether a trust decanting is considered an exercise of a power of appointment in a fiduciary capacity or a form of a trust distribution, we recommend that the Internal Revenue Service (the "Service") confirm that the general rules of Subchapter J apply when a trustee decants assets from a Distributing Trust to a Receiving Trust. We further recommend that, consistent with existing private letter rulings, the Service confirm that, when the Distributing and Receiving Trusts have substantially similar terms and the Receiving Trust receives all of the Distributing Trust assets, the Receiving Trust should be considered a continuation of the Distributing Trust for income tax purposes. In such a case, the trust decanting should be considered a non-event for income tax purposes; accordingly, the distribution to the Receiving Trust should not carry out distributable net income (or undistributed net income if the Distributing Trust is a foreign trust); nor should it lead to a recognition event if the distribution involves encumbered property with debt in excess of basis (or a partnership interest with a

[69] EPTL § 10-6.6(j)(2).

[70] Treas. Reg. § 26.2601-1(b)(4)(i)(A). *See also* Treas. Reg. § 26.2601-1(b)(4)(i)(E), Ex. 2.

[71] IRC § 2653(b)(2).

[72] Treas. Reg. § 1.671-2(e)(5).

negative capital account). We recommend that the Service confirm in such cases that the Receiving Trust may continue to use the taxpayer identification number of the Distributing Trust. We further recommend that the Service confirm that, even where the Distributing and Receiving Trusts are not substantially similar, all of the tax attributes of the Distributing Trust carry over to the Receiving Trust if the Distributing Trust decants all of its assets.

Additionally, we recommend that the Service confirm that, so long as the trust decanting is permitted under the governing document or applicable law, the beneficiaries do not recognize gain upon a trust decanting, except in the specific case where (i) the beneficial interests in the Distributing and Receiving Trusts vary materially *and* (ii) the beneficiaries must consent to the decanting under the trust agreement or applicable law. We also recommend that the Service confirm that, as a general matter, the Distributing Trust does not recognize gain or loss upon a distribution to a Receiving Trust.

One exception may involve a distribution of encumbered property with debt in excess of basis or a partnership interest with a negative capital account (other than a distribution from one grantor trust to another grantor trust deemed wholly owned by the same grantor). We recommend that the same principles that apply to outright distributions apply to distributions in further trust. Accordingly, gain recognition upon the distribution of such property should depend on whether *Crane v. Comm'r* and its progeny override Section 643(e); given the uncertainty on this question, if the Service concludes that gain should be recognized, we recommend that the rule apply only on a prospective basis. In any event, no gain should arise on a transfer from a Distributing Trust to a Receiving Trust that qualifies as a continuation of the Distributing Trust for income tax purposes.

Further, consistent with Treas. Reg. § 1.671-2(e)(5), we recommend that forthcoming guidance from the Service confirm that, for income tax purposes, the grantor of a Distributing Trust should be considered the grantor of the Receiving Trust.

Finally, we recommend that the Service confirm that neither the authority to decant nor the exercise of the decanting power will jeopardize the income tax charitable deduction that otherwise would be available to the grantor of the Distributing Trust so long as the decanting cannot defeat the rights of the charitable beneficiary in the Distributing Trust that give rise to the charitable deduction. In addition, the Service should confirm that, for purposes of the charitable deduction under Section 642(c), payments made from a Receiving Trust to charity upon a beneficiary's exercise of a power of appointment shall be deemed to be "pursuant to the terms of the governing instrument," so long as the granting of the power of appointment is valid under applicable law, even if no such power of appointment existed in the Distributing Trust.

B. Gift Tax

We recommend that, where the trustee of the Distributing Trust has no beneficial interest in the Distributing Trust, or the beneficial interests are limited to an ascertainable standard, a trust decanting should not give rise to a taxable gift, even where there is a shift of a beneficial interest.

We further recommend that, unless the beneficiary also is a trustee participating in the decanting decision or such beneficiary's consent is required for a decanting which reduces his or her beneficial interest, the beneficiary will not be deemed to have made a taxable gift when the trustee exercises the power to decant trust assets.

We also recommend that the Service confirm that there is no taxable gift upon a decanting from a Distributing Trust that is a non-grantor trust for income tax purposes to a Receiving Trust that is a grantor trust. The Service should also confirm that the provisions of Section 2514(d) do not apply to the exercise of a trustee's decanting power so long as the trustee has no beneficial interest in the Distributing Trust.

Finally, we recommend that the Service confirm that neither the authority to decant nor the exercise of the decanting power will jeopardize any marital deduction, charitable deduction or annual exclusion that is otherwise available to the grantor of the Distributing Trust for gift tax purposes so long as the decanting cannot defeat the rights of the relevant beneficiaries in the Distributing Trust that give rise to such deduction or exclusion.

C. Estate Tax

We recommend that the Service confirm that, unless the grantor has retained the power to participate in the exercise of the decanting power, the trustee's exercise of a trust decanting power does not cause estate tax inclusion with respect to the grantor. We further recommend confirmation that the provisions of Section 2041(a)(3) do not apply to the trustee's exercise of a decanting power.

Finally, we recommend that the Service confirm that neither the authority to decant nor the exercise of the decanting power will jeopardize the marital deduction or charitable deduction available for estate tax purposes with respect to the assets of the Distributing Trust so long as the decanting cannot defeat the rights of the relevant beneficiaries that give rise to such deduction.

D. Generation Skipping Transfer Tax

We recommend that, for GST tax purposes, in the case of a decanting of the entire trust, the tax attributes of the Receiving Trust flow from the Distributing Trust. Accordingly, we recommend that the Service confirm that, in identifying the transferor of the Receiving Trust in order to determine whether a GST event has occurred, the person who is the transferor of the Distributing Trust for GST tax purposes also be considered the transferor of the property transferred to the Receiving Trust, unless the decanting triggers a gift or estate tax. Where less than the entire Distributing Trust is decanted, no GST tax should be triggered with respect to any property that remains in the Distributing Trust by virtue of the decanting alone.

We further recommend that the Service confirm that the conversion of a Grandfathered Trust that is a complex trust (for income tax purposes) to a grantor trust does not taint GST exempt status.

We also recommend that Service clarify that the two safe harbors rules applicable to decanting Grandfathered Trusts apply, with certain modifications, to a trust that is exempt

from GST tax as a result of an allocation of GST exemption. With respect to the first safe harbor, we recommend that a modification of a trust to which the transferor's GST exemption was allocated should not taint GST exempt status if (1) either (i) authority exists under the trust instrument permitting a trustee to appoint in further trust without the consent or approval of any beneficiary or court, or (ii) applicable state law permits such a distribution, irrespective of whether the law so permitted at the time that the Distributing Trust became irrevocable; and (2) the terms of the Receiving Trust do not extend the time for vesting of any beneficial interest in the trust beyond 21 years plus lives in being at the date the Distributing Trust became irrevocable. If the Distributing Trust has a term that may extend beyond the common law rule against perpetuities, a decanting to a Receiving Trust with a term that may also extend beyond the common law perpetuities period will also not taint GST exempt status because the term applicable to the assets received from the Distributing Trust will not have been extended.

The Service's guidance further should confirm that with respect to a trust to which the GST tax does not apply because it was created by an individual who is neither a US citizen nor resident and funded in a fashion which was not subject to US estate or gift tax, a decanting should not affect the exempt status, even if the perpetuities period is extended or there are other changes in beneficial interests.

We further request that the Service issue guidance concerning the future application of the GST tax with respect to an exempt trust that loses its exempt status as a result of a decanting. In this regard, we recommend that the taint result in an inclusion ratio of one for the trust and that the GST tax consequences be applied prospectively. For purposes of ascertaining the identity of the transferor (to determine whether future GST events occur), the rules under Chapter 13 should be applied to the trust from inception.

Finally, we recommend that the Service confirm that a decanting will not jeopardize the zero inclusion ratio of a Distributing Trust that qualifies under Section 2642(c), so long as the decanting cannot defeat those rights of the Distributing Trust's beneficiary that are necessary for the Distributing Trust's qualification for a zero inclusion ratio under Section 2642(c).

III. INCOME TAX ISSUES

The exercise of a power by a trustee to distribute assets from a Distributing Trust to a Receiving Trust raises several income tax questions.[73] The questions concern the fiduciary income tax consequences of such a distribution, the potential gain recognition by the beneficiaries of the Distributing Trust or by the Distributing Trust itself, and the identity of the grantor following the distribution. Trust decanting also raises questions relevant to the charitable deduction rules for both individuals and trusts.

[73] Similar income tax questions may arise if a beneficiary exercises a power to appoint assets from a Distributing Trust to a Receiving Trust in a non-fiduciary capacity.

A. Fiduciary Income Tax Consequences

1. General Treatment as a Distribution

Under the rules of Subchapter J of Chapter 1 of the Code, a distribution from a complex trust generally will carry out a share of the trust's distributable net income, or DNI, to the beneficiary to whom the distribution is made.[74] The beneficiary, in turn, generally will be required to include in gross income an amount equal to the share of the DNI carried out from the trust.[75] If the trust making the distribution is a foreign trust, the distribution also may carry out a share of the trust's undistributed net income, or UNI, which will be includible by the beneficiary, subject to an interest charge.[76]

There does not appear to be any express authority that specifically provides that the rules of Subchapter J apply to a decanting distribution from a Distributing Trust to a Receiving Trust. However, the Treasury Regulations and case law indicate that a trust can be a beneficiary of another trust, with the rules of Subchapter J applicable to a distribution to the beneficiary trust.[77] As a general rule, we believe that it is appropriate for the rules of Subchapter J to apply to a decanting distribution from one trust to another trust.[78] This result is appropriate, in our view, whether the trust decanting is viewed as an exercise of a power of appointment (in a fiduciary capacity) or a trust distribution.

2. Exception for Substantially Similar Trusts

An exception to this general rule, however, may be appropriate in a situation where all of the assets of a Distributing Trust are distributed to a Receiving Trust having substantially similar terms. In our view, the Distributing and Receiving Trusts should be deemed to have substantially similar terms if the trusts have the same beneficiaries, standards for distributions and timing for payments. In such a case, it is reasonable to view the Receiving Trust as a continuation of the Distributing Trust. Accordingly, the distribution to the Receiving Trust should not carry out DNI (or UNI if the Distributing Trust is a foreign trust) but rather

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[74] IRC § 661.

[75] IRC § 662.

[76] IRC §§ 665-668.

[77] *See* Treas. Reg. § 1.643(c)-1, which provides that for purposes of Part I of Subchapter J (which includes the fiduciary income tax rules described above), a beneficiary includes an heir, legatee or devisee (*including an estate or trust*) (emphasis added). *See also* Duke v. Comm'r, 38 BTA 1264, 1269 (1938); Comm'r v. Bishop Trust Co., 136 F2d 390 (9th Cir. 1943), aff'g 42 BTA 1309 (1940); Harwood Estate v. Comm'r, 3 TC 1104 (1945) ; White Estate v. Comm'r, 41 BTA 525 (1939); Lynchburg Tr. & Sav. Bank v. Comm'r, 68 F2d 356 (4th Cir. 1934).

[78] In contrast, if a trust is divided pursuant to the terms of a trust agreement or applicable state law, DNI will not be carried out pursuant to the rules of Subchapter J. Rather, each trust resulting from the division will receive a pro rata portion of the original trust's DNI.

should be treated as a non-event for income tax purposes.[79] This result is consistent with the conclusion reached by the Service in *Private Letter Ruling* 200607015 (February 17, 2006).[80]

We further believe that the foregoing treatment of the Receiving Trust as a continuation of the Distributing Trust should apply whether the decanting involves all of the assets of the Distributing Trust or all of the assets other than any assets distributed to a beneficiary of the Distributing Trust contemporaneously with the decanting.[81]

Further, in this limited circumstance, the Receiving Trust should be permitted to use the taxpayer identification number of the Distributing Trust.

3. Succeeding to the Distributing Trust's Tax Attributes

If all of the assets of a Distributing Trust are distributed to one or more Receiving Trusts, there also is a question as to whether the Receiving Trust or Trusts should succeed to the Distributing Trust's tax attributes, such as its net operating loss carryovers, its capital loss carryovers and its foreign tax credit carryovers. The Code specifically provides that on the termination of a trust, any unused net operating loss carryovers and capital loss carryovers pass out to the trust's beneficiaries.[82] There does not appear to be any specific authority addressing the transfer of other tax attributes to beneficiaries upon the termination of a trust. At a minimum, in the case of a decanting treated as a continuation of the Distributing Trust, the Receiving Trust should succeed to all of the Distributing Trust's tax attributes.[83] We further believe that a Receiving Trust should succeed to the tax attributes of a Distributing Trust even if the terms of the trusts are not substantially similar.

4. Decanting a Foreign Trust in Favor of a Domestic Trust

Under Subchapter J, a distribution from a foreign trust to a US person of accumulated income generally will carry out the foreign trust's UNI, including an additional interest charge for the deemed period of the accumulation. In addition, accumulated capital

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[79] We believe the same result — a non-event for income tax purposes — would follow when encumbered property with debt in excess of basis (or a partnership interest with a negative capital account) is distributed from one trust to another trust in which the substantive provisions remain the same.

[80] *See also* Priv. Ltr. Rul. 200723014 (June 8, 2007) and Priv. Ltr. Rul. 200527007 (July 8, 2005).

[81] In such a case, the distribution to the beneficiary will carry out all of the Distributing Trust's DNI (limited to the amount of the distribution). By comparison, if the decanting also were treated as a distribution, each of the beneficiary and the Receiving Trust would receive a pro-rata share of Distributing Trust's DNI. Our recommendation is consistent with the tax treatment of a complete decanting, followed by a distribution to the beneficiary.

[82] IRC § 642(h); Treas. Reg. § 1.642(h)-3(d).

[83] We believe that a Receiving Trust should succeed to the tax attributes of a Distributing Trust even if the terms of the trusts are not substantially similar. This result is consistent with other areas of the tax law. For example, if a private foundation transfers all of its assets to one or more private foundations that are effectively controlled by the same persons that control the transferor private foundation, the transferee private foundation is treated as if it were the transferor for purposes of Chapter 42 of the Code. *See* Treas. Reg. § 1.507-3(a)(9).

gains are recharacterized as ordinary income.[84] These rules are commonly referred to as the "throwback rules."[85] The throwback rules generally should apply to a decanting from a foreign Distributing Trust to a domestic Receiving Trust under the general premise that a decanting should be treated as a trust distribution. We recommend that an exception should apply in the case of a decanting treated as a continuation of the foreign Distributing Trust.[86] Under those circumstances, for the reasons discussed earlier, the Receiving Trust should be viewed as a continuation of the Distributing Trust. The consequences in such a case should be the same as if the trust were domesticated without any change in terms (*e.g.,* by changing the identity of the trustee to a US person). Because domestication of a foreign trust in this manner is treated as a mere continuation of the trust, the throwback rules would not immediately apply. The Receiving Trust would instead inherit the tax attributes of the Distributing Trust, and the throwback rules would be triggered in the future upon a distribution from the Receiving Trust to a US person.[87]

With respect to a decanting treated as a distribution, the US Receiving Trust will be subject to the reporting requirements under Section 6048(c). Where the decanting is considered a continuation of the Distributing Trust, we assume that the same reporting requirements will continue to apply to the Receiving Trust so that the Service will be on notice of the transfer. We ask that the Service confirm this point.

B. Gain Recognition

In many Private Letter Rulings, the Service has addressed whether a distribution from one trust to another trust causes gain to be recognized under Section 1001.[88] In considering possible gain recognition on such a distribution, there are two separate issues – first, whether gain should be recognized by the beneficiaries of the Distributing Trust, and second, whether gain should be recognized by the Distributing Trust itself.

1. Gain Recognition by Beneficiaries

As a general matter, gain or loss is realized under Section 1001 upon the conversion of property into cash or upon the exchange of property for other property that differs materially in either kind or extent.[89] In *Cottage Savings v. Comm'r*,[90] the US Supreme Court

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[84] *See* IRC § 643(a)(6)(C).

[85] *See* IRC §§ 665 – 668.

[86] *See, e.g.,* Henry Christensen III, INTERNATIONAL ESTATE PLANNING § 4.11[3] (2d ed. 2011); Robert C. Lawrence, INTERNATIONAL TAX & ESTATE PLANNING 7-153 (PLI 1996). Further support for this position is found in Section 665(c)(2)(A), which applies the throwback rules to, among other trusts, certain domestic trusts that were previously foreign trusts. If domestication itself triggered the throwback rules, it would not be necessary to apply such rules to domestic trusts with a foreign heritage.

[87] *See* Rev. Rul. 91-6, 1991-1 CB 89, where the Service noted that the transformation of a foreign trust into a domestic trust does not eliminate the then applicable 6 percent addition to tax on a foreign-based accumulation distribution.

[88] *See, e.g.*, Priv. Ltr. Rul. 200227020 (July 7, 2002), Priv. Ltr. Rul. 9450036 (Dec. 16, 1994) and Priv. Ltr. Rul. 9332014 (May 14, 1993).

[89] *See* Treas. Reg. § 1.1001-1(a).

adopted an expansive view of when property received in an exchange would be considered to be materially different from the property transferred. The Court determined that "properties are 'different' in the sense that is 'material' to the Code so long as their respective possessors enjoy legal entitlements that are different in kind or in extent."[91]

A number of Private Letter Rulings released after the *Cottage Savings* decision suggest, by implication, that a distribution from one trust to another might constitute a taxable exchange of an interest by each beneficiary of a Distributing Trust for an interest in a Receiving Trust if the beneficiary's new interest is "materially different" from its old interest.[92] In each of these rulings, the Service found that the beneficiary's interests in the two trusts were not materially different and therefore that the beneficiary did not recognize gain. We believe that even in a situation where a beneficiary's interests in a Distributing Trust and a Receiving Trust differ materially, a decision by a trustee to decant trust property should not result in gain recognition to the beneficiary. Unlike the holder of securities in *Cottage Savings*, a beneficiary of a trust that is decanted by a trustee has not exchanged any interest. Rather, the trustee has taken the action that causes the property to be distributed from the Distributing Trust to the Receiving Trust. No exchange by a beneficiary occurs if the trustee's actions are authorized by the governing instrument or state law.[93] This conclusion is not inconsistent with *Cottage Savings* because the beneficiaries' legal entitlements in the Distributing Trust include the right to have assets distributed to the Receiving Trust.[94]

Other Private Letter Rulings have been consistent with this view. These rulings indicate that a beneficiary will not recognize gain in the case of a distribution to another trust that is authorized by the trust instrument or by local law.[95] For example, in Private Letter Ruling 201134017, the Service stated that because the transfer of assets would be made under the authority granted to the special trustee under the express terms of the trust document, the beneficiaries would not acquire their interests in the new trust as a result of the exchange of their interests, and therefore, the proposed decanting would not result in realization of gain or loss by

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[90] 499 U.S. 554 (1991).

[91] *Id.* at 565.

[92] *See, e.g.*, Priv. Ltr. Rul. 201207001 (Feb. 17, 2012); Priv. Ltr. Rul. 201136014 (Sept. 9, 2011); Priv. Ltr. Rul. 199951028 (Sept. 28, 1999).

[93] *See* Priv. Ltr. Rul. 200135007 (Sept. 4, 2001). In that ruling, the Service stated that a partition did not result in an exchange because the trust beneficiaries "do not acquire their interest in the individual trusts as a result of an exchange of their interests in the trust, but rather by reason of the authority granted under the [state] law. There is no exchange of property here; instead, the trustee is merely exercising a right to divide the trust as allowed by state law."

[94] *See also* Treas. Reg. § 1.1001-3(c)(1)(ii), which provides that an alteration of a legal right or obligation that occurs pursuant to the terms of a debt instrument generally is not a modification of the instrument that will cause recognition under Section 1001, whether the alteration occurs automatically by operation of the terms of the debt instrument or whether it occurs as a result of the exercise of an option provided to an issuer or a holder to change the terms of the instrument.

[95] *See, e.g.*, Priv. Ltr. Rul. 201204001 (Jan. 27, 2012), Priv. Ltr. Rul. 201133007 (Aug. 19, 2011); Priv. Ltr. Rul. 201134017 (Aug. 26, 2011).

either the trust or any beneficiary.[96] These rulings also are consistent with Treas. Reg. § 1.1001-1(h), which provides that a non-pro rata severance of a trust does not constitute an exchange of property for other property differing materially either in kind or extent if applicable state law or the governing instrument authorizes the severance and the non-pro rata funding.

We recognize, however, that in cases where the decanting could not be achieved in accordance with the trust instrument or state law without the consent of the beneficiary and the beneficiary's interests in the Receiving Trust differ materially from that of the Distributing Trust, then gain may be recognized by the beneficiary who affirmatively consented to the change.[97] This position is consistent with Revenue Ruling 69-486,[98] which ruled that a distribution may result in gain recognition to a beneficiary in a narrow set of circumstances, specifically where the distribution (i) occurs as a result of an agreement by the beneficiaries and, in addition, (ii) is not authorized under the terms of governing instrument or applicable state law. Accordingly, based on Revenue Ruling 69-486, if a beneficiary must consent in order for the trustee to decant, gain might be recognized if the beneficiary's interests in the Distributing and Receiving Trusts are materially different.[99]

On the other hand, so long as beneficiary consent is not required under the trust instrument or applicable law, provided the decanting is authorized and effectuated by a non-beneficiary trustee, the beneficiary should not recognize gain even if the beneficial interests in the Distributing and Receiving Trusts materially differ.

2. Gain Recognition by the Distributing Trust

There also is a question as to whether a Distributing Trust recognizes gain when appreciated trust assets are distributed to a Receiving Trust. We believe that, as a general matter, there should be no gain recognized by a Distributing Trust in such a situation.

If both the Distributing Trust and the Receiving Trust are grantor trusts deemed owned by the same person for income tax purposes,[100] no gain should be recognized on the distribution based on principles of Revenue Ruling 85-13.[101] In this Ruling, the Service

[96] Priv. Ltr. Rul. 201134017 (Aug. 26, 2011).

[97] *See* Zaritsky, Lane and Danforth, FEDERAL INCOME TAXATION OF ESTATES AND TRUSTS (WG&L) ¶ 2.19.

[98] 1969-2 CB 159.

[99] We note that a provision requiring that a beneficiary receive notice, or that requires approval by a court or other third party, should not be treated as a right to consent. Similarly, if the beneficiary releases the Trustee, upon a formal or informal accounting, with respect to the period during which the decanting occurred, such release should not be treated as the exercise of a consent right for these purposes. Court approval, however, may affect the GST tax consequences of an exempt trust. See Section VI(B)(2) of this Report.

[100] *See* IRC §§ 671-679.

[101] 1985-1 CB 184. In Revenue Ruling 85-13, the grantor of a trust acquired the corpus of the trust in exchange for the grantor's unsecured promissory note. The Service determined that the grantor was considered to have borrowed the corpus of the trust; consequently, the grantor was treated as the owner of the trust property under Section 675(3).

concluded that a transaction between a grantor and a trust deemed wholly owned by the grantor under Subchapter J does not give rise to a recognized event because the grantor is considered to own the trust assets for income tax purposes. The Service has cited this principle in concluding that a transaction between two grantor trusts, both of which are treated as wholly-owned by the same individual, does not give rise to a transfer for income tax purposes.[102]

Moreover, regardless of whether the Distributing Trust and the Receiving Trust are grantor trusts deemed owned by the same person, no gain should be recognized for the same reason that no gain is recognized when a settlor transfers property to a domestic non-grantor trust. There is no amount realized by the settlor, as the settlor is not considered to receive anything in exchange for the transfer. Nonrecognition treatment also is consistent with CCA 200923024 (June 5, 2009), which concludes that the conversion of a non-grantor trust to a grantor trust is not a transfer of property that requires gain to be recognized. And finally, the presence of Section 684 — described in the next paragraph — supports our conclusion that gain generally is not recognized upon a contribution to a (domestic) non-grantor trust. Section 684, which applies to transfers to foreign trusts, would not be necessary if gain generally were recognized on the transfer of assets to a non-grantor trust.

There are two possible exceptions to the general rule of nonrecognition on a transfer of appreciated property from one trust to another. The first such exception results from the application of Section 684. Under Section 684, if a US person transfers property to a foreign non-grantor trust, the transfer is treated as a sale or exchange for an amount equal to the fair market value of the property transferred, with the transferor recognizing gain. Accordingly, a distribution of appreciated assets from a Distributing Trust that is a domestic trust to a Receiving Trust that is a foreign non-grantor trust will result in gain recognition under Section 684.

A second possible exception to nonrecognition on a transfer of appreciated property from one trust to another (where the Distributing and Receiving Trusts are not both grantor trusts deemed wholly owned by the same grantor) may apply in a situation where the property that is transferred is encumbered with debt in excess of basis or is a partnership interest with a negative capital account. In such a case, gain may result based upon the principles of *Crane v. Comm'r*.[103] In *Crane*, the Supreme Court held that a taxpayer's amount realized includes recourse and nonrecourse liabilities from which the taxpayer is discharged.[104] Based on *Crane*, the Service has concluded in several instances that a termination of grantor trust status results in gain recognition if the trust holds property having liabilities in excess of basis or partnership interests with negative capital accounts.[105]

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[102] Rev. Rul. 2007-13, 2007-1 CB 684.

[103] 331 U.S. 1 (1947).

[104] *See also* Treas. Reg. § 1.1001-2(a)(1) ("the amount realized from a sale or other disposition of property includes the amount of liabilities from which the transferor is discharged as a result of the sale or disposition").

[105] *See, e.g.,* Treas. Reg. § 1.1001-1(e) (example 5) and Tech. Adv. Mem. 200010010 (March 13, 2000). *See also* Madorin v. Comm'r, 84 T.C. 667 (1985).

We have considered the interaction between *Crane* and its progeny, on the one hand, and Section 643(e), on the other hand. Section 643(e) provides that gain generally is not recognized on a distribution of appreciated property from a non-grantor trust. [106] There does not appear to be any authority as to the interplay of *Crane* and Section 643(e).[107] This uncertainty extends beyond decanting and exists generally where there is an outright trust distribution. We recommend that any forthcoming guidance from the Service address this point and treat trust decanting (except from a grantor trust which is not subject to Section 643(e)) and an outright distribution in a similar fashion. While we believe that existing authority could support either position, if the Service concludes that a distribution of encumbered property with debt in excess of basis (or a partnership interest with a negative capital account) from a non-grantor trust triggers gain, we recommend that such tax treatment be prospective. However, regardless of whether *Crane* overrides Section 643(e) in this context, if the Receiving Trust is treated as a continuation of the Distributing Trust or if both the Distributing and Receiving Trusts are grantor trusts deemed owned by the same person, gain should not be recognized on the distribution.

C. Identity of the Grantor

If property is distributed from one trust to another trust, it is important to be able to identify the "grantor" of the Receiving Trust. Among other reasons, identifying the grantor of the Receiving Trust may be important in order to determine whether the Receiving Trust is a grantor trust under Sections 671 through 679.

Treas. Reg. § 1.671-2(e)(5) provides that if a trust makes a transfer to another trust, the grantor of the Distributing Trust generally will be treated as the grantor of the Receiving Trust. An exception applies if property is distributed from a Distributing Trust to a Receiving Trust pursuant to the exercise of a general power of appointment. In such a case, the person exercising the power of appointment will become the grantor of the Receiving Trust. [108] This result is consistent with Section 2514, which provides that a person who exercises a general power of appointment will be treated as making a transfer of property for gift tax purposes.

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[106] Section 643(e) does not apply when the Distributing Trust is a grantor trust. This is because Section 643(e) applies for purposes of Subparts A, B, C and D of Part I of Subchapter J. The grantor trust rules are found in Subpart E of Part I of Subchapter J. Accordingly, in the case of a distribution of property encumbered with debt in excess of basis or a partnership interest with a negative capital account from a grantor trust to a non-grantor trust or to a grantor trust deemed owned by a different person, gain may be recognized under Section 1001.

[107] Under Section 643(e), gain is recognized on a distribution of appreciated property from a trust if an election is made to recognize gain under Section 643(e)(3) or if the distribution of appreciated property is made in satisfaction of a pecuniary amount. Section 643(e)(1) provides that "the basis of any property received by a beneficiary in a distribution from an estate or trust shall be (A) the adjusted basis of such property in the hands of the estate or trust immediately before the distribution, adjusted for (B) *any gain* or loss *recognized by the* estate or *trust on the distribution*" (emphasis added). It is not clear whether the basis increase in respect of gain recognized on the distribution relates only to a basis increase resulting from gain that is recognized as a result of the application of Section 643 (that is, because an election is made to recognize gain under Section 643(e)(3)).

[108] We believe that the foregoing income tax rules are correct and that similar principles should be applied to trust decanting for GST tax purposes.

D. Adding Beneficiaries

If state law or a decanting provision in the Distributing Trust instrument authorizes the Receiving Trust to include beneficiaries who were not included in the Distributing Trust, such a power would likely render the Distributing Trust a grantor trust for income tax purposes.[109] In that regard, with one exception, no state statute allows for the addition of beneficiaries.[110] Under South Dakota law, a trustee may accelerate the interest of a remainder beneficiary by decanting into a trust that provides such a beneficiary with a current interest. In addition, it is possible that future state statutes or provisions of the Distributing Trust instrument may permit the addition of beneficiaries. In cases where state law or the trust instrument permits the addition of beneficiaries, the decanting power will render the Distributing Trust a grantor trust for income tax purposes under Section 674 if the grantor is living. In contrast, if a beneficiary cannot be added – as in the case of every current decanting statute save one – the decanting authority itself will not trigger grantor trust status.

E. Charitable Deduction

1. Contributions to the Distributing Trust

An income tax charitable deduction is available to the grantor with respect to a contribution in trust in limited circumstances. For example, contributions to a trust where the remainder interest is in favor of a charity generally will give rise to an income tax deduction if the trust is a charitable remainder annuity trust or a charitable remainder unitrust (described in Section 664) or a pooled income fund (described in Section 642(c)(5)).[111] Where the charity has an income interest, contributions to the trust also will give rise to an income tax deduction if: (i) the charity's interest is in the form of a guaranteed annuity interest or a unitrust interest; and (ii) the donor is treated as the owner of the interest under the grantor trust rules.[112]

As mentioned earlier, most state statues specify that the decanting may not reduce the fixed income interest of a beneficiary of a charitable remainder or charitable lead trust.[113] Therefore, so long as the decanting authority may not alter the fixed rights that give rise to the charitable deduction, the authority to decant should not affect the income tax deduction with respect to the funding of the Distributing Trust. In contrast, if the instrument governing the Distributing Trust or state law permits a decanting that may change the charitable interest, no charitable deduction should be available to the taxpayer contributing to the Distributing Trust, even if the trustee does not exercise the decanting power. This is so because, under such limited circumstances, the underlying premise giving rise to the deduction – an ascertainable right ascribed to charity – is not present because it may be defeated. In that regard, we note that even where the Distributing Trust agreement and statutory law are silent, common law principles

[109] IRC § 674.

[110] A trustee's ability to decant in favor of a trust that grants a beneficiary a power of appointment does not constitute a power to add beneficiaries. *See infra*, Section I(C)(2)(h) of this Report.

[111] IRC § 170(f)(2).

[112] IRC § 170(f)(2)(B).

[113] See Section I(C)(2)(e) and (f) of this Report.

might constrain the authority to decant in a fashion that would defeat charity's interest.[114] In such cases, the authority to decant similarly should not affect the grantor's charitable deduction.

2. Distributions from the Receiving Trust Pursuant to a Power of Appointment

A charitable deduction generally is available for a trust distribution if, among other requirements, the payment is made "pursuant to the terms of the governing instrument."[115] As discussed earlier, a trustee with decanting authority generally may decant in favor of a Receiving Trust which confers a power of appointment upon a beneficiary of the Receiving Trust.[116] This is because, under some specific decanting statutes and common law principles, a trustee with broad discretion to distribute trust property outright to a beneficiary also has the authority to exercise such discretion in favor of the beneficiary in a more limited fashion. If the Receiving Trust includes a power of appointment which specifies that it may be exercised in favor of charity, the subsequent exercise of such a power of appointment in favor of charity should qualify as a payment pursuant to the terms of the governing instrument.[117]

In reaching this conclusion, we have considered *Brownstone v. U.S.*[118] The facts in that case are distinguishable since the exercise of the power in *Brownstone* was in favor of the power holder's estate and not in favor of charity. The payment to charity was made pursuant to the terms of the decedent's Will and not pursuant to the exercise of the power of appointment. Here, the payment in question is pursuant to the exercise of a power of appointment validly granted under state law.

IV. GIFT TAX ISSUES

Section 2501 imposes the gift tax on "the transfer of property by gift…." The regulations define the term "gift" as "[a]ny transaction in which an interest in property is gratuitously passed…" to another person.[119] Further, Section 2512(b) provides that if property is transferred for less than full and adequate consideration in money or money's worth, the excess of the value of the transferred property over the value of consideration received is a gift for gift tax purposes.[120] The gift tax is not limited to transfers made directly by the transferor.[121] Accordingly, any indirect gift in which an interest in property is transferred for less than full and

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[114] *See, e.g.,* Mark L. Ascher THE FIDUCIARY DUTY TO MINIMIZE TAXES , 20 Real Prop. Prob. & Tr. J. 663 (1985). *See also* UNIFORM TRUSTEES' POWERS ACT (1964) § 3(b), 7B U.L.A. 743 (stating that stating that a trustee has "a duty not to exercise any power...in such a way as to deprive the trust of an otherwise available tax exemption, deduction or credit...").

[115] IRC§ 642(c)(1).

[116] *See infra*, Section I(C)(2)(h) of this Report.

[117] See Priv. Ltr. Rul. 200906008 (Feb. 6, 2009).

[118] Brownstone v. U.S., 465 F.3d 525, 98 AFTR 2d 2006-6889 (Sept. 27, 2006).

[119] Treas. Reg. § 25.2511-1(c)(1).

[120] IRC § 2512(b).

[121] IRC § 2511(a).

adequate consideration, regardless of the means or device employed, is a gift subject to gift tax.[122] Consequently, transfers that result in the shifting of an economic right or benefit to another person that also reduces the potential gross estate of the transferor generally are within the scope of the gift tax.[123]

The gift tax regulations state that donative intent on the part of the transferor is not an essential element in determining whether a gift for gift tax purposes has been made.[124] The application of the tax is, instead, "based on the objective facts of the transfer and the circumstances under which it is made, rather than on the subjective motives of the donor."[125] Although donative intent is not required for a gift, the Tax Court has held that a voluntary act of transfer is required for a gift subject to the gift tax.[126] Specifically, the Tax Court stated "we do not believe that a taxable event can occur for gift tax purposes unless there is first and in fact an act of transfer by the donor; and there can be no act of transfer unless the act is voluntary and the transferor has some awareness that he is in fact making a transfer of property, that is, he must intend to do so."[127] Further, the Code and Treasury Regulations make it clear that the gift tax is the primary and personal liability of the transferor and is imposed upon the transferor's act of making the transfer.[128]

Therefore, for purposes of evaluating the gift tax consequences of decanting trust assets, the analysis turns on the identity of the individual who participates in, consents to or, perhaps, acquiesces in a decision to decant the assets of a trust and the relationship or connection of such individual to the Distributing Trust and the Receiving Trust.

A. Trustee as Beneficiary

Generally, no taxable gift results from a trustee's distribution of trust property to a beneficiary where the trustee has no beneficial interest in the trust.[129] A taxable gift may arise, however, upon the distribution of trust assets if the trustee has a beneficial interest in the trust

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[122] Treas. Reg. § 25.2511-1(c)(1).

[123] *See, e.g.,* Dickman v. Comm'r, 465 US 330 (1984) (where an interest-free demand loan between family members resulted in a gift); Estate of Lang v. Comm'r, 613 F.2d. 770 (9th Cir. 1980) (where a mother made a taxable gift to her son by permitting the statute of limitations to run on the collection of loans made to him). *See also* TAM 200014004 (where surviving spouse acquiesced in payment of excess trustees' fees to her children and such excess payments were deemed taxable gifts because the payment of the fees facilitated her estate planning by transferring assets to her children).

[124] Treas. Reg. § 25.2511-1(g)(1).

[125] *Id. See also* Comm'r v. Wemyss, 324 US 303 (1945).

[126] Estate of Dimarco v. Comm'r, 87 T.C. 653 (1986), acq. 1990-2 C.B.1.

[127] *Id*. at 663. *See also* Harris v. Comm'r, 340 US 106 (1950) (where the Court stated that if a contractual division of marital assets was wholly conditional upon the entry of a decree by the court, then the distribution of the assets could not be a voluntary promise or agreement that resulted in a transfer subject to the gift tax).

[128] *See* Treas. Reg. § 25.2511-2(a).

[129] *See* Treas. Reg. § 25.2511-1(g)(1) ("A transfer by a trustee of trust property in which he has no beneficial interest does not constitute a gift by the trustee…").

and is permitted to participate in the distribution decision,[130] unless the distribution may be made only pursuant to an ascertainable standard.[131]

These same gift tax principles should apply where a trustee exercises the power to decant trust assets. Accordingly, where the trustee of the Distributing Trust has no beneficial interest in the Distributing Trust, a trust decanting should not give rise to any gift tax issues, even where there is a shift of a beneficial interest.[132] However, if an individual is a trustee with an unrestricted power to decant trust assets and also is a discretionary beneficiary of the trust over which he or she holds the decanting power, the exercise of the decanting power by such trustee/beneficiary (which reduces his or her beneficial interest) should result in a taxable gift. It is irrelevant for gift tax purposes that the trustee/beneficiary may be acting solely in a fiduciary capacity when exercising the decanting power if such exercise by the trustee/beneficiary results in a shift of any portion of his or her beneficial interest to another beneficiary.[133] In any event, in most cases, this gift tax issue will not arise because the trustee/beneficiary often will not have the power to decant, either as a result of prohibitions in the trust instrument or state law.[134]

B. <u>Consent of Beneficiary</u>

As noted earlier, for a taxable gift to occur, the transferor must make a voluntary transfer. In a trust decanting, the beneficiary is not making the requisite voluntary transfer because the trustee (as opposed to the beneficiary) is the party effectuating the decanting decision. Indeed, in many states, the trustee is not even required to provide notice to the beneficiary of the exercise of the decanting power. [135] Consequently, unless the beneficiary also is a trustee participating in the decanting decision (as discussed earlier), the beneficiary will not be deemed to have made a taxable gift when the trustee exercises the power to decant trust assets.

An exception may be appropriate when the governing instrument or state law requires consent of a beneficiary in order for the trustee to exercise the power to decant trust assets. In that instance, the consent by the beneficiary to reduce his or her beneficial interest will be a taxable gift.[136] Currently, Nevada is the only state that requires a trustee to secure a

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[130] Treas. Reg. § 25.2511-1(g)(2).

[131] *Id.* ("If a trustee has a beneficial interest in trust property, a transfer of 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").

[132] *See* Treas. Reg. § 25.2511-1(g)(1).

[133] *See* Treas. Reg. § 25.2511-1(c)(1) (gratuitous transfer regardless of means or device is gift subject to gift tax).

[134] *See, e.g.,* EPTL § 10-6.6(s)(2); MO REV. STAT. § 456.4-419(2); N.C. GEN. STAT. § 36C-8-816.1(d); N.H. RSA. § 564-B:4-418(c); NEV. REV. STAT. § 163.556.3.

[135] *See, e.g.*, AK STAT. § 13.36.157; 12 DEL. C. § 3528; TENN. CODE ANN. § 35-15-816(B)(27); N.H. RSA. § 564-B:4-418; A.R.S. § 14-10819.

[136] *See* Sexton v. US, 300 F.2d 490 (7th Cir. 1962) (holding that where two-thirds vote of beneficiaries was required to extend the trust term, the beneficiaries that joined in unanimous consent to exercise the trust term resulted in a taxable gift of the beneficiary's right to receive trust property at the end of the trust's original term); Rev. Rul. 86-39, 1986-1 C.B. 301 (ruling that beneficiary made taxable gift where beneficiary executed release for

beneficiary's consent to a decanting in circumstances where the decanting eliminates or limits a beneficiary's interest in the Receiving Trust.[137]

Other states require that notice be given to the beneficiary of a trust in advance of any exercise of the decanting power.[138] In these states, the beneficiaries have no legal right under state law to prevent the decanting, but may maintain an action against the trustee for breach of fiduciary duty. If the decanting is consistent with state law and the terms of the governing instrument, the courts will not interfere with the trustee's exercise of the decanting power except in the case of an abuse of discretion.[139] As a result, mere notice of the decanting is not tantamount to the beneficiary possessing the ability to prevent the trustee from exercising the power to decant. If the beneficiary cannot prevent a decanting, the beneficiary's acquiescence (or failure to object) to the decanting is not a voluntary transfer that will be subject to gift tax. Similarly, a beneficiary's voluntary consent or release of the trustee will not expose the beneficiary to gift tax, so long as consent is not required.

C. Granting a Power of Appointment

As discussed earlier, a trustee with decanting authority generally may decant in favor of a Receiving Trust that confers a power of appointment upon a beneficiary of the Receiving Trust.[140] Granting a power of appointment does not alter the analysis that the decanting itself is an exercise of discretion by the trustee, and not the Distributing Trust's beneficiary, and therefore is not a gift (assuming the trustee exercising the decanting power has no beneficial interest in the Distributing Trust). However, a taxable gift may result upon the subsequent exercise of the power of appointment over the trust corpus by the beneficiary if the exercise of the power results in the relinquishment of the powerholder's rights or interests[141] or, alternatively, under the Delaware tax trap.[142]

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trustee's acquiescence to recapitalization that diminished value of property subject to beneficiary's general power of appointment).

[137] NEV. REV. STAT. § 163.556(2)(e).

[138] *See, e.g.,* EPTL § 10-6.6(J)(2) (2011); FLA. STAT. § 736.04117(4); IC § 30-4-3-36; N.C. GEN. STAT. § 36C-8-816.1(F)(2) and (3); S.D. CODIFIED LAWS §§ 55-2-18.

[139] *See* RESTATEMENT (THIRD) OF TRUSTS, § 50.

[140] *See infra*, Section I(C)(2)(h) of this Report.

[141] *See* Treas. Reg. § 25.2524-1(b)(2) (if lifetime exercise of a special power of appointment results in the relinquishment by the powerholder of a separate interest in the trust as a life income beneficiary, a taxable gift results under § 2511); Estate of Ruth B. Regester, 83 T.C. 1 (July 2, 1984) (exercise of a special power of appointment by the owner of a life estate made a gift subject to gift tax). *See also* Rev. Rul. 79-327 (donee's exercise of the power of appointment resulted in a taxable gift). In rare instances in which a potential gift arises because a trustee/beneficiary exercises the decanting authority, or because a decanting requires a beneficiary's consent, the gift may be rendered incomplete if the beneficiary who is deemed to have made the gift is given a power of appointment. *See* Treas. Reg. § 25-2511(b); Priv. Ltr. Rul. 200715005 (Jan. 3, 2007). *But see* CCA 201208026.

[142] *See supra* Section IV(E) of this Report.

D. Decanting to a Grantor Trust

We have also considered whether a trust decanting from a Distributing Trust that is a complex trust to a Receiving Trust that is a grantor trust gives rise to any gift tax issues. In Revenue Ruling 2004-64, the Service issued guidance on the gift tax consequences of the grantor's payment of income tax attributable to a grantor trust.[143] The Service ruled that the grantor's payment of the income tax attributable to the inclusion of the trust income in his or her taxable income is not a gift to the trust beneficiaries because the payment of such tax is in discharge of the grantor's own liability, not that of the trust or its beneficiaries.[144] A similar rule applies to a trust that converts from a non-grantor trust to a grantor trust — for example, by virtue of a change of trustees.[145] Under these principles, a taxable gift similarly should not result from a decanting where the Distributing Trust is a non-grantor trust and the Receiving Trust is a grantor trust.

E. The Delaware Tax Trap

In limited circumstances, the exercise of a limited power of appointment will be a taxable gift by the person exercising the power. Under this rule, referred to colloquially as "the Delaware Tax Trap," if a holder of a limited power of appointment exercises that power during such holder's lifetime, and such exercise creates another power which, in turn, can be exercised to postpone the vesting of the trust property for a period ascertainable without regard to the date of creation of the first power, the holder's exercise of the first power of appointment will be deemed a transfer subject to gift tax.[146] The Delaware Tax Trap applies upon the exercise of the first power, whether or not the second power holder exercises the second power, if the second power may be exercised to extend the perpetuities period beyond the period applicable under the terms of the trust instrument that created the first power.

At first blush, it may seem that the trustee's exercise of the decanting power may trigger a taxable gift if the Receiving Trust grants a power of appointment to the trust beneficiary and the vesting period does not relate back to the period applicable to the Distributing Trust.[147] However, the legislative history indicates that the Delaware Tax Trap rules were not intended to apply to fiduciary powers of appointment, such as a trustee's discretionary power to invade principal.[148] In addition, the Delaware Tax Trap should not apply to a decanting pursuant to state law since most of the state decanting statutes require that the permissible period for the postponement of vesting of interests in trust property, or the suspension of power of alienation over trust property, must be determined by reference to the date of creation of the original power

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[143] Rev. Rul. 2004-64, 2004-27 I.R.B. 7 (July 6, 2004).

[144] *Id.*

[145] *See* IRC § 674 (a trust under which the grantor or a nonadverse party has the authority to make discretionary distributions is a grantor trust, unless at least half the trustees are not related or subordinate to the grantor (and none of whom is the grantor or the grantor's spouse)).

[146] IRC § 2514(d).

[147] *See, e.g.,* William R. Culp, Jr. & Briani Bennett Mellen, *Use Of Trust Decanting to Extend the Term of Irrevocable Trusts,* 37 EST PLN 3 (2010).

[148] *See* S. REP. No. 82-382, at 1 (1951), as reprinted in 1951 U.S.C.C.A.N. 1535, 1535.

in the Distributing Trust.[149] In addition, even if a trustee's exercise of the decanting power otherwise falls under Section 2514(d), such exercise should not result in a taxable gift by the trustee so long as the trustee does not have a beneficial interest in the property subject to the decanting.[150] Since a transfer by a trustee of property in which such trustee has no beneficial interest does not constitute a gift by the trustee, as discussed earlier, a decanting by a trustee with no beneficial interest in the trust property should not result in a taxable gift.[151] We recommend that the Service confirm this point.

The analysis differs with respect to powers of appointment granted to a beneficiary of the Receiving Trust. If a beneficiary is granted a limited power of appointment in the Receiving Trust and exercises that power, in further trust, and creates another power that can be exercised to extend the perpetuities period applicable to the Receiving Trust, the exercise of the power by the beneficiary of the Receiving Trust will be a taxable gift under Section 2514(d).[152]

F. Gift Tax Deductions and Exclusions

The donor is entitled to certain deductions and exclusions from the gift tax for gifts in trust, provided the trust instrument contains certain provisions. For example, under Section 2503(c), the annual gift tax exclusion is available for trusts that meet certain criteria. In addition, under Sections 2522 and 2523, charitable and marital deductions are available if the trust meets the statutory requirements. More specifically, the charitable interest must meet the criteria of a charitable remainder trust or pooled income fund under Sections 664 and 642(c)(5), or qualify under Section 2522(c)(2)(B) for certain fixed interests. To qualify for the marital deduction, the spouse's interest in the trust must meet the requirements set forth under Section 2523. If the decanting power can defeat the rights in the Distributing Trust that give rise to the deduction or exclusion, then the Distributing Trust should not be entitled to the deduction or exclusion. If, on the other hand, the decanting authority under the trust instrument or state law prohibits the trustee from defeating any of the rights that give rise to a gift tax deduction or exclusion, the existence of the decanting power should have no effect on the availability of the deduction or exclusion to the donor of the Distributing Trust.

As mentioned earlier in this Report, most state statues prohibit a decanting that will alter fixed rights or otherwise jeopardize the marital and charitable deductions. Many state statutes further ensure that a decanting may not change a beneficiary's right or interest in the trust that gives rise to the annual exclusion for gift tax purposes. Some state statutes provide similar protection for gifts that qualify for the annual exclusion based on a beneficiary's withdrawal rights over contributions to the trust. Absent protection in the Distributing Trust agreement or state law (including common law principles), decanting authority that enables the trustee to defeat a right that gives rise to an annual exclusion or gift tax deduction will jeopardize that deduction for the Distributing Trust.

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[149] *See, e.g.,*12 DEL. C. § 3528(c); EPTL § 10-6.6(p).

[150] *See generally* Culp & Mellen, *supra* note 147.

[151] *Id.*

[152] IRC § 2514(d).

V. ESTATE TAX ISSUES

Generally, a trustee's exercise of the decanting power will not result in any estate tax consequences. Only specific situations may trigger the estate tax when a decanting occurs.

A. Grantor's Involvement in Decanting

We have considered whether the grantor's possible involvement in the decanting may have estate tax implications for the grantor. In that regard, we note that, in some jurisdictions, even if the grantor is a trustee, the grantor is not permitted to participate in the exercise of the decanting power.[153] We further note that at least one decanting statute requires that notice be given to the grantor and that the decanting be consistent with the grantor's intent.[154] Merely providing notice of the decanting to the grantor will not give rise to a retained power in the grantor over the trust property, causing the trust assets to be included in the grantor's gross estate. Notice does not enable the grantor to control the trustee's discretion and does not give the grantor any power which enhances or shifts the rights of the beneficiaries of the Distributing Trust. Furthermore, acting in a fashion consistent with the grantor's intent is a fundamental fiduciary duty, provided such action is in accordance with the trust instrument and applicable law.

The regulations provide that Section 2038 does not apply if the decedent's power adds nothing to the rights of the parties under local law.[155] The regulations confirm the rule set forth in *Helvering v. Helmholz*,[156] where the Supreme Court held that a trust that could be revoked by the grantor together with all other beneficiaries was not includible in the grantor's gross estate because the revocation provision in question added nothing to what the parties could have accomplished under the law of trusts.[157] Indeed, in Private Letter Ruling 201015025 (Mar. 16, 2010), the Service determined that even where the grantor consented to a modification of a trust pursuant to a state statute, such consent did not constitute an exercise of a retained power over the trust that would cause the trust assets to be included in the grantor's estate under Sections 2036 and 2038.[158]

A grantor also is not deemed to have control simply because of a personal relationship between the grantor and the trustee, or because the trustee tends to follow the grantor's wishes in exercising discretion.[159] The trustee must adhere to fiduciary duties. So long

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[153] *See, e.g.,* EPTL § 10-6.6(s)(1); O.R.C. § 5808.18(L)(2)

[154] EPTL § 10-6.6(h) and (j)(2).

[155] Treas. Reg. § 20.2038-1(a)(2).

[156] 296 US 93 (1935).

[157] *Id*. at 97.

[158] Priv. Ltr. Rul. 201015025 (". . . Trust A and Trust B are being modified pursuant to authority granted under Statute 1; accordingly, Settlor's act of consenting to the modifications does not constitute the exercise of any retained power over the trusts. We therefore conclude that the proposed modifications to Trust A and Trust B will not cause any portion of the assets of Trust A or Trust B to be includible in the gross estate of Settlor. . . .").

[159] *See* Estate of Helen S. Wall, 101 T.C. 300 (Oct. 12, 1993) (where the court held that the trustee has a duty to exercise powers exclusively for the benefit of the beneficiaries and, therefore, without any evidence of a fraudulent side agreement regarding the manipulation of the administration of the trust between the grantor and the

as the trustee is obligated to act in a fashion consistent with those duties, there is no retention of a power or right by the transferor that would cause the trust assets to be included in the grantor's gross estate.[160]

B. Delaware Tax Trap

Similar to the Delaware Tax Trap under the gift tax rules, discussed earlier, property subject to a limited testamentary power of appointment will be includible in a decedent's gross estate for estate tax purposes if the decedent exercises the testamentary power of appointment in further trust to create a new power that may be exercised in a manner that postpones the vesting of such property or suspends the power of alienation of such property beyond the period applicable to the first power.[161] Section 2041(a)(3) provides that the exercise of a limited power of appointment in such a manner by the decedent will be considered the exercise of a general power of appointment.[162]

The decanting power, which is exercisable by a trustee during the trustee's lifetime, will not result in estate tax inclusion for the trustee. However, if a beneficiary of the Receiving Trust is granted a limited testamentary power of appointment over the trust property, and exercises that power, in further trust, by creating another power that may postpone the vesting of the trust property beyond the perpetuities period applicable to the Receiving Trust, the property subject to the power will be included in the Receiving Trust's beneficiary's estate for estate tax purposes.[163]

C. Charitable and Marital Deductions

Under Section 2055, a charitable deduction is available for estate tax purposes with respect to a charitable interest in trust only if the charity's interest meets specific criteria to ensure that such interest is a fixed determinable amount. Similar to the gift tax rules, the deduction is available for interests in a charitable remainder annuity trust or a charitable remainder unitrust (described in Section 664), a pooled income fund (described in Section 642(c)(5)) and for an income interest in the form of a guaranteed annuity interest or a unitrust interest.

With respect to the marital deduction, certain limited trust interests qualify for the marital deduction. For example, under Section 2056(b)(7), a trust that meets the definition of

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trustee, the trust property was not includible in the grantor's estate); Estate of Sherman v. Comm'r, 9 T.C. 594 (1947) (reviewed), *nonacq*., 1948-1 C.B. 4; Estate of Ballard v. Comm'r, 47 B.T.A. 784 (1942), *aff'd*, 138 F.2d. 512 (2d Cir. 1943). *See also* Rev. Rul. 95-58, 1995-2 C.B. 191 (grantor's reserved right to remove and replace independent trustee is not tantamount to a retained power such that trust property is includible in grantor's estate).

[160] *See* Estate of Hilton W. Goodwyn, T.C. Memo 1973-153. *See also* Byrum, 408 US 125 (suggesting that a grantor's influence over fiduciaries is legally irrelevant; even if the fiduciary is prevailed upon by the grantor to breach the fiduciary duties, the grantor in creating the trust does not retain any "right" to affect beneficial enjoyment within the meaning of 2036(a)).

[161] IRC § 2041(a)(3).

[162] *Id.*

[163] *Id.*

"qualified terminable interest property" will be deemed to have passed to the surviving spouse and therefore will be eligible for the marital deduction. Qualifying terminable interest property must provide the spouse with all of the trust income payable at least annually, and no person may appoint the trust property to anyone other than the spouse.[164]

If a Distributing Trust agreement or state law permits a decanting that could defeat the rights of charity or a spouse that give rise to the estate tax charitable or marital deduction, the deduction should not be available to the estate. However, as mentioned earlier, most decanting statutes do not permit a decanting that may change the interest of a beneficiary which gives rise to an estate tax marital or charitable deduction.[165] Virtually all state decanting statues prohibit any decanting that could reduce any such fixed interest. Other statues also specifically prohibit any exercise of the decanting power that would jeopardize a deduction or exclusion under certain provisions of the Code, including the charitable and marital estate tax deductions under Sections 2055 and 2056. In addition, common law principles generally prohibit a trustee from exercising a power that would negate tax benefits.

VI. GENERATION-SKIPPING TRANSFER TAX ISSUES

A. Overview of Generation-Skipping Transfer Tax

As part of the Tax Reform Act of 1986,[166] Chapter 13 was added to the Code, imposing a tax on certain lifetime and testamentary transfers of property made after October 22, 1986[167] to or for the benefit of beneficiaries who are assigned to generations two or more below the generation of the transferor.

1. Generation-Skipping Transfers

Three types of transfers trigger the GST tax: a direct skip, a taxable distribution and a taxable termination.[168] Each one involves a transfer to a "skip person," an individual two or more generations below the transferor's generation or a trust the current beneficiaries of which are all assigned to generations two or more below that of the transferor.[169] A direct skip is a transfer subject to federal gift or estate tax under Chapter 11 or Chapter 12 made to a skip person. A taxable distribution is a distribution from a trust to a skip person, other than a direct skip or a taxable termination.[170] A taxable termination is the termination of a beneficiary's interest in a trust (by death, lapse of time, release of power, or otherwise) unless one of the following exists: (i) a transfer occurs that is subject to federal gift or estate tax, (ii) immediately

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[164] IRC § 2056(b)(7)(B)(ii).

[165] *See* Section I(C)(2)(f) of this Report.

[166] P.L. 99-514.

[167] October 22, 1986 is the date of enactment of the Tax Reform Act of 1986.

[168] IRC § 2611; Treas. Reg. § 26.2612-1.

[169] In the case of a trust with no current beneficiaries, the trust will be a skip person if no distribution (other than one that has a less than 5% probability of occurrence) may be made to anyone other than a skip person, that is, a "non-skip person"). *See generally* Treas. Reg. § 26.2612-1(d).

[170] IRC § 2612(b).

after the termination of such interest, a non-skip person has an interest in the property, or (iii) at no time after the termination of such interest may a distribution be made to a skip person.[171]

2. Identifying the Transferor

The determination as to whether a GST event has occurred is made by reference to the transferor of the property. The transferor generally is the person with respect to whom the property was most recently subject to the federal estate or gift tax.[172] With respect to property passing at death, the transferor generally is the decedent and, for lifetime gifts, the transferor generally is the donor. However, there are important exceptions to the general rules.[173] Under Section 2653(a), if property remains in trust after a GST event, a determination of whether a subsequent distribution of property from the trust (or a termination of an interest) is a GST event is made as if the transferor of such property were assigned to the first generation above the highest generation of any person who has an interest in such trust immediately after the GST event.[174] We refer to this rule as the "Move Down Rule."

3. Transfers by Non US Persons

Chapter 13 applies in limited circumstances to transfers by a person who is neither a citizen nor a domiciliary of the US (referred to hereinafter as a nonresident alien or "NRA").[175] Specifically, only transfers by a NRA (or distributions from trusts funded by a NRA) that are (or previously were) subject to US gift or estate tax will be subject to GST tax. In this regard, it is important to note that the US gift tax applies to transfers by NRAs of US real and tangible personal property and the US estate tax applies generally to the US situs assets in the NRA's estate.[176]

4. GST Exemption

Every individual citizen, resident and NRA has a GST exemption that he or she (or his or her executor) may allocate to transfers made during life or at death.[177] The GST exemption generally is equal to the basic exclusion amount under Section 2010(c), which is currently $5,120,000.[178] An individual may allocate GST exemption to a transfer that is

[171] Treas. Reg. § 26.2612-1(b).

[172] IRC § 2652(a). *See also* Treas. Reg. § 26.2611-1. A transfer is subject to gift tax for this purpose without regard to exemptions, exclusions, deductions and credits. Treas. Reg. § 26.2652-1(a).

[173] For example, the transferor of property set aside in a marital deduction trust for which a special election is made under Section 2652(a)(3) is the deceased spouse who created the trust, despite the fact that the trust assets will have been subject to estate tax in the surviving spouse's estate before passing to the next generation. In addition, if the donor's spouse splits the gift pursuant to Section 2513, each spouse is treated as the transferor of one-half of the gift for GST tax purposes. *See, e.g.,* Priv. Ltr. Rul. 200218001 (May 3, 2002).

[174] IRC § 2653(a).

[175] Treas. Reg. § 26.2663-2.

[176] *See* IRC §§ 2501a)(2) and 2103.

[177] IRC §§ 2631 and 2632; Treas. Reg. § 26.2632-1.

[178] This discussion is based on current law, which is scheduled to sunset on December 31, 2012. Also note that Treas. Reg. § 26.2663-2(a) states that "[e]very NRA transferor is allowed a GST exemption of $1,000,000."

immediately subject to the GST tax, such as a direct skip, or to property transferred in trust that is not immediately subject to GST tax, but which may attract a GST tax in the future.[179] The transferor may make an affirmative allocation of GST exemption to a transfer. In addition, there are default rules that automatically allocate GST exemption to certain transfers in the absence of an express allocation provided that the transferor does not elect out of the default rules.[180]

5. Inclusion Ratio

The amount of the GST tax is determined by multiplying the taxable amount (generally, the value of the property subject to GST tax) by the applicable rate.[181] The applicable rate, in turn, is the product of the maximum federal estate tax rate then in effect and the inclusion ratio with respect to the transfer.[182] The inclusion ratio is determined by subtracting the "applicable fraction" from one.[183] The applicable fraction generally is a fraction, the numerator of which is the amount of GST exemption allocated to the transferred property and the denominator of which is the value of the transferred property on the effective date of the GST exemption allocation, with certain adjustments for tax payments and deductions.[184]

If no portion of the transferor's GST exemption is allocated to the transferred property, it will have an inclusion ratio of one. With an inclusion ratio of one, the full amount of the property will be subject to the GST tax at the highest federal estate tax rate. In contrast, if the transferor allocates GST exemption to the full amount of transferred property, the inclusion ratio will be zero, and accordingly, no GST tax will be due since the applicable rate (the product of the maximum federal estate tax rate and the inclusion ratio) will be zero. In addition, distributions from any trust with a zero inclusion ratio will not attract a GST tax. If the transferor allocates GST exemption to a portion, but not all, of the transferred property, the inclusion ratio will be a fraction between zero and one, and the GST tax will be below the maximum federal estate tax rate.[185]

Certain transfers that are not treated as taxable gifts under the Code, such as transfers that qualify for the annual exclusion under Sections 2503(b) and (e), are assigned a zero inclusion ratio, and therefore, will not attract any GST tax.[186]

6. Trusts Exempt from GST Tax

There are three types of trusts that are not subject to the GST tax. As mentioned earlier, distributions of property from trusts with an inclusion ratio of zero will not give rise to a

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[179] IRC § 2632.

[180] *See* Treas. Reg. § 26.2632-1(b).

[181] IRC § 2602.

[182] IRC § 2641.

[183] IRC § 2642(a)(1).

[184] IRC § 2642(a)(2).

[185] *Id.*

[186] IRC § 2642(c).

GST tax. In addition, trusts that were irrevocable on or before September 25, 1985 are exempt from GST tax so long as there have been no additions to the trusts (either actual or constructive) after September 25, 1985 ("Grandfathered Trusts").[187] The final category of trusts to which the GST tax does not apply are trusts created by a NRA that were not subject to the gift or estate tax.

B. GST Tax Consequences of Decanting

In this section, we consider the GST tax consequences of decanting with respect to trusts that are exposed to the GST tax (that is, trusts with an inclusion ratio greater than zero). We further analyze the effect of decanting on trusts otherwise exempt from GST tax.

1. Trusts that Are Exposed to the GST Tax

As mentioned earlier, a trust decanting generally should be treated as a distribution by the trustee for income and gift tax purposes. We recommend that the same principles apply for GST tax purposes. In the case of a decanting of the entire trust, the tax attributes of the Receiving Trust flow from the Distributing Trust. Therefore, in identifying the transferor in order to determine whether a GST event has occurred, we recommend that the Service confirm that the person who is the transferor of the Distributing Trust also be the transferor of the property transferred to the Receiving Trust, unless the decanting triggers a gift or estate tax. If the decanting triggers a gift or estate tax, the identity of the transferor should be that person with respect to whom the gift or estate tax most recently applied.

As a result, a decanting will be a GST event if the Receiving Trust is a skip person with respect to the transferor of the Distributing Trust. In addition, distributions from the Receiving Trust will attract a GST tax if the beneficiary is a skip person with respect to the transferor of the Distributing Trust, taking into account the Move Down Rule, if applicable.[188] The decanting itself may be a taxable termination if, for example, after the decanting no beneficiary of the Receiving Trust is a non-skip person with respect to the transferor of the Distributing Trust.

Where less than the entire Distributing Trust is decanted, no GST tax should apply with respect to any property remaining in the Distributing Trust. Thus, if a taxable distribution is deemed to occur as a result of some property being decanted to the Receiving Trust, the GST tax should be the liability of the Receiving Trust's trustee under Section 2603(a)(1); the property remaining in the Distributing Trust will not attract an immediate GST tax.

[187] September 26, 1985 was the date that Congress first considered the provisions of Chapter 13 under the legislation that resulted in the Tax Reform Act of 1986. That date was used as the effective date for grandfathered trust status. *See generally* Stephens, Maxfield, Lind, Calfee & Smith, FEDERAL ESTATE AND GIFT TAXATION (WG&L) ¶ 1805[2][a].

[188] *See* IRC § 2653(a).

2. Grandfathered Trusts

As mentioned earlier, the GST tax does not apply to trusts that were irrevocable on or before September 25, 1985 so long as there have been no additions to the trust (either actual or constructive) after September 25, 1985. Proscribed additions will cause a Grandfathered Trust to lose its GST exempt status.[189]

In 2000, Treasury adopted regulations that provide safe harbor rules for when a modification of a Grandfathered Trust will affect the GST exempt status of the trust.[190] Two of the safe harbor provisions specifically address modifications resulting from a trust decanting.[191]

(a) Decanting Authorized When Trust Became Irrevocable

The regulations provide that a modification of an exempt trust due to a trust decanting will not taint GST exempt status if (1) either (i) authority exists under the instrument creating the Distributing Trust permitting the trustee to appoint in further trust without the consent or approval of any beneficiary or court, or (ii) at the time that the Distributing Trust became irrevocable, applicable state law permitted such a distribution without the consent or approval of any beneficiary or court; and (2) the terms of the governing instrument of the Receiving Trust do not extend the time for vesting of any beneficial interest in the trust beyond 21 years plus lives in being at the date the Distributing Trust became irrevocable.[192]

Since the first decanting statute was enacted in New York in 1992, a Grandfathered Trust, which by definition was irrevocable on September 25, 1985, may not rely on statutory law to qualify under this exemption. Therefore, a Grandfathered Trust will fall within this safe harbor only if the trust instrument permits the decanting (without the consent of any beneficiary or the court) or if the applicable state common law in existence as of the date the trust became irrevocable permitted the trustee to appoint in further trust, and the Receiving Trust does not extend the time for vesting beyond the common law perpetuities period measured by reference to the date the original trust became irrevocable.

(b) No Shift in Beneficial Interests

The second safe harbor provides that a decanting will not jeopardize the exempt status of a Grandfathered Trust so long as the Receiving Trust's provisions (i) do not cause a beneficial interest in the trust property to be shifted to a beneficiary at a lower generational level than the original beneficiaries of that interest for GST tax purposes, and (ii) do not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the

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[189] Treas. Reg. § 26.2601-1(b)(1)(i); Treas. Reg. §§ 26.2601-1(b)(1)(iv), (v).

[190] Treas. Reg. § 26.2601-1(b)(4)(i).

[191] Treas. Reg. § 26.2601-1(b)(4)(i). The private letter rulings prior to that date adopted the position that a modification of an exempt trust that changed the quality, quantity, value or timing of any powers, beneficial interests, rights or expectancies originally provided for under the terms of the trust after the effective date of the GST tax will forfeit the exempt status of the trust. *See, e.g.*, Priv. Ltr. Rul. 200052007 (Jan. 2, 2001) and Priv. Ltr. Rul. 200006001(Feb. 14, 2000). The provisions of Treas. Reg. § 26.2601-1(b)(4)(i) set forth a different set of rules.

[192] Treas. Reg. § 26.2601-1(b)(4)(i)(A).

Distributing Trust.[193] A modification will result in a shift in beneficial interest to a lower generation beneficiary if the modification can result in either an increase in the amount of a GST transfer or the creation of a new GST transfer.[194]

This regulation confirms that, in these cases, where the decanting authorization arose after the Distributing Trust became irrevocable, a Receiving Trust will not be subject to GST tax if the only changes to the Distributing (Grandfathered) Trust are administrative in nature, in those cases where the decanting authorization arose after the Distributing Trust became irrevocable.[195] It further extends exempt status to the Receiving Trust even if the changes are substantive in nature, provided that there is no shift of a beneficial interest to a lower generation and the time for vesting of any beneficial interest is not extended.[196]

We believe that converting a Grandfathered Trust which is a complex trust (for income tax purposes) to a grantor trust should not taint GST exempt status. The regulations provide that a "modification that is administrative in nature that only indirectly increases the amount transferred (for example, by lowering administrative costs or income taxes) will not be considered to shift a beneficial interest in the trust."[197] Moreover, as confirmed by Revenue Ruling 2004-64,[198] the grantor's payment of the income tax attributable to the inclusion of the trust's income in the grantor's taxable income is not a taxable gift. If the payment of income tax is not considered to be a gift, it follows that there is no deemed transfer to the trust when the grantor pays the income tax. If there is no deemed transfer to the trust when the grantor pays the income tax, it appears that there is no shift to a beneficiary in a lower generational slot. We recommend that the Service confirm this point in future guidance.

3. Exempt Trusts Due to Allocation of GST Exemption

There is no regulation specifically addressing modifications of trusts that are exempt from GST tax because of the allocation of the GST exemption (rather than due to grandfather protection). Nevertheless, the Service has stated that the regulations dealing with Grandfathered Trusts, by analogy, are relevant. The Service has noted that "[n]o 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, a change that would not affect the GST status of a Grandfathered Trust should similarly not affect the exempt status of such a trust."[199]

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[193] Treas. Reg. § 26.2601-1(b)(4)(i)(D)(1).

[194] Treas. Reg. § 26.2601-1(b)(4)(i)(D(2). ("If the effect of the modification cannot be immediately determined, it is deemed to shift a beneficial interest in the trust to a beneficiary who occupies a lower generation…than the person or persons who held the beneficial interest prior to the modification.").

[195] *See, e.g.,* Priv. Ltr. Rul. 200607015 (Nov. 4, 2005).

[196] *See, e.g.,* Treas. Reg. § 26.2601-1(b)(4)(i)(E)(Ex. 2).

[197] Treas. Reg. § 26.2601-1(b)(4)(i)(D)(2).

[198] Rev. Rul. 2004-64, 2004-27 I.R.B. 7 (July 1, 2004).

[199] Priv. Ltr. Rul. 200743028 (May 29, 2007). *See also* Priv. Ltr. Rul. 200714016 (Nov. 15, 2006); Priv. Ltr. Rul. 200420011 (Jan. 29, 2004).

We recommend that Service clarify that the two safe harbors directly applicable to decanting Grandfathered Trusts apply, with certain modifications, to a trust that is exempt from GST tax as a result of an allocation of GST exemption. With respect to the first safe harbor, we recommend that a modification of a trust to which the transferor's GST exemption was allocated should not taint GST exempt status if (1) either (i) authority exists under the Distributing Trust permitting a trustee to appoint in further trust without the consent or approval of any beneficiary or court, or (ii) applicable state law permits such a distribution, irrespective of whether the law so permitted at the time that the Distributing Trust became irrevocable; and (2) the terms of the governing instrument of the Receiving Trust do not extend the time for vesting of any beneficial interest in the trust beyond 21 years plus lives in being at the date the Distributing Trust became irrevocable. Under these circumstances, the trustee continues to be limited to the common law rule against perpetuities, unless the Distributing Trust was not so limited, and must have authority either under the trust instrument or state law. Because the transferor took affirmative steps to allocate GST exemption to the Distributing Trust, the decanting authority as of the date that the trust became irrevocable, in our view, should not be the focus of the inquiry. Rather, once GST exemption has been allocated, so long as the exercise of the decanting power does not give rise to a gift or estate tax, and does not extend the permissible perpetuities period in the Distributing Trust, we believe that the relevant inquiry should be whether decanting is presently authorized. There is no reason that a trustee's decanting should affect the GST exempt status.

4. Trusts Created by NRAs

We also recommend that the Service confirm that a decanting should not affect the exempt status of a trust created by an NRA which did not give rise to a US gift or estate tax. This is the case, in our view, even if the perpetuities period is extended or there are other changes in beneficial interests. This type of trust is outside the GST tax system, unless there is an event which causes the trust property to be subject to US gift or estate tax.

5. Loss of GST Exempt Status

We further recommend guidance concerning the GST tax consequences of the loss of GST exempt status by a trust that is exempt from GST tax (either due to Grandfathered Trust status or the allocation of exemption). With respect to Grandfathered Trusts, we recommend applying the GST tax rules prospectively. Solely for purposes of ascertaining the identity of the transferor (to determine whether future GST events occur), we recommend that the rules under Chapter 13 be applied to the trust from inception. Accordingly, in analyzing the GST tax consequences of a tainted Grandfathered Trust, the Move Down Rule would apply.[200]

With respect to trusts that are exempt by reason of the allocation of GST exemption, a decanting that taints GST exempt status should cause an immediate loss of exempt

[200] For example, if the Grandfathered Trust created by grandfather for the benefit of grandchild required a principal distribution to the grandchild at age 40, and such trust was decanted in a manner that taints GST exempt status, there should be no immediate GST tax and subsequent distributions to the grandchild will not be GST events. Applying the Chapter 13 rules solely for determining the identity of the transferor after the funding of the trust, the deemed transferor will be the grandfather's child (that is, the grandchild's parent). However, the trust would have an inclusion ratio of one and distributions to a beneficiary in a generation below the grandchild will trigger the GST tax.

status (so that the trust has an inclusion ratio of one). However, the GST rules applicable to determine the identity of the transferor again should apply in determining whether a future transfer (or termination of interest) triggers a GST tax.

6. 2642(c) Trusts

Section 2642(c) provides a special rule for direct skips that are nontaxable gifts. In that case, the trust's inclusion ratio is deemed to be zero without the use of the transferor's GST exemption. This rule applies to transfers in trust, but only if the trust meets specific criteria, including that it benefit only one beneficiary during his or her lifetime and that the trust assets must be includable in the beneficiary's estate if the beneficiary dies during the trust term. Some state decanting statutes prohibit the exercise of the decanting power if it would jeopardize the trust's qualification under Section 2642(c). If the trustee of the Distributing Trust may defeat the beneficiary's interest that gives rise to the special interest under Section 2642(c) (taking into account the terms of the trust instrument, statutory law and common law principles), the trust may not qualify under Section 2642(c).

VII. CONCLUSION

This Report proposes income, gift, estate and GST tax guidance applicable to trust decantings. There are common elements that permeate the tax treatment. For example, for income and gift tax purposes, we recommend that the decanting power generally be treated as a form of distribution. Similarly, we recommend that the tax attributes of the Receiving Trust for income, gift and GST tax purposes, such as the identity of the transferor, be measured by reference to the Distributing Trust and that certain tax attributes of the Distributing Trust continue with the Receiving Trust, except in limited circumstances. We further recommend that exclusions, deductions and other favorable tax treatment, whether for income, gift, estate or GST tax purposes, should not be affected by a decanting power unless it can be exercised in a fashion that may defeat the rights which give rise the exclusion, deduction or other favorable tax treatment.