

# Strategic Trusts, IRC Sec. 831b Captives, ESOPs: Saving Income, Estate and GST Tax

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# **Strategic Trusts, IRC Sec. 831b Captives, ESOPs: Saving Income, Estate and GST Tax**

**Strafford Webinar  
January 8, 2020**

## **EXHIBIT 13**

### **IRC § 678 and the Beneficiary Deemed Owner Trust (BDOT)**

*Exploiting Opportunities to Simplify and Lessen Income Taxation of Trusts and Improve Asset Protection Through the Use of Targeted Powers of Withdrawal that Shift Taxation to Beneficiaries and Away from Fiduciary Income Tax Systems*

*By Edwin P. Morrow III, J.D., LL.M. (tax)*

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By Edwin P. Morrow III, J.D., LL.M. (tax)

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<sup>1</sup> Portions of this outline were presented at various CLEs 2011-2018 but the bulk of it published in Leimberg Information Services as *Ed Morrow: IRC Section 678(a)(1) and the “Beneficiary Deemed Owner Trust” (BDOT)*, LISI Estate Planning Newsletter #2587 (Sept 5, 2017). © 2017-2018 Edwin P. Morrow III – Contact: [edwin.morrow@usbank.com](mailto:edwin.morrow@usbank.com), or [edwin.morrow3@gmail.com](mailto:edwin.morrow3@gmail.com). Recent 2019 update includes updated discussion of Section 199A (II.f), conversions (II.k.) and tax elections (II.gg).

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## IRC §678(a)(1) and the “Beneficiary Deemed Owner Trust” (BDOT)

### EXECUTIVE SUMMARY:

Many trust settlors would prefer their beneficiaries be able to avoid the complexities and potential inequities involved in the fiduciary income tax system.<sup>2</sup> Most practitioners have assumed that to avoid this after a settlor’s death requires granting a beneficiary a withdrawal power over the entire trust. This is not the case. Settlers can achieve such status without such a drastic provision by including a power to withdraw both traditional accounting and taxable income attributable to principal, without the more drastic power to withdraw the entire corpus itself.

This article refers to any trusts whose entire taxable income must be reported by a beneficiary and the trust ignored as a separate taxpayer as “beneficiary-deemed owner trusts” (“BDOTs”). This should not be confused with the somewhat-related concept of a BDIT (“beneficiary defective inheritor’s trust”), which involves a partially released or modified power over an intervivos trust to withdraw the entire corpus of a trust.<sup>3</sup>

For many clients’ basic estate plans that lean towards granting more beneficiary control and access, such a design may be a cheaper, more efficient and preferred method of designing trusts. Moreover, there are many situations in which this structure may not fit the estate plan initially, but it makes sense to shift to such a design at a later date.

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<sup>2</sup> By “fiduciary income tax system”, I am referring to Subchapter J, Subparts A-D, IRC §641-§669, and Subpart F, §681-§685, which deems a trust or estate to be a separate taxpayer and controls most traditional estate and trust tax accounting, rather than Subpart E, commonly known as the grantor trust rules, which ignores the trust as a separate taxpayer as to any covered income and deems such income to be owned and reportable by the grantor or beneficiary, IRC §671-679.

<sup>3</sup> A “beneficiary defective inheritor’s trust” (BDIT) is a third party created irrevocable intervivos trust that avoids any powers that would make the settlor a grantor, with *Crummey* withdrawal rights and lapses designed to create irrevocable trusts that are taxed for income tax purposes to the current beneficiary while the power is in effect, under IRC §678(a)(1), and then post-lapse under §678(a)(2). They are typically initially funded with only \$5,000 due to the 5%/\$5,000 lapse limitation of IRC §2514. This article focuses on a different but related variant of this concept, where the beneficiary has a current withdrawal right over only the taxable income attributed to the corpus, rather than the entire corpus itself, and further comparison and contrast will be noted later in the article. For great “BDIT” articles, see *Gift From Above: Estate Planning On a Higher Plane*, Trusts and Estates, November 2011, by Richard A. Oshins, Lawrence Brody, Jerome M. Hesch & Susan P. Rounds; *The BDIT: A Powerful Wealth Planning Strategy When Properly Designed and Implemented*, LISI Estate Planning Newsletter #1824 (June 22, 2011), by Richard Oshins, Lawrence Brody and Katarinna McBride; *A Balanced Solution*, Trusts and Estates, May 2011, by Steven Gorin; *Is the BDIT Ready for Prime Time?*, by Jonathan Blattmachr & Howard Zaritsky, Probate Practice Reporter, Sept. 2012.

Estate/gift tax benefits include allowing a beneficiary to reduce his or her estate by the taxes paid on the BDOT's income without being required to take a distribution, and enable greater growth in the exempt trust by lowering the tax rate attributable without need for distributions.

Income tax benefits include simpler tax reporting, lower tax brackets, capital gains tax exclusions for residences, more favorable Section 179 expensing, disregarded transactions, S corporation status, charitable deductions for business income, life insurance and annuity rules, unlocking trapped capital losses, and many more benefits often overlooked.

Asset protection for such trusts, while seemingly substandard, is hardly a disaster. Any ill effects of a withdrawal power can not only be counteracted but even turned into an advantage over other trust designs. A comparison chart at the end summarizes the various state asset protection statutes and law around powers of withdrawal and lapses.

A BDOT is an important stop in the continuum of trusts that seek to land on the side of trusting beneficiaries rather than severely restricting them, while still offering the asset protection and estate tax benefits of trusts. With the dwindling and perhaps even disappearing importance of the estate tax, the income tax design aspect of the estate plan becomes more important.

The ability for trusts to change to (and from) a BDOT structure may offer significant compelling advantages over traditional trust design, especially for those families who may otherwise consider outright dispositions at predetermined ages. In conjunction with provisions to optimize the basis increase and avoid basis decreases at both upstream and downstream beneficiaries' deaths ("optimal basis increase trust" clauses), the BDOT offers a compelling alternative for families who want to maximize the income tax efficiency of their trusts.

## **Basics of IRC § 678, Prior to Any Lapses or Releases**

IRC §678(a) requires that a beneficiary be considered the owner of *any portion* of a trust when a beneficiary has the power to withdraw corpus or income:

### **“a) General rule**

A person other than the grantor shall be treated as the owner of *any portion* of a trust with respect to which:

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

For simplicity, this article will primarily address how §678 works if no other grantor trust provision applies. For instance, when a grantor of a trust dies, the grantor's estate does not step into the shoes of the grantor.<sup>4</sup> Thus, the only grantor trust provision that could apply to a trust at the grantor's death (unless there were additional grantors/contributors other than the decedent) would be IRC §678 (even if a spouse is still beneficiary and/or retains powers). This would be equally true if all grantor trust triggering powers, rights and dealings (such as borrowing) were released and/or otherwise eliminated during the settlor's lifetime, but for purposes of this article we will assume that no other grantor trust provisions apply, such as after a settlor's death.

It is also easier to first understand how IRC §678(a)(1) works as to powers over corpus, before exploring the more intriguing and overlooked possibilities of designing see-through trusts as to *taxable income only*.

## **The Effect of *Current* Withdrawal Rights over Corpus under §678**

In the post-mortem context, the most commonly found variant triggering §678 is a marital trust that grants the surviving spouse an unrestricted right of withdrawal over the entire trust.<sup>5</sup> This would clearly trigger §678(a)(1) because the surviving spouse would have the power to vest the corpus in him or herself. Such a trust would be taxed no differently than the surviving spouse's own revocable living trust – all income would be taxed to the beneficiary.<sup>6</sup> Unfortunately, such a trust usually offers the same asset protection benefits as a revocable trust – close to *none!*<sup>7</sup> This is why QTIPs are the more commonly used version of marital trust, especially for blended families.

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<sup>4</sup> Rev. Rul. 75-267.

<sup>5</sup> IRC §2056(b)(5).

<sup>6</sup> While the income taxation would be the same, such a trust funded by a third party is triggering §678, while a self-settled revocable living trust would be triggering §676 and likely other grantor trust provisions.

<sup>7</sup> This is discussed in more detail in the section of this paper on the asset protection effect of presently exercisable general powers of appointment and their lapses. While there are a few states that protect such assets, applicability would be uncertain at best under any conflict of law analysis if the settlor/trust and beneficiary were in different states, and in bankruptcy even if the settlor and beneficiary lived in a state subject to more protective statutes. See *Restatement, Second of Trusts* § 156; *Restatement, 3d of Trusts* § 60 cmt. F. and further discussion and listing of various states' lapse provisions/protections in the accompanying chart.

Trusts subject to a presently exercisable general power of appointment (withdrawal right) over the entire corpus would also subject the trust to most states' spousal elective share laws (by contrast, trusts subject only to *testamentary* powers would not in the vast majority of states, except perhaps in Delaware). See, e.g., *Uniform Probate Code* § 2-205(1)(A).

This same income tax result would occur if children or any other beneficiary were granted a similar withdrawal right. For example, if a trust granted the beneficiary the power to withdraw the assets at age 35 and the beneficiary was past that age and yet kept the assets in the trust, the trust's income would be taxed to the beneficiary under §678(a).

For estate tax purposes, if a beneficiary powerholder holds or uses a presently exercisable power to appoint to a trust for themselves, the entire proceeds will generally be included in their estate.<sup>8</sup> Releasing such a power without retaining any power that would make the gift incomplete would cause a taxable gift.<sup>9</sup> If a holder exercises or releases a power and retains an income interest and testamentary limited power of appointment, it will be an incomplete gift until death but cause estate inclusion.<sup>10</sup>

Thus, while drafting a trust for beneficiaries with an unlimited withdrawal right does simplify income tax reporting and avoids the fiduciary income tax system, it fails to achieve even the most basic of estate tax or asset protection planning goals.

These estate tax and asset protection issues associated with withdrawal powers over corpus are usually not a worry when a trust is funded with only \$5,000 and the withdrawal power will lapse soon after funding (as with a beneficiary defective inheritor's trust, a.k.a. "BDIT"). However, they are very significant when considering the disposition of an entire estate or a much larger trust corpus. This brings us to a more viable alternative for such situations and the focus of this article.

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Although this will vary state to state, unfettered beneficiary withdrawal rights may negatively affect property division, equitable distributions and alimony upon divorce, see short discussions of these cases:

<https://www.linkedin.com/pulse/guagenti-court-upholds-third-party-irrevocable-trust-edwin-morrow/>

<https://www.linkedin.com/pulse/decanting-blockbuster-new-decision-ferri-v-case-edwin-morrow;>

<https://www.linkedin.com/pulse/pfannenstiel-overturned-assault-divorce-court-inherited-edwin-morrow;>

<https://www.linkedin.com/pulse/gibson-lack-professional-trusteeadministration-dooms-settlor-morrow.>

<sup>8</sup> I.R.C. §2041(a)(2); Treas. Reg. §20.2041-3(d)(1). See also *Estate of Gartland*, 34 TC 867 (1960), *aff'd* 293 F.2d 575 (7th Cir. 1961), *cert. den.* 368 U.S. 954 (1962) (released power with retained interest still includes trust corpus in estate).

<sup>9</sup> IRC §2514(b).

<sup>10</sup> PLR 9309023.

## The Effect of Current Rights to Taxable Income Only Under §678(a)(1)

It is also possible to have income be taxable directly to the beneficiary under §678(a)(1) if the beneficiary has an unfettered right to withdraw the taxable income, without need to reference any right to withdraw corpus. If the right to withdraw is only exercisable with the required consent of a trustee or any other party it would not be exercisable “solely by himself”.

A trust that pays all net income, even if that includes all capital gains, to a beneficiary does NOT trigger grantor trust status – such trusts must report under the Form 1041/K-1 Subchapter J tax regime. However, if the beneficiary is also the sole trustee and is entitled to all net income it may be a partially beneficiary deemed owner trust as to the net accounting income.<sup>11</sup>

If a current beneficiary is sole trustee with liberal distribution standards (e.g. health, education and support without need to consider other resources available to the beneficiary) such that a certain floor is de facto available to the trustee/beneficiary to withdraw, this raises the possibility that §678 is triggered, but the conclusion on this point is far from reliable for proactive planning purposes.<sup>12</sup>

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<sup>11</sup> One tax court case held that when a beneficiary who was sole trustee was entitled to all net income, it was a beneficiary deemed owner trust under IRC §678 as to the net accounting income, but not the corpus (capital gains), because “[h]e was able to, was required to, and did vest the income of the trust in himself. Petitioner as trustee was required to cause the trust periodically to pay him (as income beneficiary) the entire net income of the trust. Petitioner, as trustee, owed fiduciary duties with respect to the income only to himself, the sole income beneficiary. Accordingly, we conclude that petitioner has the sole power to vest the trust’s income in himself and is treated as the owner of the income portion of the trust.” *Goldsby v. Comm.*, TC Memo 2006-274. Partial beneficiary deemed owner trust status as to accounting/ordinary income only is not necessarily always a positive result for taxpayers, but it may be in some circumstances. It is messier and more complicated to report and divide income, but it’s unlikely the IRS is going to bother auditing for this issue.

<sup>12</sup> There are colorable arguments that a sole beneficiary/trustee triggers §678(a) even when limited by an ascertainable standard, but this is debatable and generally unreliable for proactive planning purposes. The majority of cases find that even the slightest limitation will take a powerholder out of grantor trust status. This paper will assume there are no forfeiture provisions, consent requirements, duties or purposes otherwise fettering the right. For a good argument that sole trustee/beneficiaries limited by ascertainable standards may still trigger §678(a) under its plain language, see pages 17-20 of Bryan Howard’s CLE outline at <http://www.howardmoble.com/articles/FixingBrokenTrusts.pdf>. For the contrary position that I’ll assume is correct for planning purposes for this paper, see *Beneficiary as Trust Owner: Decoding Section 678*, by Jonathan Blattmachr, Howard Gans and Alvina Lo, 35 ACTEC Journal 106, 108-114 (Fall 2009). As purely a point of statutory construction, Howard probably has the better argument, since a sole trustee/beneficiary limited only by a liberal HEMS restriction has a *power solely exercisable* by themselves to vest income/principal up to what a

It is easy to ignore or misinterpret the “power \*\*\*to vest\*\*\* the income” portion of §678(a)(1), since there have been fewer reported cases, rulings and articles on trust structures that only allow withdrawal powers over taxable income, yet dozens of PLRs and articles on withdrawal powers over corpus. Treatises have very little if any discussion of this potential variation.

**Yet.**

*But there is no reason to ignore “or the income” in the statute and no requirement under §678(a)(1) that a beneficiary/powerholder have any power over corpus beyond the income attributed to corpus to shift all the income taxation to the beneficiary.* In fact, the taxpayer in the seminal case upon which the statute was based had no right to withdraw underlying principal.<sup>13</sup>

## **How is “Income” Defined for §678 Purposes?**

If §678(a)(1) is triggered by the “power \*\*\*to vest\*\*\* the income”, what is meant by “income”?

The code and Treasury Regulations are crystal clear that “income” in §678(a) refers to *taxable* income, not accounting income:

“(b) Since the principle underlying subpart E (section 671 and following), part I, subchapter J, chapter 1 of the Code, is in general that income of a trust over which the grantor or another person has retained substantial dominion or control should be taxed to the grantor or other person rather than to the trust which receives the income or to the beneficiary to whom the income may be distributed, **it is ordinarily immaterial whether the income involved constitutes income or corpus for trust accounting purposes. Accordingly, when it is stated in the regulations under subpart E that “income” is attributed to the grantor or another person, the reference, unless specifically limited, is to income determined for tax purposes and not to income for trust accounting**

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court would ordinarily permit (this is *especially* true if there is no requirement to consider other resources available). However, as a practical matter this interpretation is completely impractical and unworkable, as it would force both taxpayers and the IRS to evaluate every year what a judge could possibly approve under state law for HEMS to determine the extent to which §678(a)(1) applies! Treasury should clarify this point by regulation and simply declare that any ascertainable standards nix application of §678(a).

<sup>13</sup> *Mallinckrodt v. Nunan*, 146 F.2d 1 (8th Cir. 1945). The concept of a power over income shifting taxation to the powerholder pre-dates §678 and even *Mallinckrodt* and was in regulations from the 1939 code: § 39.22(a)-22 (1939), and in cases prior to *Mallinckrodt*.

**purposes.**<sup>14</sup> [emphasis added] [note: §678 is in Subpart E. The §678 regulations mimic the code section and refer to code section 671 and regulations thereunder, both of which refer to *taxable income*.]<sup>15</sup>

This is in stark contrast to the definition of “income” for the rest of Subchapter J (Parts A-D, F: i.e., non-grantor trusts), which defaults to a completely different definition that relies on trust accounting concepts.<sup>16</sup>

This is the source of significant confusion among practitioners.<sup>17</sup>

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<sup>14</sup> Treas. Reg. §1.671-2(b) Applicable Principals. IRC §671 “Where it is specified in this subpart that the grantor or another person shall be treated as the owner of any portion of a trust, there shall then be included in computing **the taxable income** and credits of the grantor or the other person...”

<sup>15</sup> IRC §671 “Where it is specified in this subpart that the grantor or another person shall be treated as the owner of any portion of a trust, there shall then be included in computing **the taxable income** and credits of the grantor or the other person...”. Treas. Reg. § 1.678(a)-1(a) “Where a person other than the grantor of a trust has a power exercisable solely by himself to vest the corpus **or the income** of any portion of a testamentary or inter vivos trust in himself, he is treated under section 678(a) as the owner of that portion, \*\*\*. **See section 671 and §§ 1.671-2 and 1.671-3** for rules for treatment of items of income, deduction, and credit where a person is treated as the owner of all or only a portion of a trust.”

<sup>16</sup> Treas. Reg. § 1.643(b)-1 “Definition of income. For purposes of **subparts A through D [note this specifically excludes subpart E grantor trust rules]**, part I, subchapter J, chapter 1 of the Internal Revenue Code, “**income**,” when not preceded by the words “taxable,” “distributable net,” “undistributed net,” or “gross,” **means the amount of income of an estate or trust for the taxable year determined under the terms of the governing instrument and applicable local law**. Trust provisions that depart fundamentally from traditional principles of income and principal will generally not be recognized. For example, if a trust instrument directs that all the trust income shall be paid to the income beneficiary but defines ordinary dividends and interest as principal, the trust will not be considered one that under its governing instrument is required to distribute all its income currently for purposes of section 642(b) (relating to the personal exemption) and section 651 (relating to simple trusts). Thus, items such as dividends, interest, and rents are generally allocated to income and proceeds from the sale or exchange of trust assets are generally allocated to principal.\*\*\*”

<sup>17</sup> Some authors believe that the above regulation defining “income” in §678 as referring to taxable income is suspect or unreliable because it makes the addition of the word “corpus” in §678(a) “superfluous”, see *Beneficiary as Trust Owner: Decoding Section 678*, by Jonathan Blattmachr, Howard Gans and Alvina Lo, 35 ACTEC Journal 106, 118-119 (Fall 2009) and Michael A. Yuhas & Carl C. Radom, *The Grantor Trust Rules: Competing Powers and Ascertainable Standards*, 85 Prac. Tax Strategies 4, pages 9-10 (July 2010). I respectfully disagree. The regulation can be safely relied upon as a very reasonable, if not mandatory, interpretation of §671 and §678, especially in light of the consistent history, intent, cases and rulings noted in the section of this paper following. It still makes sense for Congress to have added “corpus” in the statute and regulation to clarify that §678 is meant to also cover instances in which a power of withdrawal might not reference income or even if a power of withdrawal were defined to *exclude* taxable income. Without §678(a) including a power to vest the

Let's start by explaining a trust that provides that the primary beneficiary has the unfettered right to withdraw "all net income". Unless defined otherwise in the trust, this means the beneficiary is taxed only on fiduciary accounting income (e.g., dividends, interest, rents), but not necessarily all *taxable* income. This is a function of trust accounting and state principal and income law, not §678, and leaves a large gap of unshifted taxable income potentially taxable to the trust. For instance, a traditional IRA distribution might be 100% *taxable* income, but only 10% or less *accounting* income, and extraordinary dividends and capital gains would not usually be accounting income either.<sup>18</sup>

Conversely, a trust could grant a beneficiary a withdrawal right over taxable income attributable to principal, but *not* accounting income, and under §678(a)(1) such a power would shift only that withdrawable income (e.g. *not* the interest, dividends, rents, but income allocable to principal such as 90% of the IRA RMD and most capital gains) to the beneficiary.<sup>19</sup>

But a trust could easily define the withdrawal right to include all *taxable* income regardless of whether it is accounting income or income allocated to principal, such as capital gains. We must look to the definition of income in the withdrawal right under the

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"corpus", not just the income attributable to corpus (principal), clever attorneys could simply draft a provision wherein one could withdraw the entire corpus excluding the taxable income attributable thereto and avoid the ambit of §678 altogether, which Congress certainly wisely wanted to avoid and pre-§678 case law precedent discussed later herein clearly would not have tolerated either. Taking a position contrary to the regulation that a power to withdraw capital gains or other income attributable to principal would not implicate §678(a)(1) would be foolhardy, as there is no basis or authority for the conclusion and plenty in the regulations, history of the statute and case law to the contrary.

This definition also explains the seemingly confusing contradiction in §678(b): "Exception where grantor is taxable. Subsection (a) shall not apply with respect to a power over income, as originally granted or thereafter modified, if the grantor of the trust \*\*\* is otherwise treated as the owner under the provisions of this subpart other than this section." A power over the entire corpus is of course a power over all its income unless carved out otherwise and this explains the many rulings holding that §671-677 powers trump §678(a) *Crummey* powers if both exist simultaneously. The only reason for §678(a) to exist is to determine the taxation of "income" (meaning taxable income, which includes capital gains and other income attributable to principal). Since we are not talking about a wealth tax, it does not matter whether §678(a) applies to corpus by itself, the only thing that matters is whether §678(a) applies to taxable income (which may include income attributable to corpus) – if it does, whether through power over accounting income, income attributable to principal or both, then §678(b) says that §671-677 trumps it.

<sup>18</sup> See Uniform Principal and Income Act, §409, §404.

<sup>19</sup> Treas. Reg. §1.671-3(b)(2). It is "immaterial whether the income involved constitutes income or corpus for trust accounting purposes." This point is also confirmed in discussion of various cases and PLRs in material following.

trust instrument, and if a beneficiary can withdraw all the taxable income including capital gains and other income normally allocated to principal, then the beneficiary *must* report such income, even if the beneficiary cannot withdraw principal beyond that.<sup>20</sup> It is *not* optional to report any income to the trust as a separate entity and/or report the trust as liable for the tax.<sup>21</sup>

Failing to take the withdrawable income is not relevant to the §678 analysis, nor is renouncing the right to prior income (usually).<sup>22</sup> Such a power has even been ruled effective when held by a minor where there was no court-appointed guardian with authority to exercise it.<sup>23</sup>

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<sup>20</sup> For example, in *U.S. v. De Bonchamps*, 278 F.2d 127 (9<sup>th</sup> Cir. 1960), the court found, in interpreting §678, that a life tenant should not be taxed on the income because they did not have the sole power to take the capital gains upon sale of the underlying asset. “We have concluded that, upon the record before us, the powers of these life tenants are not the equivalent of a power to vest in themselves the corpus of the estate **or** the capital gains in question.” (emphasis added, the court clearly implying by including “or” that if they *could have* taken the capital gains, though not necessarily the entire corpus, it would have been taxed to the power holders). This point even clearer in the *Campbell* case discussed later herein.

<sup>21</sup> Note, I am referring to reporting as a separate taxpayer, non-grantor trust under the fiduciary income tax scheme. Grantor trusts have an option to file a limited Form 1041, checking the box as a grantor trust, which we’ll revisit at the end of this article. For obtaining protections for tax positions taken contrary to authority or regulation, see IRS instructions for Forms 8275 or 8275-R.

<sup>22</sup> *Grant v. Commissioner*, 174 F.2d 891 (5<sup>th</sup> Cir. 1949). Although, §678(d) does provide that “Subsection (a) shall not apply with respect to a power which has been renounced or disclaimed *within a reasonable time after the holder of the power first became aware of its existence.*” – note that “reasonable time” is quite different from qualified disclaimer rules which are strictly tied to a nine month window (unless the disclaimant is under age 21). For example, H dies in 2012, leaving assets to bypass trust, W dies in 2017 and uses her testamentary limited power to appoint to a new trust for D, granting D a withdrawal right. It is too late for D to make a qualified disclaimer for estate/gift tax purposes (assuming D is well over age 21), but probably not too late for D to make a non-qualified disclaimer of the withdrawal right for §678(d) purposes, as she would have only become aware of her withdrawal power after W’s death.

<sup>23</sup> Generally the estate and gift tax effect of general powers of appointment (and lapses) are unaffected by a powerholder’s incapacity. *Fish v. U.S.*, 432 F.2d 1278 (9<sup>th</sup> Cir. 1970). IRC §678(a) is similar – see Rev. Rul. 81-6, holding that a minor beneficiary with a withdrawal right (*Crummey* power) is deemed the owner for §678 purposes even if local law requires a court appointed guardian and none has ever been appointed. Similar is *Trust No. 3 v. Commissioner*, 285 F.2d 102 (7<sup>th</sup> Cir. 1960), which concerned several minors who had rights to withdraw/terminate a trust. Although a withdrawal power is effective for §678(a) regardless of a beneficiary’s legal capacity, it would be prudent to specifically allow an agent under a durable power of attorney or court-appointed conservator or guardian to exercise the right. If you included language in the trust that *prohibited* an agent/guardian from acting, this probably *would* take the trust outside of IRC §678’s purview.

If the powerholder *actually* withdraws the taxable income withdrawable, it is generally a **non-event** tax-wise and is not a distribution reported under Subchapter J, Parts A-D.<sup>24</sup> The important income tax event is having the power itself, *not* the distribution. A right to use property (such as a vacation home) is not the same as a distribution or right to withdraw income from it.<sup>25</sup> For trusts that are partial grantor, partial non-grantor trusts (e.g. five and five power trusts), the analysis might be more complicated.<sup>26</sup>

### **Case Law Clarifying that a Power to Withdraw Taxable Income Attributable to Principal Without Having the Ability to Withdraw the Entire Corpus Itself Still Shifts Taxation to the Power Holder**

The granddaddy of all grantor trust cases, *Mallinckrodt*, from which Congress basically codified into IRC §678 in 1954, concerned a father who established a trust for his son, his son's wife and their children.<sup>27</sup> The son's wife was to get \$10,000/yr, and the son could withdraw any income above that. The trustee reported all the income, including the undistributed income that the son could have withdrawn but did not, and deducted the \$10,000 distribution to the wife. The court held that reporting of income/deduction for the \$10,000 was proper, but that the undistributed income that the son could have withdrawn, but did not, must be reported *on his tax return* as income:

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<sup>24</sup> Rev. Rul. 67-241.

<sup>25</sup> Treas. Reg. §1.671-2(e)(2)(ii).

<sup>26</sup> Generally, distributions in kind from a non-grantor trust to fund a pecuniary amount can trigger taxation known as *Kenan* gain, and non-pro rata divisions of even a residuary do the same if there is no trustee authority to make non pro rata distributions, pursuant to Rev. Rul. 69-486, but most trusts nowadays should have the power to do this and many states build such power into their statute. See Uniform Trust Code §816(22). With a fully beneficiary deemed owner trust, however, distribution in kind is likely a non-event, since pursuant to Rev. Rul. 85-13 and progeny, discussed later herein, a transaction between a deemed owner and themselves would be disregarded. Conceivably, however, a withdrawal power of a pecuniary amount exercised over any portion that is a non-grantor trust could trigger *Kenan* gain if satisfied with appreciated assets in kind. The withdrawal from the portion that is non-grantor would carry out DNI like any other trust distribution, potentially leaving capital gains taxed in trust and shifting other taxation to the beneficiary to the extent of distribution.

<sup>27</sup> *Mallinckrodt v. Nunan*, 146 F.2d 1 (8<sup>th</sup> Cir. 1945), this same reasoning is followed in other cases where beneficiaries had no withdrawal right over the entire principal, but only the income. E.g. *Spies v. United States*, 180 F.2d 336 (8<sup>th</sup> Cir. 1950), *Goldsby v. Commissioner*, T.C. Memo 2006-274 (where taxpayer/beneficiaries attempted to get an individual charitable deduction, arguing that a conservation easement contribution from the trust came from income taxable to the beneficiary under §678 – the tax court found that §678(a) applied, and a charitable deduction would be allowed if it had come from a taxpayer's grantor trust portion, but ultimately denied the deduction since the contribution was not traced to the ordinary income. The parties and court inexplicably ignored §678(a)(2), which may have helped the taxpayer get a prorated deduction).

[The] “power of the petitioner to receive this trust income each year, upon request, can be regarded as the equivalent of ownership of the income for purposes of taxation.\*\*\* income is taxable to the possessor of such power, and that logically it makes no difference whether the possessor is a grantor who retained the power or a beneficiary who acquired it from another.\*\*\* Since the trust income in suit was available to petitioner upon request in each of the years involved, he had in each of those years the "realizable" economic gain necessary to make the income taxable to him.”<sup>28</sup>

While *Mallinckrodt* did not specify or discuss whether capital gains or other income attributable to principal was included in the trust’s definition of withdrawable income, it is clear from the case that if it were, it would have been taxable to the son who held the power to withdraw it. Important for understanding §678(a)(1) is that it was immaterial whether the son could withdrawal corpus beyond the taxable income of the trust.

In an even clearer case that is directly on point, *Campbell v. Commissioner*, an irrevocable trust had this clause:

“The net income from said trust shall be distributed by the Trustee to the beneficiaries [petitioner and Kathleen], jointly or the survivor of them, not less than once each year \* \* \*. Provided, however, the Trustee shall distribute only that part of the net income which is derived *from Capital gains as is requested each year by the beneficiaries* and if no such request be made then all of such capital gains shall be retained as a part of the Trust fund and be reinvested as principal.”<sup>29</sup>

The beneficiary did not request and the trust did not distribute the capital gains income, although the beneficiary could have clearly requested it. Citing *Mallinckrodt*, the tax court in *Campbell* held that:

“Section 678(a)(1) clearly provides that a person with the power, exercisable solely by himself, to vest the corpus or the income in himself will be treated as the owner of that portion of the trust over which his power exists. Here, Kathleen and petitioner had the power exercisable solely by themselves to receive the King Trusts' *capital gains income*. Accordingly, pursuant to section 678(a)(1),

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<sup>28</sup> *Id.* at 5.

<sup>29</sup> *Campbell v. Commissioner*, T.C. Memo 1979-495.

petitioners are deemed to be *the owners of the capital gains income* from the King Trusts.”<sup>30</sup>

Thus, with the plain language of §678(a)(1), regulations under Treas. Reg. §1.671-2 and longstanding case precedent, it’s clear that beneficiaries with withdrawal rights over trust taxable income, regardless of whether there is any power whatsoever over corpus beyond that, MUST report any such income (and expenses, credits allocable thereto) on their Form 1040. *There is no authority to argue otherwise.*

Though it is not a citable precedent as the above authority is, a recent IRS private letter ruling is completely in accord:<sup>31</sup> in PLR 2016-33021, a trust (trust #1) established by a decedent had established another trust (trust #2), reserving a §678 solely exercisable withdrawal power over the net income, with the power lapsing on the last day of the calendar year.<sup>32</sup> Of course, the original trust cannot be considered a grantor under §§673-677 - the original grantor was dead. But as a separate taxpayer, trust #1 could be a deemed owner under §678.<sup>33</sup> The power over income that trust #1 held over trust #2, the decanted trust, was defined to include “(i) any dividends, interest, fees and other amounts characterized as income under § 643(b) of the Code, (ii) any net capital gains realized with respect to assets held less than twelve months, and (iii) any net capital gains realized with respect to assets held longer than twelve months.”<sup>34</sup> Note that, just

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<sup>30</sup> *Id.* at 16. While at least one of the trusts involved a husband as grantor of a trust for his wife and would today invoke grantor trust status through §677 via §672, in 1972 when this case was decided §672 spousal attribution was not in the code.

<sup>31</sup> PLRs are not citable as precedent and may only be relied on by the taxpayer who obtained the ruling. IRC § 6110(j)(3). However, they may still be useful in avoiding penalties for substantial understatement of tax under IRC § 6662, see Treas. Reg. §1.6662-4(d)(3)(iii).

<sup>32</sup> PLR 2016-33021.

<sup>33</sup> The grantor trust regulations specifically contemplate a non-individual as a deemed owner, Treas. Reg. §1.671-2(c): “An item of income, deduction, or credit included in computing the taxable income and credits of a grantor or another person under section 671 is treated as if it had been received or paid directly by the grantor or other person (**whether or not an individual**).” This is later confirmed in §1.671-2(e)(4) and (5), and more specifically in (e)(6), example 8. Also, when §678 refers to a “person other than the grantor shall be treated as the owner”, remember that “person” for the Internal Revenue Code is “construed to mean and include an individual, a trust, estate, partnership, association, company or corporation.” IRC §7701(a)(1).

<sup>34</sup> *Id.* Query whether this would be an issue if assets were held for *exactly* twelve months? Or more importantly, what about income that is allocable to principal under §643(b) but not capital gains, such as 90% of a required minimum distribution (or under some state/trusts, the distribution over accounting income) or additional distributions beyond RMDs from IRAs, or extraordinary dividends or distributions from pass through entities allocated to principal, etc.? I

as we are exploring in this article, *the beneficiary deemed owner (trust #1) in this PLR did NOT have the power to withdraw corpus or principal of the trust beyond the taxable income*. The IRS ruled that the net capital gains, as well as the net income that would be part of DNI, would be *taxed to the power holder (trust #1), despite the power holder having no power whatsoever over corpus beyond the net capital gains*.

Regulations are clear that someone can be deemed owner of income allocable to corpus as well as ordinary income: “If a grantor or another person is treated as the owner of a portion of a trust, that portion may or may not include both ordinary income and other income allocable to corpus.”<sup>35</sup> Thus, a beneficiary can be deemed the owner for income tax purposes of the accounting income, as in the *Goldsby* case, owner of the capital gains income attributed to principal/corpus, as in *Campbell*, or owner of both, as in PLR 2016-33021 (and likely *Mallinckrodt*).<sup>36</sup> None of these variations need require a power to withdraw the entire corpus. To quote the Supreme Court, “the power to dispose of income is the equivalent of ownership of it.”<sup>37</sup>

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would not draft the withdrawal power that way, but there could be a typo in the PLR – they may have meant income under §643(a), DNI, plus capital gains, rather than §643(b) plus capital gains. While the goal of the second trust established in this PLR is not discussed, it raises some interesting questions and planning ideas. For example, Trust #1 in this PLR is taxed on all of the taxable income of Trust #2, apparently despite any distributions being made to beneficiaries by Trust #2. The ruling makes no mention of what the taxable effect of *distributions* from Trust #2 would be. Would those distributions be attributed to Trust #1? If not, it would allow distributions to be made from Trust #2 while still permitting income to be trapped in Trust #1 without carrying out DNI (while ordinarily for 99% of taxpayers this is disadvantageous, this might be quite advantageous for high bracket taxpayers in higher income tax states and other unique situations). Though unclear, my opinion is that Trust #2 would be ignored for all income tax purposes under Rev. Rul. 85-13 and other rulings discussed in more detail later herein, and thus its distributions would be attributed to Trust #1 along with its income. Were there other subtle differences between the trusts not mentioned in the PLR?

<sup>35</sup> Treas. Reg. 1.672-3(b).

<sup>36</sup> The regulations that explain how to divide income of a trust that is only partially subject to the grantor trust rules are colloquially known as the portion rules. Treas. Reg. §1.671-3 outlines three different ways that taxable income might be divided if it’s not clear that 100% is attributed to an individual or 100% to the trust: 1) Paragraph (a)(2): Individual is deemed owner of specific property and the income therefrom; 2) Paragraph (a)(3): Income divided on a fractional basis; 3) Paragraph (b)(1): Income is divided based on rights to income based on fiduciary accounting principles

With a BDOT, the income attributable to all assets of the trust is withdrawable, 100% of all taxable income, and both the ordinary income and the income attributable to principal (allocable to corpus) would be withdrawable by the beneficiary. Therefore, under either method the taxable income should be attributable to the beneficiary.

<sup>37</sup> *Harrison v. Schaffner*, 312 U.S. 579 (U.S. Mar. 31, 1941), quoted by the *Mallinckrodt* case.

## Simple Example of Application of a See Through Grantor Trust §678(a)(1) Provision

To understand the practical basics, let's examine a basic trust with \$2 million, generating \$40,000 of unrealized capital gains, \$40,000 of capital gains and \$40,000 of interest and dividends. With a fully §678(a) trust in which the beneficiary can withdraw all taxable income, including capital gains or other taxable income that might be allocated to principal under trust accounting and the state's Uniform Principal and Income Act, the beneficiary would simply report all \$80,000 of taxable income, and any expenses and credits allocable thereto, on her Form 1040 regardless of what she actually receives, and *the trust itself can have no income*.<sup>38</sup>

The trust increases to \$2.12 million, tax-free, while the beneficiary has phantom income and can elect to pay the income tax (approx. \$20,000 depending on the bracket) from outside assets, which minimizes income tax and maximizes the amount of assets protected from creditors and sheltered from estate tax (there is more detail on these aspects in the supplemental material).

### Conclusion

A beneficiary deemed owner trust (BDOT) can be a useful tool, particularly in lieu of situations where someone might prefer outright distributions or a liberal "beneficiary-controlled trust" otherwise. It obviously has no place for severe cases where someone cannot trust a beneficiary at all or needs to severely restrict a beneficiary's access, such as for minors or those receiving certain disability benefits, or wants to dynastically grow principal for the next generation and does not trust the first generation of beneficiaries to curb their withdrawals. That said, in many cases it may be appropriate to add such a clause later or grant the power to an independent trustee or trust protector to later add such a clause, even on an annual reviewable basis, whenever the trustee or trust protector deems it appropriate. If you think of it, many trusts you have on your desks have something substantially equivalent buried in their boilerplate now - permitting the trustee to segregate or otherwise qualify a trust for the QSST election.

BDOT advantages are not limited to the obvious ability to avoid filing a full Form 1041 and avoid having income, especially capital gains, trapped in trust taxed at top tax rates

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<sup>38</sup> Or, more accurately, the trust would have no income to report under Subparts A-D of Subchapter J as a separate taxpayer, but only reportable to the beneficiary under Subpart E grantor trust rules, which may or may not involve filing a Form 1041 as noted later herein.

after only \$12,500.<sup>39</sup> Taxation of certain income or the permissibility of certain deductions, such as the sale of a personal residence, Section 179 business expensing or charitable donation of business income all have special tax rules better exploited by a §678(a) trust than a non-grantor trust. Some of the most valuable benefits are discussed in their own sections in an addendum after this article, along with additional discussion of the asset protection nuances and a 50 state chart of the applicable creditor protection law surrounding withdrawal powers and lapses in each state.

From an estate tax perspective, BDOTs allow a beneficiary to reduce his or her estate by the taxes paid on its income, without being required to take a distribution, and enable greater growth in the exempt trust by lowering the tax rate without need for distributions. By restricting the withdrawal window, BDOTs can usually be completely outside of the estate tax, or assets might selectively be included with a formula OBIT clause.

Asset protection is hardly an issue when examining state law and the effect of cessor clauses on creditor protection. In fact, the ability to grow the trust more with less taxation and spend down attachable assets by paying the trust's tax from outside funds is a substantial *benefit*. Most states have either complete protection, or at least "five and five" level protection for lapses, and both state law and bankruptcy law honor forfeiture or trust protector clauses that can safely remove such powers if ever needed.<sup>40</sup> If taxable income might exceed a state's lapse protection, the trust may change situs to another jurisdiction, the trustee can manage the amount withdrawable through its investment policy, in most UTC states the settlor can retain a modified "hanging power" designed to avoid exposure to creditors and/or the beneficiary can use their power to either spend the excess income or invest it into a myriad of other asset protection vehicles (life insurance, 529 plan, qualified plan, IRA, IGT, DAPT, etc.).

The BDOT does not rely on private letter rulings, but on code, regulations, revenue rulings and decades of case law. However, certain ancillary aspects are still uncertain and only have PLRs as guidance, such as the effect of lapses under Code § 678(a)(2) if the current power is removed for whatever reason (discussed in addendum).

In conclusion, a BDOT is an important stop in the continuum of trusts that seek to land on the side of trusting beneficiaries rather than severely restricting them, while still

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<sup>39</sup> This bracket, like all individual income tax brackets under IRC §1, adjusts annually for inflation and increased from \$12,400 to \$12,500 in 2017. Rev. Proc. 2016-55, §3.01. See Rev. Proc. 2018-57 for most recent 2019 inflation adjustments.

<sup>40</sup> *Domo v. McCarthy*, 612 NE2d 706, 709 (Ohio 1993). These are also referred to as "cessor" clauses, e.g., in the recent *Castellano* case, though the seminal U.S. Supreme Court case, *Nichols v. Eaton*, 91 U.S. 716 (1875), refers to the "cesser" of income. See collected cases in Spero, *Asset Protection: Legal Planning, Strategies and Forms*, ¶6.07. *Shifting Interest Trusts. Also, Restatement of Trusts, 3d, §57 Forfeiture for Voluntary or Involuntary Alienation*

offering the asset protection and estate tax benefits of third party created spendthrift trusts. The BDOT offers significant income tax advantages over traditional trust design, especially in conjunction with provisions to optimize basis at both upstream and downstream beneficiaries' deaths.

## II. Supplemental Material

### a) Creating Beneficiary Deemed Owner Trust Status for Specific Assets and Income Therefrom – Possible but Usually not Ideal

If our hypothetical beneficiary above only had an unfettered right to withdraw *accounting* (ordinary) income (interest, dividends, rents), then \$40,000 must be reported on her Form 1040, the \$60,000 of capital gains would be taxed to the trust (and/or beneficiary if further distributions are made) under non-grantor trust rules and deductible expenses would have to be allocated or apportioned accordingly.<sup>41</sup> Similarly, if the beneficiary had a cap on the withdrawal right, e.g., only up to 4% (\$80,000) – then she would only be taxable to the cap, and expenses would be prorated accordingly (regardless of whether she actually takes the \$80,000). There is no reason that a §678(a)(1) power has to be all or nothing, or even the same every year if an independent trustee or trust protector were to change it. It can be more targeted than the traditional distribution structure under Subchapter J, which does not allow tracing of types of income.

For example, let's say a trust grants the beneficiary the unfettered withdrawal right to all income attributable to all assets *except* the municipal bond portfolio, the stock portfolio and the Roth IRA. This leaves income from those assets (top rates 0%, 23.8% for LTCG/QD, 0% respectively) in trust, and only shifts taxation of any ordinary income rent, traditional IRA distribution, annuity or taxable interest to the beneficiary.<sup>42</sup> This exploits a larger delta of the likely tax rate differential between a trust and beneficiary, i.e. a 43.4% or 39.6% trust tax rate down to a likely 15% or 25% taxed to the beneficiary rather than 23.8% to 15%.

This withdrawal power could also be capped – e.g., all income attributable to assets other than the muni bond portfolio above the trust's top tax rate bracket, or even 28% rate bracket (\$12,500 or \$6,000 respectively), or even reference an external criteria,

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<sup>41</sup> Treas. Reg. §1.671-3(b) and various portion rules discussed throughout Treas. Reg. §1.671-2 and §1.671-3. Some expenses might be attributed to the asset producing the income, and some, like a trustee fee, might be apportioned. Treas. Reg. §1.671-3(a)(2): "If the portion treated as owned consists of specific trust property and its income, all items directly related to that property are attributable to the portion. Items directly related to trust property not included in the portion treated as owned by the grantor or other person are governed by the provisions of subparts A through D (section 641 and following), part I, subchapter J, chapter 1 of the Code. Items that relate both to the portion treated as owned by the grantor and to the balance of the trust must be apportioned in a manner that is reasonable in the light of all the circumstances of each case, including the terms of the governing instrument, local law, and the practice of the trustee if it is reasonable and consistent."

<sup>42</sup> Treas. Reg. §1.671-3(a)(2)

such as income to a point until his/her taxable income exceeds the beneficiary's top income tax bracket.<sup>43</sup>

*These variations complicate administration, however, and the desire to squeeze every last cent of tax savings leads to diminishing returns that may not be warranted because of greater complexity.* Remember that a partial grantor, partial non-grantor trust forces an apportioning of any attributable expenses, such as investment management/trustee, attorney fees, though directly attributable expenses (e.g. real estate taxes on a property) may be traced and be specifically allocated to the §678(a) beneficiary's income or the non-grantor trust portion, depending on which portion is getting the income so attributed.<sup>44</sup> It may also open a greater risk of audit. Though it's certainly possible to accomplish, any structure with withdrawal rights over only certain types of assets would have issues if the beneficiary were the sole trustee or controlling investment trustee/advisor, and fiduciary duties and conflicts would have to be worked around even with an independent trustee. A partial grantor/non-grantor trust would also not come under Rev. Rul. 85-13 (discussed further herein).

If you combine a 5/5 power with a power over less than 100% of taxable income, the calculation would have to be done separately. For example, let's say you had a corpus of \$500,000 and the power to withdraw accounting income only, which was \$25,000, and also the power to withdraw 5% of corpus (which is also \$25,000), but there was \$25,000 of capital gains. A portion of the capital gains would also be taxable to the powerholder – the calculation would be separate.<sup>45</sup>

Thus, despite the above possibilities, by far the most likely use for a beneficiary deemed owner trust is a family that wants to simplify trust administration and accounting for their beneficiaries and ensure they could not be "worse off" income tax wise with a trust than an outright distribution. This means granting a withdrawal power over **all** taxable income (probably even including municipal bond income, which is often taxable for state but not for federal). Such a provision can eliminate a traditional Form 1041 filing and may open up other tax planning possibilities discussed later herein, such as swapping assets.<sup>46</sup>

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<sup>43</sup> For discussion of parsing §678 withdrawal powers for different types of income, see *The Minimum Income Tax Trust: Drafting Techniques to Help Unburden Estate Planners, Trusts and Estates*, May 2014 by James Blase.

<sup>44</sup> Treas. Reg. §1.671-3(a)(2).

<sup>45</sup> See *Oppenheimer v. Comm'r*, 16 T.C. 515 (1951), with similar facts.

<sup>46</sup> See Treas. Reg. §1.671-4 for alternative methods of grantor trust reporting– if the deemed grantor is trustee a Form 1041 filing can be avoided. If a third party is trustee, a Form 1041 is required. It's not nearly as complicated though.

## **b) Advantage – Section 179 Expensing Denied to Non-Grantor Trusts**

Surprising to many people, estates and non-grantor trusts are *not* eligible for the juicy \$510,000 IRC §179 expensing deduction – that alone should be a reason to consider a see through trust structure for those families passing on a capital-intensive business.<sup>47</sup> If the loss of this deduction was not expensive enough, tax reform recently doubled the §179 expensing for tax years starting after Dec 31, 2017 to *\$1 million*, without altering the elimination of this deduction for non-grantor trusts and estates in §179(d)(4).<sup>48</sup>

For example, an LLC, 50% owned by a trust, invests in \$500,000 worth of machinery and equipment used in the United States in 2017 and the LLC's net income but for this expense would be \$600,000 (the Form 1065 partnership tax return must report the §179 and depreciation expense as a separately stated item on line 12 of K-1).<sup>49</sup>

An individual owner (whether via beneficiary deemed owner trust or not) would have a mere \$50,000 of net taxable income from the LLC (\$300,000-\$250,000 §179 expense deduction), whereas the non-grantor trust would have this juicy deduction disallowed and may have \$300,000 of income (minus whatever depreciation may be allowed to the partner outside of §179 over the useful life of the asset, e.g. ten year property may be 1/10 of \$500,000, times 50% ownership, or \$25,000).<sup>50</sup> This is a huge tax difference between the two varieties of trusts (and one hardly ever discussed at tax conferences)!

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<sup>47</sup> IRC §179(d)(4) “Section not to apply to estates and trusts. This section shall not apply to estates and trusts.” A QSST election may partially solve the issue if the business is an S corporation— QSSTs are in some ways de facto §678(a) trusts except for substantial sales of assets/stock, see e.g., Treas. Reg. §1.1361-1(j)(8). However, the §678(a) solution may be the only good solution to exploit §179 for an LLC/LP taxed as a partnership owned by a trust. The generous \$500,000 expensing provision was made permanent by §124 of the Protecting Americans from Tax Hikes (PATH) Act of 2015. It adjusts upwards for inflation and in 2017 will increase to \$510,000. See Rev. Proc. 2016-55 for inflation adjustments.

<sup>48</sup> See SEC. 13101. MODIFICATIONS OF RULES FOR EXPENSING DEPRECIABLE BUSINESS ASSETS of H.R. 1 colloquially known as the “Tax Cuts and Jobs Act”, modifying IRC §179(b). This also adjusts for inflation and for 2019 will be \$1,020,000. Rev. Proc. 2018-57, §3.26.

<sup>49</sup> See Rev. Rul. 74-71 and Treas. Reg. §1.702-1(a)(8)(ii) for LLC/partnership requirements to separately state Section 179 and depreciation and depletion expense for non-grantor trusts and estate beneficiaries. For S corporations, see IRC §1366(a)(1)(A).

<sup>50</sup> Treas. Reg. §1.179-1(f)(3) provides “Special rules with respect to trusts and estates which are partners or S corporation shareholders. Since the section 179 election is not available for trusts or estates, a partner or S corporation shareholder that is a trust or estate may not deduct its allocable share of the section 179 expense elected by the partnership or S corporation. *The partnership or S corporation's basis in section 179 property shall not be reduced to reflect any portion of the section 179 expense that is allocable to the trust or estate.* Accordingly, the partnership or S corporation may claim a depreciation deduction under section 168 or a section

This lack of a §179 deduction makes it much more likely for business income to be trapped in non-grantor trusts at the *highest possible tax rates*. Moreover, making higher distributions may cause other problems. Even if higher distributions could be justified under the document to avoid trapping the \$275,000 in our example in trust, it would eliminate that much corpus from the various asset protection and estate tax benefits intended by the trust. By contrast, using a beneficiary deemed owner trust structure permits the §179 deduction and paradoxically *reduces* the amount of the income subject to access via distribution or withdrawal because it is based on net taxable rather than gross income.

Some argue that § 179 expensing should be treated like depreciation and depletion. I disagree. Generally, for non-grantor trusts any depreciation is apportioned between the income beneficiary and the trust pursuant to the trust document and, absent specific provision (or depreciation reserve), apportioned on the basis of trust income allocable between the beneficiary and trust (e.g. if the income were \$100,000 and the beneficiary received \$50,000, 50/50).<sup>51</sup> Thus, in many cases a beneficiary might receive all the depreciation deduction (which sounds great at first, but could easily lead to more phantom income trapped in trust at the highest tax rates).<sup>52</sup> In fact, the IRS has even ruled that a beneficiary can receive depreciation deductions greater than income received via K-1 from a trust (it's no different from a grantor trust in that respect).<sup>53</sup> Perhaps the IRS will one day take a liberal interpretation of §179(d) to ultimately apply §179 in the same manner, but be skeptical until then. *Expenses are simply not the same as depreciation*. There is no analogous code, regulation or ruling to permit excess deductions outside of depreciation and depletion, except on termination.<sup>54</sup> That said, perhaps the IRS would someday allow a *beneficiary* to take a §179 deduction up to a beneficiary's pro rata trust business income passing out on K-1 like other allowable deductions and hold the remainder in abeyance.<sup>55</sup>

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38 credit (if available) with respect to any depreciable basis resulting from the trust or estate's inability to claim its allocable portion of the section 179 expense.”

<sup>51</sup> IRC §167(d) and IRC § 642(e).

<sup>52</sup> Example: Trust is 50% member of LLC w/\$8 million gross income, \$2 million expenses (\$6 million net) and \$8 million of depreciation. Trust's share is \$3 million income, \$4 million depreciation but trust only receives \$1 million of distributions. Trust sends beneficiaries all net income (\$1 million), beneficiaries receive all the depreciation deduction (\$4 million) and trust has \$2 million phantom income.

<sup>53</sup> Rev. Rul. 74-530.

<sup>54</sup> IRC §642(h).

<sup>55</sup> See Treas. Reg. §1.179-3 for carry forwards when a taxpayer cannot use §179 deduction.

### c) Advantage – Net Investment Income 3.8% Surtax

The 3.8% net investment income tax applies to income of trusts and estates beyond the compressed tax rate bracket of \$12,500, rather than \$200,000 or \$250,000 MAGI for single and married filing jointly taxpayers respectively.<sup>56</sup>

But it gets worse.

Let's say we have closely held LLC or S corporation business income. Not only might non-grantor trusts have the problematic issue of higher phantom income due to the denial of the Section 179 deduction noted above, but the net investment income 3.8% surtax may apply to the business income. For an individual, even if their AGI exceeds the \$200,000/\$250,000 limit, active business income is not subject to this tax.

Contrast non-grantor trusts: the trustee must be active in the business. While hiring a co-trustee sufficiently active in the business may “work”, it is unclear what it takes for a non-grantor trust to be active rather than passive, which is the determining factor for the surtax. We have two favorable court cases, but non-acquiescence from the IRS and an extraordinarily strict TAM, with the potential for future treasury regulations to change the result.<sup>57</sup> In short, it's expensive to be right and more expensive to be wrong, and no way to be certain.

Moreover, this uncertainty may apply to QSSTs just as it does to ESBTs. We tend to think of QSSTs as similar to beneficiary deemed owner trusts, and they are very similar

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<sup>56</sup> IRC §1411(a)(2).

<sup>57</sup> See *Mattie K. Carter Trust v. United States*, 256 F. Supp. 2d 536 (N.D. Tex. 2003) and *Aragona Trust v. Comm'r*, 142 T.C. 165 (T.C. Mar. 27, 2014), PLR 201029014 (the IRS ruled that the trust might materially participate in the company's activities if A, the beneficiary and trustee, was involved in the operations of D's activities on a regular, continuous, and substantial basis). All of the above are taxpayer-friendly, but in spite of *Carter/Aragona* taxpayer victories, the IRS has not acquiesced and has staked out very strict positions in IRS TAM 2013-17010, in which a special trustee of two trusts had limited authority to vote, sell, or retain trust-owned stock. The special trustee was a shareholder and president of the company owned in part by the trusts. Despite the substantial activity, the IRS concluded that the “sole means” for the trusts to establish material participation is “if the fiduciaries, **in their capacities as fiduciaries**, are involved in the operations of the [company] on a regular, continuous, and substantial basis.” As one article in the area concluded, “It is hard to see how a trustee acting on behalf of the trust as shareholder would ever be able to satisfy regular, continuous, and substantial activity if limited to operating in a traditional shareholder role, particularly when much of that activity is disregarded as “investor” work.” *Trustee Material Participation in Businesses: A Surprising Way to Overcome TAM 201317010 and Avoid the NII Tax*, by Steve Gorin and Richard Barnes, ABA Probate and Property, Vol. 29, No. 2 (2015).

Thus, it is wise not to overpromise trustees/beneficiaries of a non-grantor trust as to the ability to avoid this 3.8% surtax, despite the current authority for doing so.

as to the ongoing income, where activity of the beneficiary will determine applicability of the surtax. However, as noted in the section below, QSSTs are **not** taxed the same for any *sales* of the S corporation stock. Thus, while final regulations did not confirm this, the net investment income surtax treatment for a QSST selling S corporation stock probably has the same requirements, uncertainty, pitfalls and issues noted above the same as any other non-grantor trust.<sup>58</sup>

By contrast, Section §678(a)(1) withdrawal provisions shift the net investment income “surtaxation” to the deemed owner (similar to a QSST for ongoing income), and the relevant inquiry is whether the beneficiary deemed owner is active or passive in the business, which is relatively easy and straightforward to discern, and the MAGI thresholds start much higher, as noted above.<sup>59</sup> The participation of the trustee(s) is irrelevant. Tax reform did not change this.

While generally BDOTs (and to a lesser extent, QSSTs) are usually more advantageous on this point, this is only if the beneficiary is sufficiently active in the business or has MAGI lower than the NIIT threshold (\$200,000 single/\$250,000 married filing jointly). If a beneficiary has nothing to do with a business and higher income, the 3.8% tax would apply, and in this instance non-grantor ESBT status would afford at least the potential for avoidance if a sufficiently active trustee is hired.

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<sup>58</sup> Prop. Reg. § 1.1411-7(a)(4)(iii)(C) “Treatment of Qualified Subchapter S Trusts (QSSTs). In the case of a disposition of S corporation stock by a QSST, the rules of this section are applied by treating the QSST as the owner of the S corporation stock.”

<sup>59</sup> Treas. Reg. §1.1411-3(b)(v) excepts “A trust, or a portion thereof, that is treated as a grantor trust under subpart E of part I of subchapter J of chapter 1. However, in the case of any such trust or portion thereof, each item of income or deduction that is included in computing taxable income of a grantor or another person under section 671 [26 USCS § 671] is treated as if it had been received by, or paid directly to, the grantor or other person for purposes of calculating such person's net investment income.”

## d) Advantage – S Corporation Ownership

Grantor trusts are also eligible S corporation stockholders, *regardless* of whether there is a QSST or ESBT election, but it cannot be partially grantor as to accounting income or only a portion of the income, it can only have one deemed owner and the grantor or beneficiary deemed owner must be a U.S. citizen or resident (incl. non-resident alien spouse if community property).<sup>60</sup> “[T]he trust is a permitted shareholder if the grantor or *another person* includes in computing taxable income and credits all of the trust's items of income, deductions, and credits against tax under the rules in 1.671-3.”<sup>61</sup>

For many purposes, a QSST is the same as a §678 beneficiary deemed owner trust for income tax purposes, in fact, the QSST regulations reference §678. However, when the larger tax event of a sale of stock or the company itself occurs, the QSST loses its advantage to pass through income to the beneficiary's tax return similar to a §678(a) trust. Whenever S corporation stock is sold, it reverts back to ordinary non-grantor trust treatment as to the sale, potentially trapping most or even all of the taxable income in the trust. Surprisingly, this is also true when the assets of the company are sold and the company liquidated, or when at least 80% of the company is sold in a §338(h)(10) transaction (i.e. in an “asset deal” as well as a “stock deal”).<sup>62</sup>

While a lifetime power of appointment generally precludes QSST elections, a presently exercisable general power of appointment over the entire income (or corpus) still permits the trust to continue as an eligible S corporation owner.<sup>63</sup> What if other S corporation owners are nervous about the trust's eligibility? A trustee may make an ESBT election to protect the trust. To the extent it is a grantor trust, the effect of the

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<sup>60</sup> IRC §1361(c)(2)(A) “the following trusts may be shareholders: (i) A trust all of which is treated (under subpart E of part I of subchapter J of this chapter) as owned by an individual who is a citizen or resident of the United States.” Subpart E of part I of subchapter J is referring to IRC §§671-679, which includes §678(a). See also, *In re Forte*, 234 B.R. 607 (Bankr. E.D.N.Y. May 6, 1999). PLR 2012-16034 recently followed this, ruling that a beneficiary-grantor trust created via *Crummey* power qualifies as an S corporation shareholder.

<sup>61</sup> 1995-2 C.B. 135 (I.R.S. July 1, 1995)

<sup>62</sup> Treas. Reg. §1.1361-1(j)(8), PLR 1999-05011 (sale of assets and liquidation treated as income to trust, not QSST beneficiary), PLR 1999-20007 (stock deal treated as an asset deal pursuant to §338(h)(10) election treated as income to trust, not QSST beneficiary).

<sup>63</sup> Treas. Reg. §1.1361-1(j)(2)(iii): “If, under the terms of the trust, a person (including the income beneficiary) has a special power to appoint, during the life of the income beneficiary, trust income or corpus to any person other than the current income beneficiary, the trust will not qualify as a QSST. **However, if the power of appointment results in the grantor being treated as the owner of the entire trust under the rules of subpart E, the trust may be a permitted shareholder under section 1361 (c)(2)(A)(i) and paragraph (h)(1)(i) of this section.**”

ESBT election is simply disregarded.<sup>64</sup> By contrast, the regulations are unclear at best as to whether a beneficiary of a fully or partially grantor trust can make a QSST election to protect S status.<sup>65</sup> If a beneficiary-deemed-owner transfers S corporation stock to a grantor trust with suspended passive losses due to insufficient basis in the S corporation stock, these should still be retained, whereas other transfers cause the loss to simply expire.<sup>66</sup> QSST to ESBT (and vice versa) transitions are permitted, but have strict prohibitions against frequent toggling back and forth within 36 months, whereas there is no apparent prohibition regarding grantor trust toggling.<sup>67</sup>

QSSTs have to pay out all their income annually to the beneficiary, and beneficiaries must sign the appropriate election, else risk disqualifying the S corporation (potentially an issue when a beneficiary dies!).<sup>68</sup> BDOTs would have neither such requirement.

QSSTs are typically set up as separate trusts from the other assets to avoid the mandatory income requirement applying to all the trust, requiring an additional tax return and accounting. BDOTs would not have this additional tax return requirement.

Any remote possibility of corpus being distributed to another person during the beneficiary's lifetime, such as a forfeiture clause, kills the QSST ab initio, but such remote possibilities would not kill a BDOT.<sup>69</sup> The IRS takes the position that trust payments to a grantor trust for a beneficiary do *not* meet QSST requirements, but a BDOT could have any income not withdrawn pass to a separate trust if desired.<sup>70</sup>

BDOTs have an additional benefit when the primary beneficiary dies. Similar to other grantor trusts after an owner's death, a BDOT would have an additional two years after the beneficiary's death to qualify as an S corporation owner without the need for a QSST or ESBT election.<sup>71</sup> There is a procedure to grant relief for late filed elections.<sup>72</sup>

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<sup>64</sup> Treas. Reg. §§ 1.1361-1(m)(2)(v) and § 1.1361-1(m)(8), Example (3) provides example of an IRC § 678 trust making an ESBT election.

<sup>65</sup> Treas. Reg. § 1.1361-1(j)(6)(iv).

<sup>66</sup> Generally, suspended S corporation losses are personal and *not* transferable to other taxpayers, with exceptions for transfers to spouse on divorce. Treas. Reg. §1.1366-2(a)(6)(i).

<sup>67</sup> Treas. Reg. §1.1361-1(j)(12) and (m)(7).

<sup>68</sup> Although, if the income is not distributed and the trustee catches up on delayed distributions, the IRS may permit relief against inadvertent termination. See PLR 2017-10001. IRC §1362(f).

<sup>69</sup> See, e.g. Rev. Rul. 93-31.

<sup>70</sup> PLR 9014008

<sup>71</sup> IRC §1361(c)(2)(ii).

## **e) Other Miscellaneous but Juicy Deductions Eliminated by ESBTs but not Curbed for BDOTs (or QSSTs) – Including 199A?**

It's not just the qualification of a trust as an S corporation shareholder that is important, but the tax treatment of the trusts that own them. BDOTs and QSSTs may be entitled to very significant deductions and reductions in tax. ESBTs eliminate some of these deductions, even more so than other non-grantor trusts. QSSTs allow deductions to pass through to the beneficiary similar to a BDOT, but QSSTs are severely hampered by the fact that they must pay out the income of the trust, not merely permit it to be withdrawn, thus causing a leakier trust from an estate and asset protection standpoint.

The S corporation portion of an ESBT is only allowed a deduction for a narrow category of items.<sup>73</sup> Notably, there is no income distribution deduction that would otherwise allow tax shifting to the beneficiaries.<sup>74</sup> There are other important deductions lost as well. The IRS has ruled, for example, that a net operating loss from an S corporation that would normally be deductible under IRC §172 would not be deductible by the S corporation portion of the ESBT because it's not on the prescribed list of allowable deductions.<sup>75</sup> These kinds of deductions can be quite valuable.

Moreover, tax rates are higher, even comparing to individuals in the top income tax bracket, since ESBTs must pay tax at the highest marginal rate and have \$0 AMT exemption.<sup>76</sup> These negatives extend to sale of S stock, even if on installment sale.<sup>77</sup>

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<sup>72</sup> Rev. Proc. 2013-30

<sup>73</sup> IRC §641(c)(2)(C): "The only items of income, loss, deduction, or credit to be taken into account are the following:

- (i) The items required to be taken into account under section 1366.
- (ii) Any gain or loss from the disposition of stock in an S corporation.
- (iii) To the extent provided in regulations, State or local income taxes or administrative expenses to the extent allocable to items described in clauses (i) and (ii).
- (iv) Any interest expense paid or accrued on indebtedness incurred to acquire stock in an S corporation.

No deduction or credit shall be allowed for any amount not described in this paragraph, and no item described in this paragraph shall be apportioned to any beneficiary.

<sup>74</sup> This would be allowed under ordinary non-grantor trusts under IRC §651 or §661.

<sup>75</sup> IRS Chief Counsel Advice ILM 2007-34019, in which an estate/trust post-mortem but pre-ESBT election had losses to carry forward but the IRS denied the ESBT the ability to deduct them because §172 was not on the list. This may not be persuasive reasoning, since the loss originally arose out of §1366 deductions which would be allowable, but realize you have the IRS to fight in claiming such losses against ESBT income.

<sup>76</sup> Treas. Reg. §1.641(c)-1(e)

Tax reform recently helped out ESBTs in two main regards, however. First, rules similar to IRC § 170 rather than §642(c) permitting charitable deductions against income will be allowed to ESBTs moving forward, eliminating the need to trace contributions to gross income. Secondly, non-resident aliens (“NRAs”) can now be a beneficiary of an ESBT (but not if the NRA is the grantor and it is a grantor or partial grantor ESBT) – in such case an ESBT would be preferred over outright ownership or through a QSST or grantor trust (including BDOTs), since an NRA is not an eligible S corporation owner (nor is a grantor trust as to an NRA).<sup>78</sup> Where NRAs and S corporations intersect, a fully non-grantor ESBT, or a grantor trust as to a US citizen/resident are the only options.

The largest and most discussed new deduction added by the recent tax reform is the new Section 199A, which provides a deduction of up to 20% of qualified business income. It is broad enough to include partnerships, S corporations and trusts and estates.<sup>79</sup> While Congress added nothing in the tax reform bill to add to the narrow ESBT exceptions listed in IRC §641(c)(2)(C), the Treasury Department confirmed that ESBTs get the §199A deduction or not in final regulations issued in January 2019:

(vi) Electing small business trusts. An electing small business trust (ESBT) is entitled to the deduction under section 199A. Any section 199A deduction attributable to the assets in the S portion of the ESBT is to be taken into account by the S portion. The S portion of the ESBT must take into account the QBI and other items from any S corporation owned by the ESBT, the grantor portion of the ESBT must take into account the QBI and other items from any assets treated as owned by a grantor or another person (owned portion) of a trust under sections 671 through 679, and the non-S portion of the ESBT must take into account any QBI and other items from any other entities or assets owned by the ESBT. For purposes of determining whether the taxable income of an ESBT exceeds the threshold amount, the S portion and the non-S portion of an ESBT are treated as a single trust. See §1.641(c)-1.”<sup>80</sup>

However, serious Section 199A issues remain (see next section).

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<sup>77</sup> IRC §641(c)(2)(C), Treas. Reg. §1.641(c)-1(d)(3). Although the interest component of an installment sale of S stock is attributed to non-S portion, see Treas. Reg. §1.641(c)-1(g)(3).

<sup>78</sup> See §13541 and §13542 of the Act. IRC §1361(b)(1)(C) (non-resident alien), IRC §1361(c)(2)(B)(v) (ESBT exception).

<sup>79</sup> SEC. 199A. QUALIFIED BUSINESS INCOME.

“(a) In General.—**In the case of a taxpayer other than a corporation, there shall be allowed as a deduction** for any taxable year an amount equal to the sum of—

<sup>80</sup> Treas. Reg. §1.199-6(d)(3)(vi).

## f) Advantage – Ensuring §199A in Light of Final Regulations

On August 8, 2018, the Treasury Department issued [proposed regulations](#) on the new IRC Section 199A, known as the 20% qualified business income deduction. On January 18, 2019, the Treasury Department issued final regulations.

Portions of the proposed regulations pertaining to non-grantor trusts and estates were much harsher than expected and probably went beyond Treasury’s authority to issue a reasonable interpretation of the statute. In its final regulations, however, Treasury backed off somewhat, but vowed to revisit Section 643(f), stating they “are taking under advisement whether and how these questions should be addressed in *future guidance*.”

By contrast, grantor trusts (including BDOTs) are simply ignored pursuant to the final regulations and the Section 199A rules apply as if the deemed owner directly conducted the activities.<sup>81</sup>

Let’s focus on important provisions that remain in Treas. Reg. §1.199A-6 that target non-grantor trusts and how BDOTs may be used to plan around them.

The portion of the proposed regulations regarding distribution deductions that would have prevented many trusts from receiving a §199A deduction was eliminated in the final regulations.<sup>82</sup> However, the concept behind this provision – that trust distributions should be ignored for purposes of the §199A income threshold – still applies to ESBTs! Thus, BDOT strategies may be especially useful for those wanting to transition an S corporation (particularly if it is a specified service business in which the grantor or any non-grantor trust may be unable to receive a deduction from).

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<sup>81</sup> Prop. Reg. §199A-6(d)(2): “(2) *Grantor trusts*. To the extent that the grantor or another person is treated as owning all or part of a trust under sections 671 through 679, such person computes its section 199A deduction as if that person directly conducted the activities of the trust with respect to the portion of the trust treated as owned by the grantor or another person.” Unchanged in final regulations as Treas. Reg. §199A-6(d)(2).

<sup>82</sup> Prop. Reg. §1.199A-6(d)(3)(iii), drastically amended in final regulations, read:

“(iii) Threshold amount. The threshold amount applicable to a trust or estate is \$157,500 for any taxable year beginning before 2019. For taxable years beginning after 2018, the threshold amount shall be \$157,500 increased by the cost-of-living adjustment as outlined in § 1.199A-1(b)(11). **For purposes of determining whether a trust or estate has taxable income that exceeds the threshold amount, the taxable income of a trust or estate is determined before taking into account any distribution deduction under sections 651 or 661.**”

Let's walk through an example of why distributions affecting taxable income of a trust is important. Let's assume that a taxpayer transfers a pass-through business interest whose income would be qualified business income but subject to income threshold limitations were the income attributed to the settlor personally, either because it is a specified service business or because the business had insufficient wages and/or unadjusted basis, to a non-grantor trust for two children. The §199A deduction may be lost if income in the trust exceeds the threshold, **even if** distributions were made to the beneficiary such that the taxable income of the trust were reduced **below** the threshold. Under the final regulations, however, this will only apply to an ESBT, but not for a partnership interest (including LLC/LP taxed as such) owned by a trust.

For example, a trust gets a Form K-1 for specified service business income of \$260,000, \$10,000 of other income and has \$20,000 of deductible expenses and distributes \$100,000. Under the Treasury Department's final regulations, an ESBT would not be entitled to **any** §199A deduction, but a trust owning a partnership/LLC would be entitled to one. This is because distributions to a beneficiary from DNI reduce a trust's net taxable income - unless it is a non-grantor trust ESBT.

*Taxpayers could be WORSE OFF* contributing S corporation stock to an ESBT - that is, the family will pay more income tax overall using trusts than if they simply made an *outright* gift- **if** they do not adequately adapt through the use of BDOT or QSST provisions. For example, if in the prior example, the taxpayer had simply made gifts of the same S corporation stock to two children OUTRIGHT, the children would get the K-1s from the S corporation directly. If the children make less taxable income than their threshold/phase out amounts (this would be \$157,500-\$207,500 if single, \$315,000 - \$415,000 if married in 2018, and will be adjusted for inflation in 2019), assuming they are not so young that the kiddie tax applies, then the children will receive the full §199A deduction and may also avoid imposition of 3.8% net investment income tax!

**Example:** As part of his business succession planning, John had been planning to shift ownership of some of his S corporation which is a specified service business to his daughter Susan who works in the business, and had planned to use a trust to protect the stock from any future divorce from his loser son-in-law, and for other asset protection and estate tax advantages. The share is expected to generate \$225,000 of income. As an ESBT, the trust will pay the highest rate of tax on the full amount of income. However, if John switches to an outright gift (or gifting to a BDOT or partial BDOT or QSST as discussed below), Susan will not only get the 20% 199A deduction, but her top tax rate may only be 24% or 32%, with most of the income taxed at much lower rates.

To simplify and illustrate the vast difference (ignoring deductions and other income etc., for tax year 2018) in brackets, \$225,000 of taxable income in a non-grantor ESBT trust means **\$83,250** (ESBTs receive no run up in bracket). \$225,000 of taxable income taxed to a married couple, however, is “\$28,179 plus 24% of the amount over \$165,000”, only **\$42,579** (this might go up a bit depending on Susan’s other income, but married couples do not reach the top rate until \$600,000 of taxable income, not \$12,500)! The amount is nearly double! Moreover, the above is not even counting the savings on 3.8% net investment income tax, which is hard for non-grantor trusts to avoid (or at best, extremely uncertain). By contrast, the 3.8% net investment income tax is clear and easy for Susan to avoid if she’s active in the business too, even if AGI exceeds \$250,000. The tax on \$225,000 of net investment income for an ESBT non-grantor trust could be 3.8% over \$12,500 **or \$8,075, whereas the NIIT on such income may be \$0 if taxed to Susan.** For those living in states with progressive income tax rates and/or compressed tax rates for trusts, the state income tax savings may also be significant. Moreover, a non-grantor trust would have been denied a juicy Section 179 deduction up to \$1 million (as adjusted for inflation) pursuant to IRC §179(d), but now that John’s switched to using an outright gift or a BDOT or QSST, the family will get to benefit from Section 179 expensing as well! For many business owners, this alone could mean the difference between a huge income tax if taxed to a non-grantor trust and no tax at all if shifted to the children.

Another dubious section of the proposed regulations attacking non-grantor trusts was *retained* in the final regulations, albeit with a welcome amendment. Prop. Reg §1.199A-6(d)(v) had read:

**“(v) Anti-abuse rule for creation of multiple trusts to avoid exceeding the threshold amount.** Trusts formed or funded with a *significant* purpose of receiving a deduction under section 199A will not be respected for purposes of section 199A. See also §1.643(f)-1 of the regulations.”

On finalization, this regulation was renumbered and amended, with the important difference noted below in bold italics:

“(vii) Anti-abuse rule for creation of a trust to avoid exceeding the threshold amount. ***A trust*** formed or funded with a ***principal*** purpose of ***avoiding, or of using more than one, threshold amount*** for purposes of calculating the deduction under section 199A will not be respected ***as a separate trust entity*** for purposes of ***determining the threshold amount*** for purposes of section 199A. See also §1.643(f)-1 of the regulations.”<sup>83</sup>

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<sup>83</sup> Treas. Reg §1.199A-6(d)(3)(vii).

## How Practitioners Legitimately Avoid the Above Anti-Abuse Rule

It's anyone's guess how the IRS will find §199A threshold avoidance to be a principal purpose in establishing a trust. No one gives away millions of dollars to get a minor income tax deduction! That said, despite ACTEC suggesting that Treasury provide some examples (I was on a committee that submitted comments), Treasury declined to do so. Thus, we have no idea how aggressive an IRS auditor might be in concluding there is some nefarious purpose to the trust.

Some may wish to avoid the potential application of this rule altogether. We can accomplish a client's various non-tax goals of transferring business interests without losing the §199A deduction in four different ways that avoid the above anti-abuse rule:

- 1) gift closely held business interests *outright*;
- 2) establish a holding LLC and gift shares in that outright (this might grant more control over distributions in some cases than an outright direct gift);
- 3) gift to a qualified subchapter S trust ("QSST"), if the business is an S corporation;
- 4) gift to a beneficiary deemed owner trust ("BDOT"), in whole or in part;

All of these techniques have the potential to **save much more in income tax for the family than Treasury could ever have hoped to stop with the proposed and final regulations** (provided the kiddie tax does not apply). This is because shifting income tax to beneficiaries, in the 99% of cases where beneficiaries make less than \$600,000/\$500,000 taxable income (top brackets for married filing jointly, single), ultimately saves *much* more in tax than the §199A deduction ever could have through using a wholly non-grantor trust. I have a client right now who had been strongly considering establishing non-grantor trusts for his two daughters funded with pass through business entity (LLC) interests. The trusts would have paid a top rate of 37% upon reaching only \$12,500, and if it had qualified for a 20% §199A deduction, it would still have paid a *de facto* top rate of 29.6% (perhaps even a 3.8% surtax). His two daughters are fresh out of college and make less than \$60,000/yr. – using one of the techniques above in lieu of a non-grantor trust (or traditional grantor trust) will cause the top marginal tax rate to drop from 37% to 25-28%, with greater certainty for the additional 20% QBI deduction, not to mention lower capital gains rates (20% → 15%) and lower to non-existent net investment income tax rates (3.8% → 0%), not to mention other benefits typically denied to trusts, such as being able to use a \$12,000/\$24,000 standard deduction and receiving a share of the entities' §179 deduction! Treasury's new attack on trusts via the proposed and final regulations (and potentially future §1.643(f) regulations) gives the family a much greater reason *not to use a traditional non-grantor trust* and many taxpayers such as the one above will likely now avoid such

a structure and pay *much* less in income tax overall, than had Treasury been more reasonable and they continued on the traditional non-grantor trust path.

BDOTs (and their close cousin QSSTs) also circumvent the §199A threshold problem that ESBTs have. ESBTs cannot take a distribution deduction and cannot simply lower their income at the end of the year (or within 65 days thereof). Their taxable income is computed without any distribution deduction pursuant to IRC §641(c)).

These four techniques can enable business owning families to enjoy the deduction and incentive that Congress intended, yet Treasury threatens to deny.

**1. Gifting Without Trusts.** As discussed in the section above, in some family situations, simple gifting of business interests (usually non-voting) may retain the §199A deduction for donees without hampering non-tax objectives. After all, LLCs/LPs have some asset protection (often limited to charging orders), may have buy-sell agreements that curb a donee's sale of the interest, and depending on the ownership, may offer the ability of the donor to retain control of the entity and its distributions. Partnerships, unlike S corporations, can even make non-pro rata distributions.

However, there are many families and situations in which outright gifts of business interests are unwise, even with some retained control. Many attorneys advise against non-pro rata distributions because it may be a factor in IRC §2036 retained interest cases. S corporations, moreover, cannot have non-pro rata distributions at all. **There are significant estate, gift and GST drawbacks to outright gifts** as well – any possibility of the donor using grantor trust treatment is lost forever, as is the ability to allocate GST exclusion and exclude the interest from the child's estate. The asset protection of any outright gift, even with strong charging order protection, is woefully substandard compared to irrevocable trusts. There is no ability to create back up plans, vested remaindermen, bloodline control, successor trustees, trust protectors, split administration and many non-tax reasons why people use trusts. It's rather rare for people to even mention income tax planning as a factor in creating trusts because there are so many other benefits.

**2. Gifting Outright, but with a Holding Company.** Some additional control might be achieved by gifting pass through entity interests into a holding LLC. However, this is only possible for S corporations while the LLC is a 100% owned disregarded entity – gifting less than 100% of a single member LLC to a child where the LLC owns an S corporation would blow the S election, because if the LLC becomes a partnership with multiple owners, it would no longer be an eligible S corporation owner. For partnerships (or LP/LLCs taxed as such), it is more possible to use a holding company.

This is particularly true and useful for the donor who is a minority owner who does not control the entities' distribution policy. The donor can still control the parent holding company's distribution policy. This structure may fit some situations, but still suffers from many of drawbacks of outright gifts noted above.

**3. Using QSSTs.** If the asset proposed to be gifted is S Corporation Stock, a donor can gift the stock into a qualified subchapter S corporation trust (QSST), which will shift all the ongoing qualified business income to the beneficiary very similar to a beneficiary deemed owner trust under Section 678. Any opportunity for a §199A deduction would be based on the beneficiary's tax bracket, similar to an outright gift. A QSST has better asset protection than an outright gift in most situations, but has inferior protection vis a vis most traditional trusts (including a BDOT). This is because the income **MUST** be paid out to the beneficiary. A QSST is extremely rigid in many respects – there can be no variation in distributions year to year, no trapping of any income in the trust (except perhaps on sale of the stock), and no application of hold back or forfeiture clauses in the event of bankruptcy or other creditor attack. It does not shift the income in the event the S corporation stock is *sold* either.

**4. Using BDOTs and Partial BDOTs.** More flexible than outright gifts or QSSTs are either wholly beneficiary deemed owner trusts (BDOTs) or trusts that are partially taxed to a beneficiary and partially taxed as a separate taxpayer under the portion rules of IRC §671. Let's go back to prior examples, where the §199A deduction is lost (either because of SSB status, insufficient wages/basis etc.) when a trust receives S corp K-1 qualified business income for \$250,000.

However, what if we draft the trust (ideally two trusts) to grant the two children the power to each withdraw their portion of the taxable income? This makes the income taxable to the children directly onto their Form 1040 under §678(a) and for IRC §199A purposes. This would be very similar to a QSST, but is more flexible and enables greater asset protection. The savings would be similar to an outright gift, but all of the non-tax benefits of the trust are retained (divorce and asset protection, family bloodline protection, etc.) as well as the estate/GST benefits (ability to have the assets outside of the donee's estate). Unlike a standard QSST, capital gains on sale of S corporation stock can be passed through as well.

As we know, just like traditional *Crummey* powers (which are similar and have been consistently upheld for 50 years now), settlors can twist arms and indirectly assure themselves that kids won't take out too much as a practical matter, else they be disinherited from an estate or other trusts/gifting. Yet we have decades of history and

rulings that such indirect influence does not affect the income taxation, even if they are legally incapacitated.<sup>84</sup>

So, the two children might only take out only \$30,000 or so to pay their tax burden, leaving the rest in trust, and voila, we've got the §199A deduction back for the income. This is true even for ESBTs, since the grantor trust rules of IRC § 678 trump the non-grantor trust ESBT reporting rules!<sup>85</sup> Moreover, if the beneficiaries are in a lower bracket (<\$500,000/\$600,000), which is highly likely, we've also shifted any amounts withdrawable, whether any amount is actually withdrawn or not, to the children as beneficiary/powerholders. In most cases, the total savings by shifting tax through outright gifts or through BDOTs will dwarf the savings that might have been had using non-grantor trusts.

**Conclusion regarding the new §199A regulations and the four methods of lowering the tax on qualified business income subject to elimination or phase out.**

If Congress really wanted to prevent taxpayers' families (and their trusts) from benefitting from lower rates of tax on gifts of qualified business income producing property, they could have easily created related party rules, which are rife elsewhere in the Code.

Any strategy that involves outright gifts "force the toothpaste out of the tube" – they are hard to undo or change. By contrast, trusts can incorporate much more flexibility to later convert to a grantor trust or BDOT (if initially non-grantor) or to a non-grantor trust (if initially a BDOT or other grantor trust) as the tax law and family situation changes.

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<sup>84</sup> See Rev. Rul. 81-6.

<sup>85</sup> IRC §641(c), Treas. Reg. §1.641(c)-1.

### **g) Advantage – Tax Burn and Asset Protection TurboBoost Through Deemed Owner’s Payment of Trust’s Tax Burden from Outside of Trust Assets Without Requiring Distributions**

When the beneficiary deemed owner is taxed directly, yet does not have to take all of the income, two extremely beneficial opportunities arise: 1) to the extent the beneficiary does not take the income up to the lapse protection, the amount remains in the trust, sheltered from state/federal estate tax; 2) to the extent the beneficiary does not take the income, up to the lapse protection afforded by the particular state (which may be unlimited), the amount remains sheltered from creditors, increasing the amount of accessible assets of the beneficiary protected from creditors, and decreasing the amount accessible to creditors (assuming the beneficiary does not pay income tax from 401(k), 529 plan or some asset protected account).

Let’s take a simple example: Jane is beneficiary of a \$2 million trust that has \$80,000 of taxable income. Jane has other assets with which to pay the \$25,000 of tax attributable. Her failure to withdraw the income and her payment of tax from outside assets reduces her creditor-accessible non-trust assets by \$25,000 and increases her creditor protected assets by \$80,000. Every year. It may have a similar effect for state/federal estate tax purposes. Over time, this effect can be extremely valuable. By contrast, most advisors in an ordinary trust situation would have strongly suggested sending all \$80,000 out to her to minimize income taxes, thus having the *opposite* effect of depleting the asset/estate protected bucket and adding to the exposed/taxable bucket of assets. Compressed trust tax rates that encourage distribution of all of a trust’s income are highly detrimental from an asset protection perspective.

If there is a current power over income greater than 5%, any minimal power currently accessible is subject to creditors (in most states) and subject to estate tax. “Hanging powers” may not be, as discussed below.

## **h) Advantage – Protecting Unneeded Distributions of Income and Modifying the Withdrawal Right to Keep More Funds in Trust Protected After Lapse**

If assets are distributed but not spent in an ordinary trust, the asset protection is usually lost. Because of the increased differential of compressed trust tax rates and individual tax rates for most taxpayers, and the increased attention to this tax rate differential by financial professionals, this becomes ever more likely.

This is not the case with a beneficiary deemed owner trust, however. If income is *not* withdrawn in a given year, it is possible that none of this lapsed income may lose protection (or, very little of it).

Beneficiaries may not need to spend all the net income immediately, and may prefer keeping funds in the protective wrapper of the trust. Remember, beneficiaries do not have to take the income to be taxed on it. What if they don't take it and the power lapses? In addition to federal estate tax and asset protection reasons, residents in some states may wish to maximize a trust's corpus to leverage and exploit a state's estate tax exclusion amount.<sup>86</sup> Let's explore how we keep any withdrawable but untaken funds protected from being considered a contribution by the beneficiary for estate/gift and state law asset protection purposes.

The lapse protection under federal estate and gift tax law is fairly well known colloquially as part of a "five and five" power. To the extent a right of withdrawal (presently exercisable general power of appointment) is allowed to lapse, it will not be considered as a taxable transfer to the extent of the greater of \$5,000 or 5%.<sup>87</sup> So, if someone had

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<sup>86</sup> For instance, someone in Seattle could easily have a \$1 million home, \$1 million in other assets, and wants to fund the entire \$2 million to exploit the \$2 million+ state estate tax exclusion because their spouse has the same amount or more of assets – not funding the bypass with the home might cause \$200,000 or more in additional *state* estate tax at the surviving spouse's death. Washington state has a \$2 million estate tax filing (with slightly more sheltered) threshold with 10%-20% progressive rates.

<sup>87</sup> IRC §2514(e) (gift tax): "(e) Lapse of power. The lapse of a power of appointment created after October 21, 1942, during the life of the individual possessing the power shall be considered a release of such power. The rule of the preceding sentence shall apply with respect to the lapse of powers during any calendar year only to the extent that the property which could have been appointed by exercise of such lapsed powers exceeds in value the greater of the following amounts:

(1) \$5,000, or

(2) 5 percent of the aggregate value of the assets out of which, or the proceeds of which, the exercise of the lapsed powers could be satisfied."

a right to withdraw 6% of a trust, and let this entire power lapse without withdrawing any funds, 5% would not be considered to be a gift, but 1% would be (though, depending on the trust, it may be an incomplete gift or a gift in part to oneself). The burden will be on the taxpayer to show the value of the trust at the end of the year if the 5% is used.<sup>88</sup> This may not sound important to many taxpayers who would likely spend the income and even if they didn't, do not have \$11 million estates to worry about gift tax anyway. However, this concept is also incorporated into many states' creditor protection laws, so it is still an important concept.

If the power to withdraw is not based on the entire corpus, but on the accounting income alone, the 5% would be calculated based on the accounting income available to withdraw, *not* the entire principal.<sup>89</sup>

Although the above rule should not apply to a BDOT wherein a beneficiary has the power to withdraw all the taxable income, attorneys might amend the withdrawal power to cover the greater of the net taxable income or 5% of corpus and clarify that the withdrawal power can be satisfied out of the entire corpus of the trust. This should still shift all of the taxable income to the power holder beneficiary under §678(a)(1), but provides access in years of low income/yield and greater assurance that the lapse protection applies to the full 5% of corpus. If the taxable income is less than 5% of the

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IRC §2041(b)(2), from the estate tax code section governing powers held at death, has identical language.

<sup>88</sup> In *Estate of Augusta C. Noland*, TC Memo 1984-209, the taxpayer had a right to withdraw \$25,000 per year but failed to take any and simply let it lapse. While a higher portion or all of that may have fallen within the "five and five" lapse exception, the court limited it to \$5,000 "Because Petitioner did not offer any proof as to the value of the trust properties at the end of the various years. Thus, the exemption is limited to \$5,000. Rule 142(a)." If the trust consists of hard to value assets, and the numbers are close, this may call for a valuation to be done to maximize/justify the 5%.

<sup>89</sup> Rev. Rul. 66-87 describes the calculation of the lapse effect of a power to withdraw accounting (ordinary) income that was not taken and concludes the 5% lapse protection is calculated on the amount of that income only (i.e. it is not calculated based on the corpus). You could make an argument that this revenue ruling is wrong and contrary to statute, since the "aggregate value of the assets out of which, or the proceeds of which, the exercise of the lapsed powers could be satisfied" refers to and should be considered the entire corpus. However, it may be correct because the trust withdrawal power in Rev. Rul. 66-87 did not permit the lapsed powers to be exercised over ALL of the "proceeds of" the trust assets (i.e. not the income attributable to principal, such as capital gains) which §2514(e) references, therefore it had to apply the smaller value. See also Rev. Rul. 85-88, 1985-2 C.B. 201, *Fish v. U.S.*, 432 F.2d 1278 (9th Cir. 1970) and PLR 2007-36023 all holding the same. These rulings should not apply to any withdrawal power that extends to all the proceeds (taxable income, not just accounting income) that can be satisfied from any assets of the corpus, but a broad definition of the lapse is a "belt and suspenders" approach to ensuring the maximum lapse protection.

corpus in a given year (which is *very common* in today's investing environment), *the entire amount would remain protected, even if the beneficiary doesn't withdraw a dime.*

Thus, if the net taxable income is 4%, and the beneficiary for whatever reason chose not to withdraw this net income and let it lapse and add to corpus, the beneficiary would not be considered to have made a taxable gift transfer under federal law, and would not be considered a settlor of the trust under most state's creditor protection laws, as discussed below. If the trustee triggered some capital gains or had high return investments and the trust had 7% taxable income, but the beneficiary withdrew 2% to spend or reinvest outside the trust or pay their taxes, the same lapse protection of the entire amount would occur.

What if taxable income were 7% and the beneficiary did not take at least 2% (and the lapse is over \$5,000), meaning you have a lapse beyond the "five and five" rule? The estate/gift tax lapse protection often overlaps with state creditor protection law, but we should not assume it mimics federal tax law without verification. Under longstanding common law, the entire amount would be protected, but efforts to modify this through new Restatements and by the Uniform Trust Code and Uniform Power of Appointment Act lead to much variation and in many states (mostly UTC), the protected amount would be the greater of the "five and five" amount noted above, or the annual exclusion amount (\$14,000 in 2017, \$15,000 in 2018), but a surprisingly high number still provide unlimited protection unhampered by any "five and five" rule.<sup>90</sup>

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<sup>90</sup> See comparison chart at the end of article. Uniform Trust Code ("UTC") § 505(b), following which are e.g., [D.C. Code § 19-1305.05](#), [Kan. Stat. Ann. §58a-505\(b\)](#), [Fla Stat. Ann. § 736.0505\(2\)\(b\)](#), [Ala Code §19-3B-505\(c\)\(2\)](#), [RSMo § 456.5-505.6](#), [NJS.3B:31-39.b\(2\)](#), [Wisconsin statutes § 701.06\(6\)\(b\)](#). Pennsylvania mimics the UTC in a roundabout way by first defining power of withdrawal to exclude annual exclusion/5&5 powers in [20 Pa. C.S.A. §§ 7703](#), and then carving out in a different code section at 20 PA Cons Stat § 7748.

Even if your state has passed the UTC, the uniform act is not particularly uniform in this area - a few states double the annual exclusion amount if the settlor/donor is married at the time of transfer (e.g. [Ohio R.C. §5805.06\(B\)\(2\)](#), [Oregon ORS §130.315\(3\)](#), [Wisc. Stat. §701.0505\(2\)\(b\)](#)).

Some states may not have passed the UTC, but have similar protection to §505(b), such as [Idaho Code § 15-7-502\(5\)](#) and [Texas Property Code § 112.035\(e\)](#). Some states that are not UTC states are passing the Uniform Power of Appointment Act, §§502-503 of which have similar provisions. E.g., [Nevada's NRS § 163.5559\(3\)](#).

Massachusetts simply leaves the lapse protection out of its version of the trust code entirely: Massachusetts, [ALM GL ch. 203E, § 505](#) omits paragraph b of UTC 505, leaving the answer to common law.

Surprisingly, quite a few states are much more generous, e.g. [Kentucky RS §386B.5-040\(2\)](#), New Hampshire ([N.H. Rev. Stat. Ann. §564-B:5-505\(b\)](#)); [Michigan MCL § 700.7506\(c\)\(3\)](#); [Tenn. Code Ann. §35-15-505\(b\)](#) adds the same UTC §505(b) language but then backs out some of its

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import in a later paragraph, §35-15-505(e): “For purposes of subdivision (a)(2) and subsection (g), a person who is the holder of a power of withdrawal is not considered a settlor of the trust by failing to exercise that power of withdrawal or letting that power of withdrawal lapse.” [N.C. Gen Stat. § 36C-5-505\(b\)\(2\)](#); [Okla. Stat. §60-175.85](#); Arizona, [ARS §14-10505\(B\)\(2\)](#); Arkansas, [AR Code § 28-73-505\(b\)\(2\)](#), and Georgia, [GA Code § 53-12-83](#), Alaska, [AS §34.40.115](#); Delaware, [12 Del. C. § 3536\(c\)\(1\)](#); Louisiana, [LA Rev Stat § 9:2004](#); Washington, [RCW § 11.95.160](#).

The position of the Third Restatement of Trusts is to treat such trusts as self-settled to the extent of *any* lapse/release and retained interest. Restatement (Third) of Trusts § 56, comment B. However, the Third Restatement has been roundly criticized as a new creditor-friendly *creation* of new law rather than a restatement of existing law in many regards, and considering how many states are explicitly contrary on this point (i.e. **all** of them), it’s hard to call it a restatement of anything on this point. The Second Restatement of Trusts § 147 punted on this issue and referenced the Restatement of Property, Donative Transfers, which states that “Appointive assets covered by an unexercised general power of appointment, created by a person other than the donee, can be subjected to payment of claims of creditors of the donee, or claims against the donee’s estate, **but only to the extent provided by statute.**” Restatement of Property, 2<sup>nd</sup>, Donative Transfers §13.2. This should also apply to lapses, and the only reported case in the restatements that illustrates this common law is actually quite debtor-friendly. In *In Irwin Union Bank & Trust Co. v. Long*, 160 Ind.App. 509, 312 N.E.2d 908 (1974), a beneficiary let his right to withdraw 4% of the corpus (a presently exercisable power of appointment) of a trust lapse. There was no statute on point equivalent to UTC §505(b). The court, citing *II Scott on Trusts*, § 147.3 and *62 Am. Jur. 2d, Powers*, § 107, which parallels the second restatement above, held the assets of the trust (not even 4%, much less a higher percentage due to prior years’ lapses) were **not** available to creditors. Similarly, *University National Bank v. Rhoadarmer*, 827 P.2d 561 (Colo. App. 1991), cert. den. (3/3/1992), prevented a creditor from requiring the current exercise of an annual 5&5 withdrawal right and from attaching trust property with respect to which the withdrawal power had lapsed.

Courts in states that have not passed the UTC, nor a specific statute like Texas or Idaho, may find the *Long* and *Rhoadarmer* cases and their citations and earlier restatements to be persuasive, especially if their state has not indicated any intention to follow the third restatement of trusts (which is unlikely without passage of the UTC). California has neither passed the UTC, nor has any clear statute mimicking UTC §505(b). Cal. Prob. Code § 682(b) clearly applies to subject assets appointable under a general power to a power holder’s *estate’s* creditors, but it is unclear whether this statute would be persuasive at all for *lifetime* access and lapse. If anything, California statute seems to indicate that a lapse would NOT make the power holder a settlor. [Cal Prob Code § 15309](#) provides that “A disclaimer or renunciation by a beneficiary of all or part of his or her interest under a trust shall not be considered a transfer under Section 15300 or 15301.” [provisions that pierce self-settled trusts]. If, as most courts and the IRS has often found, lapses are essentially the equivalent of disclaimers or renunciations, then California law should protect such trusts post-lapse, just as they would in the event of disclaimer or renunciation. For California settlor/beneficiaries, there is no way to draft around some of the other creditor-friendly laws (even if you removed withdrawal rights and even if the trust was not deemed self-settled, creditors of California trusts have access to distributable portions of spendthrift trusts *without* withdrawal rights), other than to perhaps use another state’s laws, which to pass muster under a conflict of laws analysis would require significant contact/nexus with another state, such as a resident trustee of the state whose law is sought. See discussion of California trust/choice/conflict of laws generally, at Footnote 12 of *Ed Morrow: Asset Protection Dangers When a Beneficiary Is Sole Trustee and Piercing the Third Party*,

If a beneficiary lives in a state with reduced asset protection from the norm or if the applicable state law changes, a beneficiary can simply withdraw any amounts above the 5/5 and/or state creditor lapse protection (which is often higher, sometimes twice the annual exclusion, or could conceivably be zero) and if asset protection is desired, contribute unspent amounts to an IRA/Qualified Plan, cash value life insurance, LLC, homestead, self-settled asset protection trust or other protective structures afforded by federal or state law, which may include outright gifts or gifts to third party settled irrevocable gifting trusts, probably taxed as grantor trusts. For example, if the beneficiary deemed owner simply sent the taxable income they were entitled to withdraw in a given year to a SLAT (spousal lifetime access trust, basically an *intervivos* bypass trust for spouse and descendants), the beneficiary would still be considered the grantor (thus taxed as a grantor trust under §677/§672 rather than §678), without even having to retain a withdrawal right!<sup>91</sup>

Alternatively, the trust can include a modified “hanging power” (i.e. if income and withdrawal power for a \$1 million trust is over \$60,000 but the 5% only covers \$50,000, the powerholder retains the power to withdrawal \$10,000 that does not lapse and “hangs”, continuing into the next year). If a hanging power can only be exercised with the consent of a *non-adverse* trustee (e.g. the trustee is not a remainder beneficiary), it does not cause a taxable lapse, because it is still a general power for estate/gift tax purposes.<sup>92</sup> However, it would **not** be susceptible to creditors in the vast majority of states that limit protection to 5/5, because the definition of “power of withdrawal” in most of those states, under the UTC, *excludes* such a power.<sup>93</sup>

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*Beneficiary-Controlled, Irrevocable Trust*, LISI Asset Protection Newsletter # 339 (March 9, 2017).

<sup>91</sup> Treas. Reg. 1.671-2(e)(6), Example 9.

<sup>92</sup> IRC §2514(c)(3)(B) and Treas. Reg. 25.2514-3(b)(2), Examples 1-2 have adverse co-trustees who were remaindermen who would be affected by any appointment, whereas Example 3 has non-adverse co-trustee, someone who would not be affected by any appointment, therefore it was a general power. Trustees are not usually adverse, unless they happen to be beneficiaries.

<sup>93</sup> In UTC states the applicable creditor access provision, §505(b), refers to “powers of withdrawal” (see 50 state chart). However, the definition of a power of withdrawal under the UTC *excludes* any power that is conditioned on consent of the trustee (*unlike* the federal tax code, which still considers that a general power under §2514): UTC §103(11) “Power of withdrawal” means a presently exercisable general power of appointment **other than a power: \*\*\*(B) exercisable by another person only upon consent of the trustee** or a person holding an adverse interest.” [if a power were predicated on adverse party consent, it would no longer be a general power of appointment for estate/gift tax]. Interestingly, this provision appears to apply even if the powerholder happens to be the SOLE trustee, though I would not count on a court taking a literal reading of the statute.

## **i) Advantage – Achieving Nearly Identical or Better Protection Than a Mandatory Income, HEMS, or Even Discretionary Trusts**

Unlike a *Crummey* clause which has to have a window in time to create a present interest to qualify for the annual exclusion under IRC §2503, forfeiture provisions (a.k.a. “cessor provisions”, usually embedded in a more robust spendthrift clause) can automatically cut off such a withdrawal right in the event of creditor attack (with appropriate limited carve out for marital/conduit trusts), or a trust protector provision might do so as well.<sup>94</sup> To keep within the §678(a) “sole” power requirement, and improve asset protection, withdrawal rights could be limited to a window in time (e.g. December 15-31, or as one PLR did, simply the last day of the year), similar to how 5/5 power limitations are often drafted. More importantly, any cessor provisions or trustee/trust protector powers to cut off the withdrawal right (through decanting or built in power) should only become effective *prospectively* so as not to impugn IRC 678’s requirement that the power be “exercisable solely by himself”. My preference would be to *not* use a time window, as the cessor clause provides adequate protection and this would provide greater clarity for disregarding any mid-year transactions between a beneficiary and their BDOT.

When drafting forfeiture clauses, be wary of cutting off too much in the context of marital deduction trusts, designated beneficiary (see through) trusts or QSST trusts. More importantly, practitioners should examine their own state law and statutes for quirks and well-meaning “savings clauses”, that do more asset protection harm than

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<sup>94</sup> Carve outs are needed for marital trusts to preserve the marital deduction – a trust wherein the right to net income might be removed later would not qualify as a marital trust in the first place. A conduit trust designed to qualify as a *designated beneficiary* of retirement assets has a similar issue, but a practitioner might opt for an accumulation trust design in the first place if asset protection is a concern. A QSST has a similar issue, but if the trust is a grantor trust a QSST election is not needed – a trustee can make an ESBT election upon change from a grantor to non-grantor trust.

A cessor or forfeiture clause goes beyond a standard spendthrift clause by converting the trust to a discretionary trust. “Such a conversion is not the work of a traditional spendthrift provision; instead, it is more appropriately thought of as establishing a conditional discretionary trust.” *Safanda v. Castellano*, 2015 U.S. Dist. LEXIS 54458 (N.D. Ill. Apr. 27, 2015), upholding the effect of such a clause even when the entire trust was to be distributed absent the clause, which had stated: “[I]f by reason of bankruptcy or insolvency . . . all or any part of the income or principal might fail to be enjoyed by any beneficiary or might vest in or be enjoyed by some other person, then the interest of that beneficiary shall immediately terminate. Thereafter, the Trustee shall pay to or for the benefit of that beneficiary only those amounts that the Trustee, in its sole and absolute discretion, deems advisable for the education and support of that beneficiary...”

good. For example, Ohio has an overbroad and awkward savings statute that prevents a forfeiture clause from applying to net income requirements of marital trusts, but also to trusts owning S corporation stock, including grantor trusts and ESBTs!<sup>95</sup>

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<sup>95</sup> Ohio R.C. §5815.22 (B):

(1) Except as provided in divisions (B)(2) and (3) of this section, if an instrument creating an inter vivos or testamentary trust includes a spendthrift provision and the trust holds shares in an S corporation, the spendthrift provision shall not cause any forfeiture or postponement of any beneficial interest, income, principal, or other interest in the shares of the S corporation held by the trust [I propose amending the statute by adding: “to the extent that a beneficiary or his or her legal representative effectively files a qualified subchapter S trust election pursuant to 26 U.S.C. 1361(d), or to the extent that a trust qualifies as an S corporation owner due to a power of withdrawal pursuant to 26 U.S.C. 1361(c)(2)(A)(i) and the trustee does not timely and effectively make an electing small business trust (ESBT) election to prevent disqualification of the trust as an eligible S corporation shareholder pursuant to 26 U.S.C. 1361(e).]. For purposes of division (B)(1) of this section, "S corporation" has the same meaning as in section 1361 of the "Internal Revenue Code of 1986," 26 U.S.C. 1361.

(2) Division (B)(1) of this section does not apply if an instrument that creates an inter vivos or testamentary trust expressly states the intention of the testator or other settlor that maintenance of the corporation's status as an S corporation is less important than enforcing the forfeiture or postponement of any beneficial interest, income, principal, or other interest in the S corporation shares in accordance with the spendthrift provision in the instrument.

(3) Division (B)(1) of this section applies only to the forfeiture or postponement portions of a spendthrift provision and does not apply to any portion of a spendthrift provision that prohibits a beneficiary from assigning, alienating, or otherwise disposing of any beneficial interest in a trust or prohibits a creditor of a beneficiary from attaching or otherwise encumbering the trust estate.

Sample clause for Ohio trusts:

“Pursuant to Ohio R.C. §5815.22(B)(2), the settlor hereby expressly intends that the forfeiture clause of paragraph/Article XXXX shall still apply to this trust, provided the trustee has previously made or timely files a valid electing small business trust (ESBT) election pursuant to IRC §1361(e). It is the intention of the settlor that maintenance of the corporation's status as an S corporation is less important than enforcing the forfeiture or postponement of any beneficial interest, income, principal, or other interest in the S corporation shares in accordance with the spendthrift provision in the instrument but to protect the beneficiary's interest in this trust to the maximum extent possible while still qualifying the trust as an eligible S corporation shareholder. It is intended that the trust would qualify as a shareholder under IRC §1361(c)(2)(A)(i) as a beneficiary deemed owner trust, or if the withdrawal power over all taxable income is thereafter removed for any reason, that the trustee shall timely make or ideally shall have previously made an electing small business trust (ESBT) election pursuant to IRC §1361(c)(2)(A)(v), in either which case the forfeiture clause shall be in full force and effect.

It may be paradoxical and will certainly surprise many readers, but under common law a *mandatory payment of net income annually by the trustee might be attached much easier than an unexercised power to withdraw it.*<sup>96</sup> The Uniform Trust Code will protect mandatory income distributions from garnishment, but only insofar as the trustee makes the distributions within a reasonable time after the designated distribution date.<sup>97</sup>

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<sup>96</sup> Contrast *Univ. Nat'l Bank v. Rhoadarmer*, 827 P.2d 561 (Colo. App. 1991) cert. den. (3/3/1992), which protected a currently exercisable and lapsed 5/5 power, with *Beren v. Beren (In re Estate of Beren)*, 2013 COA 166 (Colo. Ct. App. Dec. 5, 2013), which cited *Rhoadarmer* yet found that a mandatory payment of income (no withdrawal power) was qualitatively different and could be attached by creditor.

<sup>97</sup> UTC §506(b).

## j) Advantage – Passing Through Capital Losses

As discussed in prior LSI articles,<sup>98</sup> estate planning practitioners often pay short shrift to the possibility that assets decline in value (hence the common use of the term “step up”, optimistically ignoring the fact that it may also be a “step down”). This is also an important concept to remember for ongoing income tax planning, not just adjustments in basis at death. If a non-grantor trust or estate incurs an anomalous net capital **loss**, *this is often completely wasted until a final year of termination*, at which point it can pass out to beneficiaries and be used by them to the extent of gains, or up to \$3,000 of ordinary income.<sup>99</sup> *By contrast, a fully grantor trust, even a beneficiary-deemed owner trust, wherein the beneficiary is responsible for the gains and losses on a particular asset, may pass through any capital losses directly to the beneficiary.*<sup>100</sup> A trust that converts to a BDOT may also unlock trapped capital losses.<sup>101</sup>

However, we should explore a potential tax difference here between §678(a) trusts that contain a current or released withdrawal power over only *taxable income*, and a §678(a) trust that contains a current or lapsed/released power over the entire *corpus* and other grantor trusts.

The prospect of a loss passing through when there is only a §678(a)(1) power over taxable income is a strange one, and merits further exploration – neither the *Mallinckrodt*, *Townsend* or *Campbell* cases cited above (nor any other) have dealt with the effect of a withdrawal right pursuant to §678 when the income is *negative*. How do you have the right to withdrawal a *negative* amount, which may be indicated if there is a net capital loss? If there is sufficient other capital gains or DNI type income, it is logical to net them, and the powerholder’s sole unfettered access and the rationale under the

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<sup>98</sup> *The Optimal Basis Increase Trust*, LSI Estate Planning Newsletter #2080 (March 13, 2013), has been updated and is available at the following link <http://ssrn.com/abstract=2436964>

<sup>99</sup> IRC §642(h).

<sup>100</sup> Treas. Reg. §1.671-3(a).

<sup>101</sup> E.g., in PLR 9220012 a trust had accumulated short term capital losses and two beneficiaries had a withdrawal right at age 40 which vested. “When A and B turned 40, they claimed the losses their personal returns.” The trust beneficiaries petitioned the local court successfully to remove the withdrawal right over corpus for all the beneficiaries. Regarding the two whose right had vested at age 40, the IRS ruled that “To the extent they remain available, the short-term capital losses of Trusts A and B, *which became items of deduction under section 671 reportable on the beneficiaries' returns when they turned forty*, may be used by A and B to offset their capital gains, including capital gains actually distributed by Trusts A and B.” Thus, temporarily toggling to BDOT status and then back to non-grantor trust status after the reformation/PLR permitted the beneficiaries to unlock the capital losses to offset against their own personal capital gains (and of course, up to \$3,000 of ordinary income). *However, see potential arguments against this in the following section k. on toggling/conversions.*

above-referenced cases and Subpart E still makes perfect sense (e.g., if the trust has \$50,000 dividends, and \$30,000 net capital loss, the powerholder can withdraw an amount equal to the net taxable income of \$20,000). Similar to a revocable living trust, the beneficiary is bearing the economic burden of the loss and should report the \$50,000 in dividends and \$30,000 of net capital loss (which is of course limited to offset capital gains plus up to \$3,000) on their return. But what if the trust had \$50,000 of dividends and a \$100,000 capital *loss*? The beneficiary would have no right to withdraw anything.<sup>102</sup> Must or may *the beneficiary* report the loss?

There is a regulation seemingly on point. Treas. Reg. §1.671-3(a), quoted below, indicates that the loss must be taken and reported by the beneficiary, but it may not be clear enough to convince everyone.<sup>103</sup> It may depend on whether the beneficiary power holder truly bears the burden of the loss, through the trustee accounting for this and trying the books as to withdrawal rights in future years (or past years, if the withdrawal right is cumulative and sufficient withdrawal right had been stored up from prior years). While this is irrelevant for most grantor trusts which rely on retained or attributed rights of grantor/spouses (§672-§677), §678 relies solely on economic access to income or corpus (i.e., a §678(a)(1) owner has an equitable property interest, whereas many grantor-deemed owners of irrevocable trusts, excepting current GRAT, QPRTs, etc., would not have *any* equitable interest).

If the beneficiary power holder will ultimately bear the benefit and burden when the assets produce a gain or loss, it is logical under Subpart E principles (indeed, even under the old Clifford regulations and case law prior to Subpart E) to have the beneficiary take the loss as seemingly provided in Treas. Reg. §1.671-3(a). However, if the beneficiary bears no financial detriment, no decrease in later ability to access income, then it is more logical and appropriate to have the trust as a separate taxpayer “benefit” from the taxable loss and deny the benefit to the beneficiary. In the world of Subchapter J, Parts A-D (ordinary non-grantor trust taxation), even if the trust comes under one of the exceptions to allow capital gains to pass out to beneficiaries, capital

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<sup>102</sup> Remember, however, the trustee would typically have a parallel discretion to make distributions (which might or might not be triggered whenever a withdrawal power fails to reach a certain threshold, e.g. 4% or 5%). Thus, it’s not like the beneficiary/power holder would be unable to receive any distributions in a down year – it depends on how the trust is drafted. The trust could also be drafted to have two parallel withdrawal rights – one over ordinary income/accounting income and a separate one over net capital gains, in which case the w/d right in the above scenario would be \$50,000.

<sup>103</sup> Treas. Reg. §1.671-3(a)(1) reads “(1) If a grantor **or another person** is treated as the owner of an entire trust (corpus as well as ordinary income), he takes into account in computing his income tax liability all items of income, deduction, and credit (**including capital gains and losses**) to which he would have been entitled had the trust not been in existence during the period he is treated as owner.”

losses are only part of DNI (distributable net income) to the extent they offset capital gains, except in a final year of termination when they can pass out to beneficiaries.<sup>104</sup> However, rules in Subparts A-D are not necessarily useful guidance as to grantor trusts under Subpart E, since the concepts of income and attribution are so radically different.

One tax court case sheds some light on this issue, but is not conclusive.<sup>105</sup> In *Edgar*, a taxpayer was considered a grantor as to ordinary accounting income only, not income allocable to principal (such as capital gains). At issue - who got to deduct capital losses passing through to the trust from a partnership? The court held that the grantor could not report the capital losses because he was only the grantor as to ordinary income, and while he was entitled to deductions against that, the capital losses should be allocated to the principal (which was allocated to a separate taxpaying trust under Subchapter J, Parts A-D). Had the grantor been deemed owner of income attributable to principal, the losses would have passed through. This is confirmed by an example in the regulations.<sup>106</sup>

One recent PLR discussed above which concerned a trust with a similar §678 withdrawal right over income attributable to principal but not the principal itself, PLR 2016-33021, sidestepped the issue. It ruled that net capital *gains* subject to a withdrawal provision would pass through to the beneficiary, without speaking at all to how any net *losses* should be treated.<sup>107</sup> IRC §678 and Treas. Reg. §1.671-3(a)(1) are clear that once the beneficiary is deemed the owner, **ALL income, deductions and credits pass through to the deemed owner, including losses**, but it is not clear whether or when a powerholder would be deemed to be the owner when the only “power” remaining is to vest negative income (a loss) in themselves. Here is our guidance:

“§678(a) General rule. A person other than the grantor shall be treated as the owner of any portion of a trust with respect to which:

- (1) such person has a power exercisable solely by himself to vest the corpus *or the income therefrom* in himself”

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<sup>104</sup> IRC §643(a)(3) for general rule for capital loss/DNI, Treas. Reg. §1.643(a)-3 for exceptions and IRC §642(h) for terminating distributions carrying out loss.

<sup>105</sup> *Edgar v. Commissioner*, 56 T.C. 717 (T.C. 1971).

<sup>106</sup> Treas. Reg. §1.677(a)-1(g), Example 2 “Since the capital gain is held or accumulated for future distributions to G, he is treated under section 677(a)(2) as an owner of a portion of the trust to which the gain is attributable. See § 1.671-3(b). Therefore, he must include the capital gain in the computation of his taxable income. (Had the trust sustained a capital loss in any amount, G would likewise include that loss in the computation of his taxable income.)”

<sup>107</sup> PLR 2016-33021.

Treas. Reg. §1.671-3(a)(1):

“If a grantor or another person is treated as the owner of an entire trust (corpus as well as ordinary income), he takes into account in computing his income tax liability all items of income, deduction, and credit (*including capital gains and losses*) to which he would have been entitled had the trust not been in existence during the period he is treated as owner.”

“The legislative history clearly indicates an intent to disregard the trust form when ownership is attributed to a grantor or other person in that, along with ownership, all items of tax significance (income, deductions, and credits) are likewise attributed to such persons. E.g., when ownership of trust property is attributed under secs. 671, et seq., income is included in the income of the "owner" and he is allowed deductions for expenses "which he would have been entitled to *if the trust had not been created.*" H. Rept. 1337, supra at A212 (emphasis added). See also sec. 1.671-3, Income Tax Regs”<sup>108</sup>

This situation will thankfully not come up very often – only in years with extraordinary losses. While there is substantial authority that the loss equally passes through pursuant to the regulation above, it is not a slam dunk and it may be safest to assume the possibility that a capital loss in excess of net income will **not** pass through. One might decide to pay tax as if there were no capital loss, then file for a refund, since there would be ample authority for taking the position that it passes through.

There are two methods around this uncertainty: first and (sometimes) easiest is to avoid substantial capital losses beyond capital gains inside the trust in the first place by distributing substantial loss property prior to a triggering sale *in kind*. For example, let's say the trustee had invested a quarter million dollars in a high flying stock that doesn't pan out – the \$250,000 investment tanks to \$50,000. If the stock is transferred to the beneficiary, the basis carries over and the *beneficiary* can sell the stock for a \$200,000 capital loss (perhaps offsetting their own personal capital gains in current or future years) – which is potentially more advantageous than had the loss been trapped in trust (especially if the trust is not subject to state income tax but the beneficiary is).<sup>109</sup>

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<sup>108</sup> *Estate of O'Connor v. Commissioner*, 69 T.C. 165, 175 (T.C. 1977), fn 16, which ignored a marital trust wherein a surviving spouse had a withdrawal right over corpus and assigned her interest to charity, thus deeming the charity the owner of the subsequent income under §678.

<sup>109</sup> If the trustee transfers this stock in kind pursuant to a distribution power, if the trust were a non-grantor trust taxed under Subparts A-D over at least a portion, the distribution is deductible to the trust and carries out income under IRC § 661/662 to the extent of the basis and any DNI, not to the extent of the FMV, pursuant to IRC §643(e)(2), with the beneficiary taking the property with a carryover basis, decreased or increased by any gain recognized, pursuant to IRC

Secondly, one can build in a fail-safe clause to reduce the future years' withdrawal rights over capital gains by the amount of prior net losses so that the beneficiary does bear both the fruits and the burdens of capital gains and losses. That may be persuasive in helping to conclude that §678(a)(1) should still apply to shift the net loss to the beneficiary. However, to the extent it does not, any net unwithdrawable gains in that future year in which the withdrawal right is reduced would be taxed under Subchapter J, Parts A-D (ordinary non-grantor trust), and the losses previously held in abeyance would then be able to offset the gains in that year. Therefore, even in a worst case scenario, a net capital loss would be treated no worse than a net capital loss in an ordinary irrevocable non-grantor trust taxed under Subchapter J, Parts A-D. For example, if in our \$200,000 capital loss example the IRS concludes it must be reported by the trust under Subchapter J, Parts A-D, rather than the power holder under §678(a)(1), and the next year's trust income is \$50,000 dividends/interest and \$250,000 capital gains, the net withdrawal amount in the subsequent year would be reduced from \$300,000 to \$100,000, with the trust then reporting a \$200,000 gain offset by the prior year's \$200,000 capital loss carryforward – a wash.<sup>110</sup>

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§643(e)(1). More often in our scenario, there would be no income trapped in the trust subject to Subparts A-D – it would all be withdrawable by the power holder/beneficiary, the trust thus being disregarded and the beneficiary would use their withdrawal right to take the stock in kind, or if more withdrawal power is needed the trustee (or trust protector) might have the authority to grant the beneficiary the right to withdraw the stock itself, in either case subparts A-D, including §643, would not control, but it would still be a carryover basis. This is in sharp contrast to gifts governed by §1015, which modify the carry over basis rules significantly for gifted property with cost basis higher than fair market value (i.e., loss property).

<sup>110</sup> Again, remember that in down years, the trust may have a parallel provision to permit trustee distributions as well, in this example the trustee could distribute more funds, and because there would presumably be no DNI, the distribution would be tax-free despite there being \$200,000 of capital gains in trust, since capital gains are usually not part of DNI.

### **k) Related Advantage – Changing Status from Non-Grantor to Grantor to Unlock Capital Losses and NOLs - Is Eliminating the Trust as a Separate Taxpayer a *Termination*?**

Related to the discussion above, if a trust is currently a non-grantor trust with unusable capital losses, if the trust converts to a grantor trust, including through a grant of a withdrawal power over taxable income and cause grantor trust (or BDOT) status, it may be able to unlock significant trapped losses for the beneficiary. Absent abusive facts, such a conversion would not ordinarily be a taxable event.<sup>111</sup> But it's an open question how some tax characteristics would flow to the beneficiary. The threshold question, whether it converts to a standard grantor trust or a BDOT, is whether the trust is considered "terminated" under Subchapter J.<sup>112</sup> Even if it deemed a termination, only NOLs, capital losses and excess deductions pass out on termination – this still leaves tax credits out in the cold. Passive loss carryforwards should add to basis.<sup>113</sup>

One treatise concludes that:

"a trust that becomes a grantor trust should be deemed to terminate and to distribute its assets to the grantor, as its beneficiary. Thus, the grantor should be treated as a beneficiary succeeding to the property of the trust, for purposes of Section 642(h), which would allow the grantor to succeed to the unused capital loss carryovers. A capital loss carryover resulting from an asset sale by a grantor trust should be a personal loss of the taxpayer, under Section 671. The grantor should logically continue to be able to deduct the loss carryover even if the trust ceases to be a grantor trust."<sup>114</sup>

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<sup>111</sup> CCA 2009-23024.

<sup>112</sup> IRC §642(h) provides that "Unused loss carryovers and excess deductions on termination available to beneficiaries. If on the termination of an estate or trust, the estate or trust has— (1) a net operating loss carryover under section 172 or a capital loss carryover under section 1212, or (2) for the last taxable year of the estate or trust deductions (other than the deductions allowed under subsections (b) or (c)) in excess of gross income for such year, then such carryover or such excess shall be allowed as a deduction, in accordance with regulations prescribed by the Secretary, to the beneficiaries succeeding to the property of the estate or trust."

<sup>113</sup> IRC §469(j)(12) "Special Rule For Distributions By Estates Or Trusts — If any interest in a passive activity is distributed by an estate or trust—

(A) — the basis of such interest immediately before such distribution shall be increased by the amount of any passive activity losses allocable to such interest, and

(B) — such losses shall not be allowable as a deduction for any taxable year."

<sup>114</sup> Zaritsky, Lane & Danforth, *Federal Income Taxation of Estates and Trusts* (WG&L), ¶ 7.03[5] Capital Loss Carryovers and Change of Grantor Trust Status.

PLR 9220012, discussed in footnote 101 above, which permitted beneficiaries to use capital loss carryforwards on conversion from non-grantor trust to BDOT status, is consistent with this.

Some distinguished experts, however, do not consider the conversion from a non-grantor trust to a grantor trust as a *termination*, and question whether carryovers such as passive losses, capital losses, disallowed investment interest and net operating losses would be suspended (and perhaps even expire in the case of NOLs) after changing to grantor trust status.<sup>115</sup> It's certainly an open question.

The IRS and courts may ultimately adopt a middle ground between the above two interpretations. Is the trust *terminating* as an entity for income tax purposes when it no longer has any income, deductions, credits reported to it as a separate taxpayer? Arguably, yes, but it is not clear. The most recent IRS pronouncement did not address this issue.<sup>116</sup> It may not be a simple yes or no answer. The answer should **not** turn on whether the trust terminates for *state law* – after all, many trusts, older GPOA marital trusts and §2503(c) trusts in particular, simply grant a beneficiary a right to withdraw the entire corpus at some point (becoming a IRC § 678 trust) and no one has ever argued that this is not a *de facto* termination of the trust for IRC §642(h) purposes.<sup>117</sup>

The closest analogy might be what happens when an ESBT ceases to be a separate trust. In such case, the carryovers and excess deductions are *not* suspended until the trust becomes an ESBT again - they pass out to the rest of the trust.<sup>118</sup>

The regulation discussing trust “termination” is not under the §642(h) regulations, but under §641(b) regulations, and does not speak to situations in which the tax status changes.<sup>119</sup> If, as hinted at by this regulation, vesting in the beneficiary is important,

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<sup>115</sup> Carol Cantrell, *The Fiduciary's Handbook of Sneaky Post-Mortem Income Tax Issues*, page 9-10, 47th Annual Philip E. Heckerling Institute on Estate Planning, January 14-18, 2013. See also *Mysteries of the Blinking Trust*, by Laura Peebles, Trusts and Estates, Sept. 2008.

<sup>116</sup> CCA 2009-23024.

<sup>117</sup> This is in contrast to a non-grantor trust that is winding up, which will still be considered a separate taxpayer during a reasonable wind up period, e.g. *Dominion Trust Co. of Tenn. v. U.S.*, 786 F Supp. 1321 (M.D. Tenn. 1991), but not if termination were unreasonably postponed, at which point it would be taxed to the beneficiary as equitable owner. Treas. Reg. §1.641(b)-3(d).

<sup>118</sup> IRC §641(c)(4).

<sup>119</sup> Treas. Reg. §1.641(b)-3(b): “Generally, the determination of whether a trust has terminated depends upon whether the property held in trust has been distributed to the persons entitled to succeed to the property upon termination of the trust rather than upon the technicality of whether or not the trustee has rendered his final accounting. A trust does not automatically terminate upon the happening of the event by which the duration of the trust is measured. A reasonable time is permitted after such event for the trustee to perform the duties necessary to

converting to a BDOT arguably fits into this definition better than a garden variety IGT, since most grantors have no property interest in the trust whatsoever and it's hard to argue that property has been distributed to them. By contrast, a BDOT beneficiary has extensive property rights over the assets. Treas. Reg. §1.641(b)-3(b) does not fit a conversion scenario well at all though. Once the grantor trust rules apply to a trust, they apply. There is no "wind up" period as described in the regulation.

In some conversion scenarios, might we have a "suspension" (this is my term, not a term used in any code or regulations) rather than a "termination"? It's not hard to imagine the IRS arguing that anytime there is a meaningful possibility within the unilateral control of the parties to revert back to non-grantor trust status that there is no *termination*, merely a temporary *suspension of tax status*, and therefore IRC §642(h) should not apply, and the losses and other deductions would be *suspended* until either the grantor dies, the deemed owner dies, or unless and until there is no unilateral ability of the deemed owner (or trustee) to revoke the IRC §673-678 triggering power.

While there is no clear precedent in this area, it may be relevant if the *trust instrument* gives the grantor or deemed owner the power to change from grantor (or BDOT) status back to non-grantor trust status versus such powers being granted under state law. After all, every irrevocable trust has some capacity to be amended or even resurrected under state law, and this should not thwart consideration of the trust as being terminated for all practical income tax purposes under IRC §642(h). This is analogous to the IRS not considering the ability of parties to amend irrevocable *intervivos* trusts under state law as an IRC §2036/2038 trigger.<sup>120</sup>

This is an uncertain area. If a conversion from non-grantor trust status is anticipated and the NOLs or capital losses are large enough, consider soaking them up by triggering gains prior to conversion, which might also soak up deductible expenses that may be lost. If that is not possible, consider adding provisions that prevent the grantor (or deemed owner) and perhaps even the trustee from unilaterally changing back that status. The latter would give more credence to the argument that a conversion should be considered a *termination* rather than merely a suspension.

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complete the administration of the trust. Thus, if under the terms of the governing instrument, the trust is to terminate upon the death of the life beneficiary and the corpus is to be distributed to the remainderman, the trust continues after the death of the life beneficiary for a period reasonably necessary to a proper winding up of the affairs of the trust. However, the winding up of a trust cannot be unduly postponed and if the distribution of the trust corpus is unreasonably delayed, the trust is considered terminated for Federal income tax purposes after the expiration of a reasonable period for the trustee to complete the administration of the trust. \*\*\*."

<sup>120</sup> E.g. Treas. Reg. §20.2038-1(a)(2) "However, section 2038 does not apply -\*\*\*"

(2) If the decedent's power could be exercised only with the consent of all parties having an interest (vested or contingent) in the transferred property, and if the power adds nothing to the rights of the parties under local law; or"

## I) Advantage – Avoidance of *Kenan* Gain Disasters

Arguably the most ubiquitous, overlooked and dangerous clauses in trusts are division or distribution clauses based on pecuniary amounts rather than fractional divisions. Many accountants, financial advisors and even many attorneys fail to recognize the malpractice and tax disaster traps associated with these clauses, which are rife in non-grantor trusts and estates.<sup>121</sup>

Distributions of appreciated property in kind, including low or no basis IRD assets such as non-qualified annuities, traditional IRAs or other qualified plans, to fund a pecuniary amount can trigger income taxation known as *Kenan* gain.<sup>122</sup> For example, if a trustee gives \$50,000 of stock with a basis of \$40,000 to pay towards a \$60,000 obligation (e.g. annuity), the trust incurs \$10,000 gain and the beneficiary has a basis of \$50,000 in the received stock.<sup>123</sup> This is true even for distributions to charities, though in many cases a charitable deduction up to the gain may be permitted.<sup>124</sup>

If the trust instrument requires the trustee to pay “all net income annually”, and the net income were the same as above, \$60,000, with \$50,000 of stock and \$10,000 of cash distributed, the result would be the same. The distribution would trigger gain even though the trust did not as obviously reference a pecuniary amount.<sup>125</sup>

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<sup>121</sup> There are thousands of these out there. For an example of a trust that does not specify whether it is a fractional or pecuniary staggered distribution, see page 9 of [https://www.legalzoom.com/samples/last\\_will\\_and\\_testament.pdf](https://www.legalzoom.com/samples/last_will_and_testament.pdf).

<sup>122</sup> *Kenan v. Comm.*, 114 F. 2d 217 (2d Cir. 1940) the trustees of a trust were directed to pay a beneficiary five million dollars when the beneficiary reached age 40. The trustee paid the beneficiary partly in cash and partly in appreciated securities. The court held that the beneficiary had a general claim against the trust corpus, and the satisfaction of this general claim for an ascertainable value by a transfer of specific assets was an exchange that caused the trust to realize gain. Treas. Reg. §1.1014-4(a)(3) incorporates this rule and has examples. Riddle me this, Batman – would *Kenan* have turned out differently had the corpus been \$10 million when the beneficiary turned 40 and the trust mandated that ½ the corpus as of that date (\$5 million) be distributed? I think not. Similar is *Suisman v. Eaton*, 15 F. Supp. 113 (D. Conn. 1935) aff'd per curiam, 83 F.2d 1019 (2d Cir. 1936), cert. denied, 299 U.S. 573 (1936)

<sup>123</sup> Rev. Rul. 68-392.

<sup>124</sup> Rev. Rul. 83-75 held that a trust distribution of corpus consisting of appreciated securities in satisfaction of its obligation to pay a fixed amount to a qualified charitable organization is a sale or exchange triggering taxable gain, but at least the trust is entitled to a §642(c) charitable deduction equal to the amount of gain recognized upon the distribution.

<sup>125</sup> Treas. Reg. §1.661(a)-2(f) “Gain or loss is realized by the trust or estate (or the other beneficiaries) by reason of a *distribution of property in kind if the distribution is in satisfaction of a right to receive a distribution of a specific dollar amount*, of specific property other than that distributed, or of income as defined under section 643(b) and the applicable regulations, if income is required to be distributed currently.”

More dangerously, because of the larger likely dollar amounts, if the trust instrument split into A/B shares based on a pecuniary formula, or GST exempt or non-exempt based on a formula, the result would be the same if appreciated assets in kind were distributed to the separate trust to satisfy the pecuniary obligation. For instance, if a \$3 million traditional IRA and \$50,000 of stock with a \$40,000 basis were allocated to a bypass or GST exempt trust via pecuniary formula to fund the maximum amount possible to pass estate/gift tax free (\$11.18 million in 2018), \$3 million of ordinary income and \$10,000 of capital gain would be triggered.<sup>126</sup>

If the trust had a staggered distribution, for example, 1/3 at age 35, whether this rule applies may depend on the wording of the distribution. If it were an amount equal to 1/3 of the principal or corpus on X date, *an amount frozen in time*, this sounds like a distribution of a pecuniary amount that is simply defined by use of a fraction, not dissimilar to how the distribution of net income is actually a pecuniary amount, as noted above. In fact, it's strikingly similar to the original *Kenan* case.<sup>127</sup> Although I would argue it should be treated similar to any residuary distribution, it's not 100% clear.

By contrast, if the 1/3 varied based on the value of the portfolio of assets at the time of distribution, for example if the beneficiary's rights increased or decreased between the measuring date and the distribution date accordingly, it would be no different from a distribution to any residuary beneficiary (i.e. no gain unless a special §643(e) election is made).

However, if this share comes from a beneficiary deemed owner trust (BDOT), no gain should be triggered at all under Rev. Rul. 85-13. The basis in any assets withdrawn in kind remains the same.<sup>128</sup> Thus, drafting (or converting) a staggered distribution into a withdrawal right does not have the same danger, and it may offer greater asset protection to the beneficiary as well.

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<sup>126</sup> See IRS Chief Counsel Memorandum (CCM) 2006-44020 regarding this rule applied to IRA/401(k) income in respect of a decedent (which is a somewhat debatable conclusion, as IRD rules arguably trump this, but it's best in planning to avoid a fight). For appreciated assets being used to satisfy a pecuniary marital deduction trust triggering gain, see Rev. Rul. 56-207.

<sup>127</sup> Here is a provision plucked from a random old-style trust on my desk: "The Trustee shall distribute the principal and any accumulated income of such separate trust to the beneficiary on the following basis: one-third (1/3) of the balance at age twenty-five (25), one-half (1/2) of the balance at age thirty (30) and the rest at age thirty-five (35)." It should make you nervous to fund a 1/3 or 1/2 distribution like this with IRAs or significantly appreciated assets.

<sup>128</sup> Rev. Rul. 55-294: "Where the lifetime income beneficiary of a testamentary trust exercises during his lifetime a general power of appointment over the corpus of the trust and appoints the property to himself, the basis of the property for Federal income tax purposes shall be the same in the hands of the appointee as it was in the hands of the trustees, subject to adjustment as provided in section 113(b) of the Internal Revenue Code of 1939 [now IRC §1011]."

### **m) Estate Inclusion Risk (and Advantages) can be Mitigated (and Exploited)**

Amounts of income subject to withdrawal at death are included in a beneficiary's estate, but this can be largely mitigated so that the withdrawal right is not vested and active until the end of the year. A beneficiary would be unlikely to die with any includible right and it would probably be minimal.

However, the beneficiary deemed owner trust is usually intended for the middle and upper middle class who have less than \$11-22 million taxable estates! Ultra-high net worth families have beneficiaries in the highest tax bracket (currently, \$600,000 of taxable income) who would often prefer non-grantor trust status to avoid state income tax and enable better charitable tax deductions. Adding to smaller estates is usually a *benefit* because of increased potential for basis step up. In fact, most taxpayers would prefer to trigger estate inclusion over all appreciated assets up to their available exclusion amount. Thus, in most cases a beneficiary deemed owner trust would have a formula testamentary GPOA and/or testamentary limited powers of appointment exercised to trigger the Delaware Tax Trap (IRC §2041(a)(3) causing selective estate inclusion anyway.<sup>129</sup>

If there is no additional power added, only the amount subject to withdrawal would be includable and receive a step up (or down) in basis. For example, if the withdrawal power were over the greater of the net taxable income or 5% of trust corpus, and at death the taxable income were less than 5%, then 5% of trust assets would be includable and the assets of the trust would be prorated and adjusted accordingly. For example, if a property with a basis of \$259,000 and fair market value of \$600,000 was subject to a 5% power at the time of the beneficiary's death, the new basis would be comprised of part carryover (95% times \$259,000 = \$246,050) and part new FMV/date of death basis (5% of \$600,000 = \$30,000), for a total of \$276,050 basis.<sup>130</sup>

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<sup>129</sup> Trusts with such clauses are sometimes referred to as Optimal Basis Increase Trusts, see article and updated white paper comparing various methods of increasing basis upon lateral, upstream and downstream beneficiaries' deaths at *Ed Morrow and the Optimal Basis Increase Trust*, LISI Estate Planning Newsletter #2080 (March 20, 2013), updated version available at [www.ssrn.com](http://www.ssrn.com).

<sup>130</sup> I cheated and stole this calculation from an actual case with identical facts, see *Prokopov. v. Commissioner*, TC Memo 1997-229.

## ***n) Advantage – Seizing the \$250,000 (\$500,000) capital gains tax exclusion for sale of residence under §121***

The most common of the tax savings opportunities for a practitioner to encounter in trust planning is the capital gains exclusion on the sale of a principal residence. A provision to withdraw capital gains from the sale of a residence, as discussed above, creates a §678(a)(1) trust as to that asset upon sale. Such a provision as to residential property, but not other assets, avoids many of the negatives of §678(a)(1) trusts. For example, there is very little asset protection risk to granting a beneficiary the right to withdraw capital gains income from sale of a personal residence if an independent trustee doesn't sell the property! A trust might allow the beneficiary to withdraw net capital gains from the sale of a residence, but have ordinary distribution provisions for all other assets.

Grantor trusts are permitted this exclusion provided the other occupancy requirements are met.<sup>131</sup> A non-grantor trust is **not** eligible for the \$250,000/\$500,000 capital gain exclusion on the sale of a personal residence provided by §121, even if the beneficiary is entitled to net accounting income and the right to live in the residence.<sup>132</sup> However, section §678 trusts (such as BDOTs) are specifically included in the regulations (as are disregarded entities such as SMLLCs).<sup>133</sup> *A mere right to occupy and use the property is insufficient to cause grantor trust status necessary for the §121 exclusion.* If the trust is partially a grantor trust, such as a trust with a five and five power, then the grantor may exclude that portion of the gain.<sup>134</sup> Of course, the goal with this type of provision would be to grant the withdrawal right over the capital gain from

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<sup>131</sup> See Rev. Rul. 66-159, Rev. Rul. 85-45 and PLR 1999-12026, in which the IRS looked through the trust to the beneficial owner under §678(a) for qualification under IRC §121 and its predecessor. Although in those cases the beneficiary had a right to withdrawal the entire trust principal, not just the capital gains from the sale of the home, the statute should equally apply if all the capital gains as well as other income is subject to a withdraw right, as discussed above. This is perfectly consistent with Treas. Reg. §1.671-3(a)(2) and IRC §678(a).

<sup>132</sup> E.g. in PLR 2000-18021, the IRS denied the IRC §121 exclusion to a trust where a beneficiary was entitled to accounting income but never had a power to withdraw taxable income.

<sup>133</sup> Treas. Reg. §1.121-1(c)(3): "(i) Trusts. If a residence is owned by a trust, for the period that a taxpayer is treated under sections 671 through 679 (relating to the treatment of grantors and others as substantial owners) as the owner of the trust or the portion of the trust that includes the residence, the taxpayer will be treated as owning the residence for purposes of satisfying the 2-year ownership requirement of section 121, and the sale or exchange by the trust will be treated as if made by the taxpayer. See also PLR 1999-12026 (ruling that a revocable trust was eligible – why someone bothered with obtaining a PLR for that is unclear).

<sup>134</sup> PLR 2001-04005 (bypass trust w/ 5% withdrawal power eligible for at least 5% of capital gains exclusion as partial grantor trust, though the PLR did not discuss the possibility of higher % based on prior lapses/release, which should have been argued). See also Rev. Rul. 67-241.

the sale, not the income – and not tied to 5% of corpus. The portion rules, remember, can be tied to specific assets.

This is no small benefit – with federal long-term capital gains rates at up to 23.8%, effect on social security taxation and other deductions/credits, indirect effect on alternative minimum tax, and state and local income taxes at up to 13.3% (with \$10,000 limits on the SALT deduction starting in 2018 after tax reform), there could easily be a tax cost of close to \$100,000 if this \$250,000 tax exclusion is lost. The exclusion is double for up to two years after death, but more important for the long term, *surviving spouses often remarry!*<sup>135</sup> If their new spouse meets the two year occupancy requirement, hasn't used the provision themselves in the last two years and they file jointly, the exclusion is doubled, even if only one spouse is deemed the owner, through §678, of 100% of the trust income.<sup>136</sup> Thus, losing this tax break could easily mean **\$500,000** of avoidable long-term capital gains income. When we consider the remarriage scenario, we're getting **close to a potential \$200,000 income tax effect**. Have fun explaining that to the surviving spouse or other beneficiary if it's lost.

Trustees must normally make property productive of income, but trusts routinely permit the trustee to invest in or retain a contributed residence for a beneficiary and specific language should be considered on this point.<sup>137</sup> The QTIP marital deduction, of course, permits a surviving spouse's use of a residence to qualify for the marital deduction, provided the spouse is entitled to any rent income if the property is later vacated as a residence.<sup>138</sup>

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<sup>135</sup> Statistics show that widowers are more likely to remarry much sooner after a death of a spouse than widows.

<sup>136</sup> See IRC §121(b)(4) and IRC §121(b): **(2) Special rules for joint returns.** In the case of a husband and wife who make a joint return for the taxable year of the sale or exchange of the property—

**(A) \$500,000 Limitation for certain joint returns** Paragraph (1) shall be applied by substituting "\$500,000" for "\$250,000" if— **(i)** either spouse meets the ownership requirements of subsection (a) with respect to such property; **(ii)** both spouses meet the use requirements of subsection (a) with respect to such property; and

**(iii)** neither spouse is ineligible for the benefits of subsection (a) with respect to such property by reason of paragraph (3).\*\*\*

**(3) Application to only 1 sale or exchange every 2 years**

Subsection (a) shall not apply to any sale or exchange by the taxpayer if, during the 2-year period ending on the date of such sale or exchange, there was any other sale or exchange by the taxpayer to which subsection (a) applied.

<sup>137</sup> Uniform Prudent Investor Act (Restatement of Trusts, 3<sup>rd</sup>), §181.

<sup>138</sup> Treas. Reg. § 20.2056(b)-5(f)(4), Treas. Reg. §20.2056(b)-7(h), Example 1.

There are other income tax traps when a residence used by a beneficiary is owned and maintained by the trust. The amounts spent by the trustee to maintain the residence *are generally not deductible and not considered to have been distributed to the beneficiary*.<sup>139</sup> Trustees can easily botch this accounting. Even if this is reported correctly, it may lead to more trapped and taxed in trust than necessary, as opposed to the greater simplicity of simply making distributions and letting the beneficiary pay. The mortgage interest deduction should be allowed to the extent paid by the beneficiary.<sup>140</sup>

The beauty of permitting withdrawal of the capital gains from the sale of the residence is that it has no effect on the access to income or distributions of the trust until such time as the withdrawal right is triggered (upon sale). If a trust were to have a provision speaking *only* to beneficiary access to this gain (not a full BDOT over all taxable income), such as might be done in a blended family situation, if the trust reverts back to a fully non-grantor trust thereafter, the discretionary distribution provisions can simply take into account any earlier withdrawal of capital gains from the sale of the residence as a factor that would reduce future discretionary distributions accordingly (keeping the mandatory accounting income floor, of course, if it is a QTIP or other marital trust).

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<sup>139</sup> *Commissioner v. Plant*, 76 F.2d 8 (2nd Cir. 1935); PLR 8341005; *A.I. DuPont Testamentary Trust v. Commissioner*, 574 F.2d 1332 (5th Cir. 1978) and 514 F.2d 917 (5th Cir. 1975).

<sup>140</sup> Treas. Reg. §1.163-1(b) (equitable ownership sufficient)

**o) Advantage – No Need to Trace Charitable Donations to Gross Income, Charitable Deduction Carry Forward-ability, no Reduction or Elimination of Deductions for Contributions from Business Income**

If a beneficiary directs that some of her withdrawable income go to charity, she (not the trust) would be eligible for a Schedule A tax deduction under §170.<sup>141</sup> Increased income to the beneficiary enables a greater percentage of any charitable deduction to be taken due to the increase in AGI. Because the deduction comes under the individual donation rules rather than the trust/estate deduction rules of IRC §642(c), some very annoying and troublesome restrictions to non-grantor trust/estate charitable deductions are avoided. To wit, there is no need to trace the donation to gross income, which may be difficult if not impossible to deal with for phantom income received from mutual funds or other pass through entities.<sup>142</sup> There is no need to have a specific charitable instruction in the governing instrument, and most importantly, any unused

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<sup>141</sup> *Goldsby v. Commissioner*, T.C. Memo 2006-274. See also Treas. Reg. §1.671-2(c) “An item of income, deduction, or credit included in computing the taxable income and credits of a grantor or another person under section 671 is treated as if it had been received or paid directly by the grantor or other person (whether or not an individual). For example, a charitable contribution made by a trust which is attributed to the grantor (an individual) under sections 671 through 677 will be aggregated with his other charitable contributions to determine their deductibility under the limitations of section 170(b)(1).” However, this does leave a potential gap in deductibility for charitable donations from beneficiary deemed owner trusts – if the beneficiary does not direct the payment under his or her withdrawal right, but the trustee uses a concurrent trust power to distribute corpus to charity, not pursuant to the beneficiary’s presently exercisable general power of appointment (withdrawal power), then the above regulation would not apply, and §642(c) would not be available since there would be no gross income to the trust as a separate taxable entity and the deduction lost.

<sup>142</sup> There is a very compelling argument which makes a good deal of practical sense that the “gross income” requirement in IRC §642(c) is simply a quantitative limitation rather than requirement for mechanical tracing, see Federal Income Taxation of Fiduciaries and Beneficiaries, §412.8.3. (CCH 2009), by Byrle Abbin, citing *Old Colony Trust Co. v. Commissioner*, 301 U.S. 379 (1937). That said, it is safest to assume in planning that sourcing is required, as this appears to be the IRS position and some courts have so concluded: see Rev. Rul. 2003-123, *Crestar Bank v. IRS*, 47 F.Supp. 2d 670 (E.D. Va. 1999) and *Mott v. United States*, 462 F.2d 512 (Ct. Cl. 1972). This may be easy for dividends, interests and rents, but quite hairy if taxable income is phantom income from a mutual fund or attributed via K-1 from pass through entities. For example, there may be less distribution from an LLC/LP (or none) than the taxable income. And even if a sufficient LLC/LP distribution is made to the trust, must the trustee be able to trace this distribution to the LLC/LP’s gross taxable income? That may not even be possible. There’s a good reason they got rid of tracing for the most part in Subchapter J – it’s a huge mess.

deduction can carry forward up to five succeeding years (fifteen for qualified conservation easements).<sup>143</sup>

Non-grantor trusts/estates cannot carryforward, even on termination, excess charitable contributions, and most trusts taking the charitable tax deduction also have an additional complex filing requirement, Form 1041-A, that can easily be overlooked.<sup>144</sup>

In addition to the above restrictions within IRC §642(c), non-grantor trusts have an even more devastating restriction that affects closely held business, debt-financed real estate and private equity owners. IRC §681 limits §642(c)'s deduction if any income inside the trust would be unrelated business taxable income (UBTI) if it were in the hands of a tax exempt entity.<sup>145</sup> By contrast, there are no such restrictions or tracing to business income that would limit the deduction for individuals. For example:

- 1) A trust has \$91,000 of income via K-1 from an LLC/partnership conducting a business and only \$9,000 of other income (\$100,000 total). The “quasi-UBTI” before the charitable deduction allowed under §512(b)(11) would therefore be \$90,000 (\$1,000 is subtracted as deduction per §512(b)(12)). If the trust makes a distribution of \$100,000 to a public charity that would qualify under §642(c), the portion of income allocable to “quasi-UBTI” is 9/10 of the contribution, or \$90,000 (\$90,000 UBTI/\$100,000 total income). The amount disallowed for a deduction is this amount, \$90,000, minus what would have been allowed as a charitable deduction against UBTI under §512(b)(11), 50% for public charities, times \$90,000 (\$45,000), so **almost half, \$45,000** of the \$100,000 donation is **disallowed** as a deduction pursuant to IRC §681.
- 2) If instead of to a public charity, the \$100,000 in example #1 above went to a *private foundation*, the amount allowed under §511(b)(11) would only be **30%** of \$90,000, or \$27,000, leaving **\$63,000 disallowed** under §681 and only \$37,000 of the donation usable.

What is so devastating about this disallowance is not only that it goes unused in the current year, but that it does not carry forward five succeeding years as it would for an individual, because IRC §642(c), the charitable provision applicable to non-grantor trusts, has no such corresponding provision. The deduction is *completely wasted*.

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<sup>143</sup> IRC §170(d).

<sup>144</sup> IRC §6034, Treas. Reg. § 1.6034-1(a), Instructions for Form 1041-A. IRC § 6652(c)(2) provides for separate penalties of \$10 a day, up to a maximum of \$5,000, against both the trust and the trustee for not filing Form 1041-A on time, unless there is reasonable cause.

<sup>145</sup> IRC §681(a), Treas. Reg. §1.642(c)-3(d) and (e).

If the above does not quite sound bad enough, let's change the above scenarios and instead of an LLC taxed as a partnership, we change this to a trust owning an S corporation, which is more common for larger operating businesses:

- 3) Same as scenario #1 above, but the \$91,000 of business income comes from a K-1 from an S corporation rather than a partnership, and the trust has filed an ESBT election. The same \$100,000 donation is made from the trust. In this case, the non-grantor trust is treated as two taxpayers under the uniquely stifling ESBT rules – an S corporation portion, and a non-S corporation portion. The ESBT/S corporation receives NO charitable deduction under IRC §642(c) against the \$91,000 of S corporation income.<sup>146</sup> Some of the donation may be able to be used against the non-S portion of income, the \$9,000 of interest income, but the end result is even worse than for the partnership scenarios above, **\$91,000 is disallowed.**

Adding insult to injury, any denial of deduction via IRC §681 may also cause higher *state* income tax in many states, since most states start their own taxation of trusts with federal taxable income (currently line 22 of Form 1041).

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<sup>146</sup> IRC §641(c). However, for tax years starting in 2018, the tax reform formerly known as the Tax Cuts and Jobs Act amends IRC §641(c) to permit (usually) better charitable deductions for ESBTs under rules similar to Section 170 rather than Section 642(c). In our scenario above, this would allow 60% of AGI deduction if cash (\$60,000) (30% if appreciated stock) and permit the remainder to carry forward, see SEC. 13542. CHARITABLE CONTRIBUTION DEDUCTION FOR ELECTING SMALL BUSINESS TRUSTS. However, for many individual taxpayers this may still not be as good as a grantor trust. For example, if a taxpayer/beneficiary of grantor trust had \$200,000 of income, plus \$100,000 via trust, their AGI would be \$300,000 and they could use up to \$180,000 (60% of AGI) in deductions for a cash contribution, thus being able to use the full \$100,000 deduction in our scenario. For smaller middle income donors, however, deductions from non-grantor trust may be more advantageous – see separate presentation by author on Income Tax and Charitable Planning with Non-Charitable Non-Grantor Trusts After Tax Reform. Whether a BDOT or Non-Grantor trust is more advantageous to the family may vary year by year based on AGI of trust/beneficiary, amount and type of donation, and of course state and federal tax law. The best solution may be to permit the trustee/trust protector to toggle based on anticipated charitable and income tax effects as one factor in the decision.

**p) Advantage – Higher Alternative Minimum Tax (AMT) exemptions**

Trusts and estates only receive an AMT exemption of \$24,100 and phase out at \$80,450 in 2017, whereas for individual taxpayers those amounts are \$84,500 and \$187,800 respectively for single and married taxpayers filing jointly.<sup>147</sup> So, non-grantor trusts may not only have income taxed in trust at higher rates above the \$12,500 amount, but AMT could also come into play at a lower threshold.

For tax years starting after December 31, 2017 and before January 1, 2026, tax reform increased the AMT exemption further for individuals, but **not for trusts and estates**.<sup>148</sup> For married couples filing jointly, the phase out of the exemption does not start until \$1,000,000 of income starting in 2018, as opposed only \$150,000 (adjusted for inflation) previously. Thus, tax reform indirectly creates an ever increasing advantage in the AMT realm for families to get income out of the fiduciary income tax system in cases where the AMT may apply.

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<sup>147</sup> These amounts under IRC §55 adjust for inflation, see Rev. Proc. 2016-55, §3.10 for 2017 inflation adjusted amounts, including amounts for single, head of household and married filing separately. See Rev. Proc. 2018-57, §3.12 for tax year 2019 AMT inflation adjustments with 2019 exemption of \$25,000 for trusts/estates and \$111,700 for married couples filing jointly.

<sup>148</sup> See SEC. 12003. INCREASED EXEMPTION FOR INDIVIDUALS of the “Tax Cuts and Jobs Act”, in the code at IRC §55(d)(4)

### **q) Advantage – Life Insurance Transferability**

If a beneficiary of an ordinary non-grantor trust wants to remove life insurance from their estate or in some states protect it from creditors, there is difficulty gifting or selling the insurance to a third party created non-grantor trust. Gifting it implicates the three year and retained interest rules which may cause significant estate tax.<sup>149</sup> Gifting it would also cause self-settled trust status for creditor protection purposes. Selling it to such a trust might even be *worse* – it implicates the transfer for value rule which may cause the entire death benefit to be taxed at ordinary income tax rates!<sup>150</sup>

By contrast, a beneficiary can sell a life insurance policy insuring themselves to a BDOT without triggering the transfer for value rule.<sup>151</sup> Provided that other incidents of ownership are avoided (such as a beneficiary/insured holding powers as trustee), this enables the beneficiary to use the BDOT as an ILIT to protect cash value and exclude proceeds from the estate, yet still remain a beneficiary. Essentially, it is similar to a self-settled DAPT, but with stronger creditor protection regardless of the state or whether in bankruptcy as a non-self-settled trust, all while avoiding the uncertainties of §2036 application inherent in self-settled DAPTs.<sup>152</sup>

If estate tax is a concern, however, the beneficiary of a BDOT may still want to fund a traditional ILIT (and, of course, may use their withdrawal power in a BDOT to help fund it, as that would make them the grantor for income tax purposes).<sup>153</sup> The reason is that a withdrawal power, even if only over taxable income which an insurance policy usually does not generate, could be an incident of ownership since the policy could theoretically be sold or surrendered and generate taxable income.<sup>154</sup>

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<sup>149</sup> IRC §2035, §2036

<sup>150</sup> IRC §101(a)(2)

<sup>151</sup> IRC §101(a)(2)(B) carves out an exception for transfer to an insured. Rev. Rul. 2007-13 treats a beneficiary deemed owner trust as owned by the deemed owner for §101(a)(2)(B) purposes, following Rev. Rul. 85-13.

<sup>152</sup> You can make a completed gift to self-settled DAPTs, in PLRs the IRS has refused to rule on eventual §2036 inclusion. Rev. Rul. 77-378, PLR 9837007, PLR 2009-44002. Bankruptcy courts have thus far been unkind to DAPTs in the cases addressed thus far, although both the below were “bad facts”, and DAPTs have issues with 10 year lookbacks for fraudulent transfers under 11 U.S.C. §548(e) and conflict of law analysis of multi-state issues. See *In re Huber*, 2013 Bankr. LEXIS 2038 (Bankr. W.D. Wash. 2013) and *Battley v. Mortensen (In Re Mortensen)*, Adv. D.Alaska, No. A09-90036-DMD (May 26, 2011).

<sup>153</sup> Treas. Reg. §1.671-2(e)(5), using a GPOA to appoint in trust makes the powerholder the grantor for income tax purposes.

<sup>154</sup> Incidents of ownership is a term of art in IRC §2042.

## ***r) Advantage – Trust Owned Non-Qualified Deferred Annuity Taxation***

Professional trustees tend to avoid purchasing annuities, for various good reasons, but hundreds of billions of dollars flow into them every year.<sup>155</sup> One reason that trustees tend to avoid them is that non-grantor trusts generally do not receive the same income tax deferral that an individual would receive, unless the trust is an “agent for a natural person”.<sup>156</sup> In many cases, it would be a clear breach of fiduciary duty to purchase deferred annuities for a non-grantor trust, since it would essentially be trading advantageous qualified dividend and long-term capital gain tax rates for ordinary income taxation, with higher costs. However, a grantor trust is disregarded and may be the owner of a deferred annuity and receive the same deferral of tax as an individual. Moreover, a trust that is disregarded and the beneficiary deemed the owner may permit the payment upon death to be deferred over a trust beneficiary’s life expectancy as a “designated beneficiary” (unlike other trusts).<sup>157</sup>

There are still significant costs, surrender fees and complexities as well as the potential for change of tax status that militate against the use of deferred annuities owned by or even payable to trusts. Usually trusts and annuities go together like oil and water, but at least there is the possibility that using (or if possible switching to) a BDOT design would be less of a tax disaster when they do mix.

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<sup>155</sup> For an excellent discussion of the issues highlighted by one recent case, see *Paul Hood on In re Amendment and Restatement of Revocable Living Trust of Alfred J. Berget: Non-Professional Trustee's Purchase of Three Deferred Annuities Held Not to Be a Breach of Trust*, LISI Estate Planning Newsletter #2275 (January 21, 2015).

<sup>156</sup> IRC §72(u) Treatment of annuity contracts not held by natural persons  
(1) In general If any annuity contract is held by a person who is not a natural person—  
**(A)** such contract shall not be treated as an annuity contract for purposes of this subtitle (other than subchapter L), and  
**(B)** the income on the contract for any taxable year of the policyholder shall be treated as ordinary income received or accrued by the owner during such taxable year.  
For purposes of this paragraph, holding by a trust or other entity as an agent for a natural person shall not be taken into account.

<sup>157</sup> IRC §72(s)(4): “Designated beneficiary  
For purposes of this subsection, the term “designated beneficiary” means any individual designated a beneficiary by the holder of the contract.” That said, there are conflicting rulings on whether grantor trusts can be looked through under the parallel IRA/qualified plan “designated beneficiary” rules in §401(a)(9)(E), discussed in the section on IRAs later herein.

### **s) Advantage – Avoiding Multi-State Fiduciary Income Taxation**

It's possible for trusts as a separate taxpayer to not only to get stuck with higher federal income tax rates, but even have to pay additional and/or multiple states' tax burdens or be subject to similarly compressed state income tax brackets which might be avoided using a BDOT.<sup>158</sup> This is especially true for ESBTs, as some states have rules similar to the federal taxation of ESBTs, subjecting ESBT income to the top state marginal tax rate immediately, rather than applying a state's progressive tax rate structure, and of course, as noted earlier, ESBTs receive no distribution deduction.<sup>159</sup>

Sometimes we can avoid taxation in *any* state through using professional trustees in favorable trust jurisdictions, and trapping income in trust is often strategically intended.<sup>160</sup> However, for the 99+% who are not in the highest tax bracket or do not want to use out of state trustees, trapping income *in* trust is the more serious issue.

For instance, let's say we have a settlor decedent from Delaware, Maine, Illinois, Maine, Maryland, Michigan, Minnesota, Nebraska, Oklahoma, Pennsylvania, Vermont, Virginia, Washington, D.C., West Virginia or Wisconsin. These states attempt to tax a trust based on the residency of the decedent/grantor no matter where the trust is administered, what law it uses or where its assets, beneficiaries or trustee is located (a.k.a. "founder states").<sup>161</sup> Other jurisdictions are similar with regard to *testamentary*

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<sup>158</sup> Most states have progressive or flat rates that make it just as low, if not lower, to have state income taxed to a trust as separate taxpayer, but a few have compressed rates similar to the federal fiduciary income tax such that income trapped in trust might be taxed much higher in trust than if it were taxed directly to a beneficiary, e.g. Connecticut taxes trust and estate income at the highest rate of 6.99% despite this rate not hitting individuals until \$1,000,000 of taxable income. North Dakota's top rate, though low, is very compressed for trusts and estates and starts at only \$12,300 v. \$411,500 for individuals. Vermont is similar, with their 8.95% top rate starting at \$12,300 for trusts v. \$411,500 for individuals. Rhode Island is similarly compressed, the top rate starting at only \$7,700 for trusts and estates v. \$137,650 for individuals.

<sup>159</sup> E.g. [CA Rev & Tax Code § 17731.5](#) – California's tax structure is highly progressive, with very few individuals paying the top marginal rate of 13.3% applicable to income over \$1 million.

<sup>160</sup> See, *INGs: Not Just for State Income Tax Avoidance*, by this author, available at [www.ultimateestateplanner.com](http://www.ultimateestateplanner.com) and 50 state plus D.C. trust taxation chart.

<sup>161</sup> This is more fully discussed in the ING presentation in the above footnote. There are appellate level taxpayer favorable decisions in three of these states and a recent state tax court level decision in a fourth that hold that their respective state's statute is unconstitutional as applied to trusts where it violates due process to tax trusts without sufficient contacts with the taxing jurisdiction: *Linn v. Department of Revenue*, 2 NE3d 1203 (Ill. App. Ct. 2013), *Blue v. Department of Transportation*, 462 NW2d 762 (Mich. Ct. App. 1990), *McNeil v. Commonwealth*, 67 A3d 185 (Pa. Commw. Ct. 2013), *Fielding v. Commissioner of Revenue*, Minnesota Tax Court Cases 8911-R, 8912-R, 8913-R, 8914-R decided May 31, 2017. For further discussion of this trend and the latter case especially, see *Ed Morrow on Fielding: Yet Another Case Where*

trusts created by a resident decedent: Connecticut, Washington, D.C., Illinois, Louisiana, Maine, Maryland, Michigan, Minnesota, Nebraska, Ohio, Oklahoma, Pennsylvania, Utah, Vermont, Virginia, West Virginia and Wisconsin.<sup>162</sup>

For example, a Maine resident leaves assets in trust for her son and daughter and their issue. The son and daughter may live in Florida or Texas or any low or no tax state, but their trust may get stuck with Maine income tax regardless. What if their children live in California and the trustee lives in Oregon?<sup>163</sup> The collective state taxation between the three states could conceivably exceed the federal taxation. Non-grantor trust taxation may be based on the residency of the settlor, any current non-contingent beneficiaries, the residency of the trustees or the situs of administration.

There may not always be a full credit granted either – the Supreme Court has permitted multiple states to tax the same income. When a trust as taxpayer has sufficient nexus with different states, each may tax the income.<sup>164</sup> While many states allow trusts some form of credit for taxes paid to other states, it may not be required.

Sometimes state tax will not be an issue or it may be possible to avoid these results through choice of law and trustee. Changing the residency of grantors, testators and beneficiaries is not so easy. Some may relish fighting years of battles with state tax departments to have broad statutes declared unconstitutional. However, not everyone loves litigation or has the resources of the Pritzker family to fight such battles. *Grantor trust status avoids this mess altogether.*<sup>165</sup>

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*State Income Tax Against Out of State Trusts and Residents Ruled Unconstitutional*, LISI Income Tax Planning Newsletter #117, August 31, 2017.

<sup>162</sup> Because of continuing jurisdiction by the founder state, it is more difficult to avoid nexus/taxation for *testamentary* trusts – Washington, D.C. was successful in rebuffing a due process challenge in *District of Columbia v. Chase Manhattan Bank*, 689 A.2d 539 (D.C. 1997) and could “tax the annual net income of a testamentary trust created by the will of an individual who died while domiciled in the District, when the trustee, trust assets, and trust beneficiaries are all presently located outside the District.” Lesson – *don’t use testamentary trusts if you live in one of those jurisdictions!*

<sup>163</sup> Other states will tax trusts based on residency of the beneficiary, trustee, and/or administration. California will tax the trust if there are trustees/beneficiaries, Oregon will tax if there is trustee/administration. Top income tax rates of Maine, California and Oregon are 10.15%, 13.3% and 9.9% respectively.

<sup>164</sup> *Curry v. McCannless*, 307 U.S. 357, 367 (1938): “When a taxpayer extends his activities with respect to his intangibles, so as to avail himself of the protection and benefit of the laws [nexus as defined supra] in such a way as to bring his person or property within the reach of the tax gatherer there, the reason for a single place of taxation no longer obtains.”

<sup>165</sup> Most states follow federal grantor trust status, e.g., [MGL ch. 62, §10\(e\)](#): “If the grantor or another person is treated as the owner of any portion of a trust by reason of the provisions of

## t) **Advantage - Application to QTIP trusts**

The common wisdom is that QTIP require all income be paid annually to the surviving spouse, therefore a QTIP cannot be a BDOT. *The common wisdom is wrong.* Rather than mandate all income be paid annually, marital trusts can merely require that the spouse be able to withdraw all income annually.<sup>166</sup> As discussed herein, this can make a huge difference. This floor of the right to withdraw net accounting income required by IRC §2056 can certainly be increased to include the greater of the net accounting income or the taxable income (which would usually be higher), including capital gains and other taxable income that would not be accounting income.

Obviously there are a few situations where settlors want to limit this floor and increasing it would offend the settlor's intent to ensure more growth in the corpus for eventual distribution to remaindermen. However, most couples with children of the same marriage but even some in blended families would be fine with this, and it would allow for a much easier to understand and simplified reporting structure. Normal people think in terms of taxable income (W-2, 1099), not fiduciary accounting or distributable net income. No surviving spouse thinks that the \$50,000 IRA distribution from the \$1 million IRA in a QTIP should entitle him or her to only \$5,000 of "income" from the trust.

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section six hundred and seventy-one to six hundred and seventy-eight, inclusive, of the federal Internal Revenue Code, the items of income, deduction and credits against tax which are attributable to that portion of the trust shall not be taken into account in calculating the income taxable to the trust but shall be taken into account in computing the taxable income or credits against the tax of such grantor or other person under section two.”; [MI Comp L § 206.51](#): “(7) The taxable income of a resident who is required to include income from a trust in his or her federal income tax return under the provisions of 26 USC 671 to 679, shall include items of income and deductions from the trust in taxable income to the extent required by this part with respect to property owned outright.”

<sup>166</sup> Treas. Reg. §20.2056(b)-5(f)(8): “In the case of an interest passing in trust, the terms "entitled for life" and "payable annually or at more frequent intervals," as used in the conditions set forth in paragraph (a) (1) and (2) of this section, require that under the terms of the trust the income referred to must be currently (at least annually; see paragraph (e) of this section) distributable to the spouse **or** that she must have such command over the income that it is virtually hers. Thus, the conditions in paragraph (a) (1) and (2) of this section are satisfied in this respect if, under the terms of the trust instrument, *the spouse has the right exercisable annually (or more frequently) to require distribution to herself of the trust income, and otherwise the trust income is to be accumulated and added to corpus.*” Treas. Reg. §20.2056(b)-7(d)(2) governing QTIPs looks to the above Regulation for its definition of the required income interest: “(2) Entitled for life to all income. The principles of § 20.2056(b)-5(f), relating to whether the spouse is entitled for life to all of the income from the entire interest, or a specific portion of the entire interest, apply in determining whether the surviving spouse is entitled for life to all of the income from the property regardless of whether the interest passing to the spouse is in trust.”

Explaining the income taxation of a QTIP/BDOTs to spouses would be *infinitely* easier. Whether it fits a particular client's situation will depend on their level of desire to preserve maximum principal for remaindermen or not.

If, as seems to be the case under Rev. Rul. 85-13 (discussed below), that surviving spouses can transact tax-free with their BDOTs, this enables significant estate/income tax planning opportunity. This is not intuitive at all, since QTIPs are also included in a surviving spouse's estate. Importantly, QTIP assets are valued separately for estate tax purposes. Thus, there are significant valuation discounts that may be sought (or avoided) whenever a surviving spouse and QTIP share ownership as tenants in common or co-own a closely held businesses. Consider this case law chart below that outlines discounts for simple 50/50 tenant in common ownership:

**The Devastating Effect of Unwanted Discounts on 50% Tenancy in Common Interests**

Case	TIC, CP Share	Discount
<a href="#"><u>Propstra v. United States, 680 F.2d 1248 (9th Cir. 1982)</u></a>	50%	15.0%
<a href="#"><u>Estate of George W. Youle v. Comm'r, T.C. Memo 1989-138</u></a>	50%	12.59%
<a href="#"><u>Estate of Alto B. Cervin v. Comm'r, T.C. Memo 1994-550</u></a>	50%	20.0%
<a href="#"><u>Williams v. Commissioner, T.C. Memo 1998-59</u></a>	50%	44%
<a href="#"><u>Estate of Brocato v. Comm'r, T.C. Memo 1999-424</u></a>	50%	20%
<a href="#"><u>Estate of Eileen K. Stevens v. Comm'r, T.C. Memo 2000-53</u></a>	50%	25%
<a href="#"><u>Ludwick v. Commissioner, T.C. Memo 2010-104</u></a>	50%	17.2%
<b>Simple rounded average of the discount in the above cases:</b>		<b>22.0%</b>
<b>Amount of discount had these been JTWROS w/spouse:</b>		<b>0.0%</b>

Example: Mary, a widow, owns 50% of a \$1 million property outright and 50% in her QTIP trust, but is nowhere close to having a taxable estate. At her death, the shares would be valued separately, and might be subject to a 22% or more discount (see cases above). This would be great if Mary has a taxable estate, but devastating if not – her family may lose hundreds of thousands of dollars of basis.

Widow and widowers might use this feature of BDOTs to swap/purchase/sell assets to their QTIP/BDOT to *cause* discounts (if they have a taxable estate) or *avoid* discounts (if they have a non-taxable estate). Such swaps, just like swaps with other IGTs prior to death, could save \$ millions of dollars of estate/income tax.

## ***u) Advantage – Tax-Free Transactions Between Beneficiaries and their BDOTs***

When a grantor or beneficiary is deemed to be the owner of the income under §671-679 for income tax purposes, there is no authority to treat a trust deeming the grantor as owner of all taxable income under §673-677 differently from a trust deeming the beneficiary as owner of all taxable income under §678. Indeed, regulations are clear that a §678 beneficiary shall be deemed the owner for income tax purposes: “Where a person other than the grantor of a trust has a power exercisable solely by himself to vest the corpus or the income [remember, “income” here means taxable income not accounting income] of any portion of a testamentary or inter vivos trust in himself, he is treated under section 678(a) as the owner of that portion.”<sup>167</sup>

Many readers are undoubtedly wondering – since these techniques can create what is considered a grantor trust to the beneficiary as to ALL trust taxable income, what is to stop beneficiaries from engaging in installment sales, swaps or other transactions with their fully §678(a)(1) trusts under Rev. Rul. 85-13 and its progeny? Put another way, can a taxpayer engage in a transaction with a BDOT that would be respected for income tax purposes?

The issues are identical to an installment sale or swap with a IGT or a *BDIT* (which relies on *lapses of powers over the entire corpus* per §678(a)(2)). Unlike a *BDIT*, the trust could have an unlimited seed gift, rather than a mere \$5,000, and with less attendant substance over form risk accordingly.<sup>168</sup>

Outside of the 2<sup>nd</sup> Circuit, there is no authority to take the position that one can recognize a sale between a trust over which the beneficiary is deemed the owner of all taxable income and the beneficiary themselves (or other disregarded entity). In *Rothstein*, the Second Circuit concluded that a taxpayer could enter into a sales transaction recognized for income tax purposes with a grantor trust because the trust was a separate taxpayer.<sup>169</sup> Frankly, there probably is an argument under the code that *Rothstein* is correct and that transactions between trusts and their deemed owners

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<sup>167</sup> Treas. Reg. §1.678-1(a).

<sup>168</sup> The IRS has placed *BDITs* on its “no ruling” list if the trust purchases property from the deemed owner with a note and the value of the assets with which the trust was funded by the grantor is nominal compared to the value of the property purchased. Rev. Proc. 2017-3, 2017-1 I.R.B. 130, §4.01(43). Despite the IRS doubt in this area, there is ample authority that minimal funding can still reasonably support a large sale with proper attention to guarantees. See *Jerry Hesch, Dick Oshins & Jim Magner: Note Sales, Economic Substance and “The 10% Myth”*, LISI Estate Planning Newsletter #2412 (May 9, 2016).

<sup>169</sup> *Rothstein v. United States*, 735 F.2d 704, 709 (2d Cir. 1984).

should not be ignored for income tax purposes. However, the IRS has specifically refused to follow *Rothstein*, no case since has followed it, and in the 35 years since that case the IRS has issued various memos, private letter rulings and even a series of Revenue Rulings that can be relied on for the proposition that one cannot recognize such transactions for income tax purposes:

**Rev. Rul. 85-13:** This is probably the most widely recognized (or should be) Revenue Ruling of all time by estate planning attorneys. The IRS refused to follow *Rothstein* and ruled that to the extent the grantor is treated as owner of trust, the trust will not be recognized as separate taxpayer capable of entering into a sales transaction with the grantor.<sup>170</sup> It stated that the owner of a grantor trust is not merely taxable on a trust's income, but is treated as the owner of the trust's assets for federal income tax purposes, citing *Ringwald v. United States*, 549 F.2d 89 (8th Cir. 1977), cert. denied, 432 U.S. 906 (1977); *Estate of O'Connor v. Commissioner*, 69 T.C. 165 (1977); Example 5, § 1.1001-2(c) of the regulations; Rev. Rul. 81-98, 1981-1 C.B. 40; Rev. Rul. 78-175, 1987-1 C.B. 144; Rev. Rul. 77-402, 1977-2 C.B. 222; Rev. Rul. 74-613, 1974-2 C.B. 153; Rev. Rul. 72-471, 1972-2 C.B. 201; Rev. Rul. 70-376, 1970-2 C.B. 164; and Rev. Rul. 66-159, 1966-1 C.B. 162; but cf. Rev. Rul. 74-243, 1974-1 C.B. 106.

***Madorin v. Comm.*:** "When a grantor or other person has certain powers in respect of trust property that are tantamount to dominion and control over such property, the Code "looks through" the trust form and deems such grantor **or other person to be the owner** of the trust property and attributes the trust income to such person. See secs. 671, et seq. By attributing such income directly to a grantor or other person, the Code, in effect, disregards the trust entity."<sup>171</sup>

**Rev. Rul. 88-103:** Purchase of replacement property by a grantor trust. If a taxpayer's grantor trust purchases replacement property for property of the taxpayer that has been involuntarily converted into money, the purchase can qualify the taxpayer's gain for nonrecognition under IRC §1033.<sup>172</sup>

**Rev. Rul. 92-84 (rendered obsolete in 1995 by S corp regulations):**<sup>173</sup> In a ruling later rendered obsolete, the Service ruled that gain or loss on sale of asset by Qualified Subchapter S Trust (QSST), which is treated for many purposes as a beneficiary deemed grantor trust as to its S corporation stock, is treated as gain or loss of the beneficiary deemed owner under the grantor trust rules and not of the trust, even

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<sup>170</sup> Rev. Rul. 85-13, 1985-1 C.B. 184.

<sup>171</sup> *Madorin v. Commissioner*, 84 T.C. 667, 675 (T.C. Apr. 11, 1985).

<sup>172</sup> Rev. Rul. 88-103 (I.R.S. July 1, 1988).

<sup>173</sup> Rev. Rul. 92-84, 1995-2 C.B. 135 (I.R.S. July 1, 1995).

if the gain or loss is allocable to trust corpus rather than to trust income. This did not make much sense economically, because while the QSST beneficiary is very similar to a §678(a) trust beneficiary for ongoing income, the QSST beneficiary does not necessarily receive the capital gains on the sale of a S corporation stock, as a §678(a) beneficiary deemed owner trust would.

Final regulations issued in 1995, however, overruled this this revenue ruling.<sup>174</sup> Now, it is clear the current income beneficiary of a QSST is NOT treated as the owner of the S corporation stock in determining and attributing the income tax consequences of a disposition of the stock by the QSST. Instead, any consideration received for such dispositions will be treated as received by the trust in its status as a separate taxpayer under IRC §641 and the non-grantor trust rules of Subchapter J, Parts A-D. As noted in the section on S corporations above, this is even true for asset sales and deemed asset sales of the company in a de facto sale.

While this ruling is now obsolete, the rationale is important, as well as understanding the difference between a QSST and a BDOT when any portion of the S corporation is sold or liquidated.

**IRS Notice 97-24:** Although this is merely an announcement regarding abusive trusts, it does contain some IRS language reinforcing these principals regarding grantor trusts: “2. Grantors may be treated as owners of trusts. The grantor trust rules provide that if the owner of property transferred to a trust retains an economic interest in, or control over, the trust, the owner is treated for income tax purposes as the owner of the trust property, and all transactions by the trust are treated as transactions of the owner.<sup>\*\*\*</sup> *This means that all expenses and income of the trust would belong to and must be reported by the owner, and tax deductions and losses arising from transactions between the owner and the trust would be ignored. Furthermore, there would be no taxable “exchange” of property with the trust, and the tax basis of property transferred to the trust would not be stepped-up for depreciation purposes. See Rev. Rul. 85–13, 1985–1 C.B. 184.*”<sup>175</sup>

**Rev. Rul. 2004-86:** In the context of Delaware statutory trusts, the IRS stated thus regarding the treatment of grantor trusts in its holding that the various trust beneficiaries were taxed on their share under grantor trust rules: “A person that is treated as the owner of an undivided fractional interest of a trust under subpart E of part I, subchapter J of the Code (§§ 671 and following), is considered to own the trust assets attributable to that undivided fractional interest of the trust for federal income tax

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<sup>174</sup> Treas. Reg. §1.1361-1(j)(8).

<sup>175</sup> IRS Notice 97-24 available at <https://www.irs.gov/pub/irs-irbs/irb97-16.pdf>.

purposes. See Rev. Rul. 88-103, 1988-2 C.B. 304; Rev. Rul. 85-45, 1985-1 C.B. 183; and Rev. Rul. 85-13, 1985-1 C.B. 184. See also § 1.1001-2(c), *Example 5*.<sup>176</sup>

**Rev. Rul. 2007-13:** Ruled that the sale of a life insurance policy from one “wholly-owned” grantor trust to another “wholly-owned” grantor trust is not a transfer at all for income tax purposes because the grantor is treated as the owner of the assets of both trusts.<sup>177</sup>

**TAM 2008-14026:** In a technical advice memorandum, the IRS stated that a promissory note issued by a grantor trust to its grantor is disregarded because the same taxpayer cannot be both debtor and creditor on a debt instrument: “Taxpayer was a grantor of Trust 1 and transactions between Taxpayer and Trust 1 are disregarded for tax purposes. Taxpayer is a grantor and owner with respect to Trust 1 and as a result, may not properly claim a bad debt deduction in connection with Trust 1’s redemption of the Notes from Taxpayer. A grantor that is treated as the owner of the entire trust is treated as the owner of the trust’s assets. Therefore, a promissory note of the trust that is held by the grantor is disregarded for federal income tax purposes because a taxpayer cannot be both the obligee and obligor on a debt instrument.”

**CCA 2009-23024:** An IRS Chief Counsel Advisory (“memorandum”) examined several non-grantor trusts which were converted to grantor trusts. This was deemed not to be a transfer for income tax purposes and subsequent annuity payments between the grantors and their respective grantor trusts should be ignored: “The Family Trusts became grantor trusts due to the replacement of the corporate trustee with a related party. Thus, as of Date 7, the Family directly held partnership interests in Partnership and reported no further annuity income, because, as owners of the trusts, they were both payors and payees on the annuities.” Note that in that particular memo the IRS found the proposition that transactions between trusts and their deemed owners should not be recognized to be well-settled law, even though there was some apparent abuse under the facts of the memo that might be scrutinized under other theories.

**CCA 2013-43021:** An IRS Chief Counsel Advisory (“memorandum”) examined the question of whether grantor trusts are disregarded entities for the purposes of IRC §267 and IRC §707(b)(1)(A). In short, the memo reiterated the conclusions of Rev. Rul. 85-13 and again concluded that grantor trusts are disregarded, and that the loss limitation would apply to transactions between related parties. “Rev. Rul. 85-13 reasons that it would be anomalous to suggest that Congress, in enacting the grantor trust provisions, intended that the existence of a trust would be ignored for purposes of attribution of income, deduction, and credit, and yet retain its vitality as a separate entity

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<sup>176</sup> Rev. Rul. 2004-86.

<sup>177</sup> Rev. Rul. 2007-13, 2007-1 C.B. 684.

capable of entering into a sales transaction with the grantor. The reason for the attributing items of income, deduction, and credit to the grantor under §671 is that, by exercising dominion and control over a trust, either by retaining a power over or an interest in the trust by dealing with the trust property for the grantor's benefit, the grantor has treated the trust property *as though it were the grantor's property. The Service position of treating the owner of an entire trust as the owner of the trust's assets is, therefore, consistent with and supported by the rationale for attributing items of income, deduction, and credit to the grantor.*"

While it is strange to consider, under the §1.671-3(a)(2) portion rules and the revenue rulings cited above, a partial beneficiary deemed grantor trust may have some transactions regarded and some transactions disregarded. For example, if a trust granted the right to a beneficiary to withdraw the taxable income from stock X, or stock X itself, yet not the right to withdraw stock Y or the taxable income attributable to stock Y, then if the beneficiary purchases stock X the sale must be disregarded (the beneficiary receiving carry over basis) and if the beneficiary purchases stock Y the trust's gain on the sale must be reported (the beneficiary receiving cost basis), because the trust is a separate taxpayer as to stock Y, even if the gain from the sale were part of distributable net income (DNI) and distributed to the beneficiary and reported on the beneficiary's K-1.

In our most likely proposed scenario, however, the beneficiary will be taxed on and be deemed the owner of 100% of taxable income (income attributable to both accounting income and principal), and therefore there is no basis to recognize the sale. It's no different from a settlor of an irrevocable grantor trust being deemed the owner. A beneficiary with a large capital loss cannot just sell their gain assets to their beneficiary deemed owner trust, recognize and net the gain/loss and claim the trust receives a new cost basis. While a sale (swap) may be permitted between a beneficiary and a beneficiary deemed owner trust under the trust instrument, it cannot be recognized for federal tax purposes.

Readers may be wondering, why have no articles or CLEs considered this? At least one highly esteemed author has considered the possibility of sales to beneficiary deemed owner trusts where there is no access to principal, albeit in the qualified subchapter S trust (QSST) context.<sup>178</sup> In his extensive 1278 pages of material on

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<sup>178</sup> See *Structuring Ownership of Privately-Owned Businesses: Tax and Estate Planning Implications*, by Steve Gorin, which is available by emailing the author at [sgorin@thompsoncoburn.com](mailto:sgorin@thompsoncoburn.com). I highly recommend doing so. It is more comprehensive and useful than many treatises in this area. Steve updates his outline quarterly and the quote below is from version printed 3/28/2017, section III.A.3.e.vi. "QSST as a Grantor Trust; Sales to QSSTs" pages 934-943 (citations omitted).

corporate and estate planning, attorney Steven Gorin notes various advantages of the de facto §678 grantor trust status of QSSTs and concludes they:

Allow the beneficiary to sell S corporation stock (and, indirectly, other assets) to the trust on what appears to be a tax-free basis.<sup>3791</sup> A sale to an irrevocable grantor trust is a powerful estate planning technique.<sup>3792</sup> Clients sometimes balk at selling assets to a trust where they are not beneficiaries, because they might need the assets for their living expenses. For a client who refuses to part with all of the enjoyment of sufficient assets, consider suggesting that he or she sell assets to a trust in which he or she is a beneficiary and is the deemed owner - a beneficiary grantor trust.<sup>3793</sup>

[note: Gorin is referring to a QSST above rather than a BDOT discussed in this article]

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QSSTs do not face the funding issues that apply to many other beneficiary grantor trusts. They can be funded very substantially and still be entitled to grantor trust treatment.

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If a QSST buys the beneficiary's stock from the beneficiary after making a QSST election for its then-existing S stock (issued by the same corporation), that would be a disregarded transaction for income tax purposes, following the general principle under Rev. Rul. 85-13 that a transaction between a trust and its deemed owner (for income tax purposes) is disregarded (for income tax purposes).<sup>3796</sup> The regulation that treats the beneficiary as the Code § 678(a) provides that the trust's selling or distributing the stock is attributable to the trust, not the beneficiary,<sup>3797</sup> but does not discuss the consequences of the trust buying S corporation stock.

Thus, Gorin concludes a QSST beneficiary can sell S corporation stock to a QSST without triggering income tax to the beneficiary, yet paradoxically the reverse is not necessarily true – the QSST trust cannot sell stock to the beneficiary, because a QSST is specifically considered a separate taxpayer as to its sales of underlying S Corporation stock.<sup>179</sup> While this may seem illogical, such asymmetry is altogether possible, as previously discussed in this article in the context of partially grantor, partially non-grantor trusts as to the sale of specific assets of a trust and the portion rules that mandate that income be deemed taxable to a beneficiary who can withdraw specific assets or the income therefrom.

In light of this incongruity, it should be even more likely that one should be able to sell assets without a taxable event to a BDOT that is not considered a separate

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<sup>179</sup> Treas. Reg. §1.1361-1(j)(8), PLR 1999-05011 (sale of assets and liquidation treated as income to *trust*, not QSST beneficiary), PLR 1999-20007 (stock deal treated as an asset deal pursuant to §338(h)(10) election treated as income to *trust*, not QSST beneficiary).

taxpayer as to *any* capital gains or other income attributable to principal, rather than be able to sell S Corp stock to a QSST, which is at a minimum considered a separate taxpayer when it sells S corporation stock. In the BDOT context, the income tax result should be exactly the same whether the BDOT is a buyer or a seller transacting with the beneficiary deemed owner (or other grantor trust as to the beneficiary) – either way there is no rationale to recognize the transaction as a taxable event because there is not a separate taxpayer.

At some point it would make sense for the IRS to revisit Rev. Rul. 85-13 and its progeny above, because for many purposes, it carries the grantor trust rules farther than what Congress may have originally intended (and, let's face it, there is nothing in the code that says grantor trusts are completely disregarded, the code and regulations just say to report the income, deductions, credits, gains/losses to the grantor or other deemed owner). It is theoretically possible within this structure to recognize income.<sup>180</sup> However, until the IRS rescinds or modifies its position, we have plenty of authority and precedent to rely on.

Is there any recent authority otherwise? Some may cite the grantor charitable lead trust rulings in which the payment of the required annuity/unitrust amount with appreciated property to the charity is a taxable event.<sup>181</sup> However, this can be differentiated from the above authority because the payments are going to fulfill an obligation to another taxpayer (charity) rather than a transaction between a trust and its deemed owner. These CLT rulings *could* apply, however, to a grantor trust (including a BDOT) that mandates a certain amount to be paid to a *third party*, if this mandated amount is thereafter satisfied with appreciated property. In other words, *Kenan gain and CLT payment-in-kind principles can apply to any grantor trust if funds are paid to a third party.*

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<sup>180</sup> E.g. if a deemed owner (either a grantor or deemed owner under IRC 678) sells \$500,000 of stock to a trust (or vice versa) with a basis of \$300,000, it is within the realm of reasonable interpretation to treat this as a \$200,000 gain recognition event (similar with any swaps or substitutions). Of course, this is contrary to the above Revenue Rulings (except as noted below in the CLT context).

<sup>181</sup> See, e.g. Rev. Rul. 83-75, Rev. Proc. 2007-45 §8.02(2) and PLR 2009-20031 – a grantor realizes gain on satisfaction of a CLT annuity payment with appreciated property in kind (contrary to satisfying a payment required to a grantor in a GRAT), adopting the *Kenan* gain analysis (discussed in this paper on pages 12, 53-55). This is (at least according to the IRS) true even though an individual satisfying their own charitable pledge with appreciated property in kind has been ruled to NOT trigger *Kenan* gain in Rev. Rul. 55-410. A grantor CLT could theoretically transact with a grantor “tax-free”, if it were not for prohibited transaction/self-dealing rules. One can view these rulings as ignoring the “disregarding” of grantor trusts under Rev. Rul. 85-13 and other rulings, or in my opinion, these are better viewed as a recognition that *Kenan* gain probably should be applied to binding pledges (i.e. that Rev. Rul. 55-410 is wrong), but that they’re going to let the 50+ year old ruling slide in the individual donation context only.

Example: Ginny Russ establishes an *intervivos* grantor trust that mandates that “all net income” (of course this could be equally true of a unitrust) be paid to her son, Jonny Trustfunder. If the net income is \$50,000, but the trustee pays this with \$40,000 of stock with basis of \$25,000, plus \$10,000 of cash, \$15,000 of capital gain is triggered *to Ginny*, and Jonny Trustfunder receives the stock with a FMV \$40,000 basis. Ditto if the trust says to pay half (\$500,000) at age 35, and the distribution is funded with \$250,000 basis, \$400,000 FMV stock. This is no different from a situation in which Ginny owes Jonny a \$50,000 or \$500,000 debt in our above examples. Most practitioners probably assume, erroneously, that distributions from grantor trusts are simply ignored for income tax purposes and that beneficiaries simply take a carryover basis – this is **not** always the case. Practitioners should be careful of using irrevocable grantor trust that mandate large pecuniary payouts at some point for this reason.

## **v) Advantage - Transactions between beneficiaries' spouses and fully §678(a) trusts as to beneficiaries**

As corollary to the above section, beneficiaries' spouses can generally transact with their spouse's beneficiary deemed owner trust, just as with other grantor trusts, without triggering income or gift tax as well.<sup>182</sup> However, interest income on intra-spousal (or intra-spousal grantor trusts) notes is *not* disregarded and there may not necessarily be a fully offsetting deduction for interest paid (or deemed paid through a BDOT) by the other spouse.<sup>183</sup> In the event of divorce, there is a gift tax provision that excludes transfers incident to divorce, but be careful to examine intervivos trusts for spouses after divorce, because the divorce may not necessarily be enough to turn off grantor trust status.<sup>184</sup>

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<sup>182</sup> IRC §1041 (disregarding sales between spouses for income tax purposes).

<sup>183</sup> *Gibbs v. Commissioner*, T.C. Memo 1997-196.

<sup>184</sup> IRC §2516 (transfers between spouses pursuant to divorce excluded from definition of gift). For some interesting planning ideas surrounding the use of intervivos trusts incident to divorce, see PLR 2017-07007 and short article *New PLR Highlights Creative Trust Divorce Settlement Solution for Closely Held Business Owners* at <https://www.linkedin.com/pulse/new-plr-highlights-creative-trust-divorce-settlement-solution-morrow>.

## w) Advantage – Ability to Easily Toggle Between Tax Systems

As discussed earlier in this article, a beneficiary's power to withdraw that is fettered or conditioned in some way is outside the ambit of §678, which requires a power "exercisable solely by himself".<sup>185</sup> For example, if the power may only be exercised with the consent of an adverse or non-adverse party, it cannot trigger IRC §678. However, if such a party then gives their consent in any given year, the condition would be removed and §678 would thereafter apply. Thus, one can effectively give the power to another party to toggle the income between the two tax systems.

Of course, such a power could also be given to a trust protector, but a simple consent is probably easiest. Such a power held by an adverse party (e.g. a remainder beneficiary) would even remove the power from being considered a general power of appointment for estate/gift tax purposes.<sup>186</sup> However, this may not necessarily make a difference for asset protection purposes. Whether your state considers a presently exercisable power to withdraw/appoint only with consent of *adverse* parties to be *general* for creditor protection or other purposes is dependent on whether it follows the 2nd or the 3d Restatement of Property.<sup>187</sup>

If an adverse party consents to the powerholder being granted a present withdrawal right, there is the possibility that a portion of any amount ultimately

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<sup>185</sup> IRC §678(a).

<sup>186</sup> IRC §2514/2041.

<sup>187</sup> Compare the two:

Restatement 2d Property: Donative Transfers, § 11.4 "a. *General power of appointment.* A general power of appointment gives the donee of the power the authority to confer on himself or herself the full benefit of the appointive assets to the exclusion of others. If this authority must be exercised jointly with another, *even though the joint donee may have an interest in the appointive assets adverse to the exercise of the power* in favor of the donee who can be benefited by the exercise of the power, ***that fact does not prevent the power from being a general one.***"

Restatement 3d Property: Wills and Other Donative Transfers, § 17.3 "e. *Joint power with nonadverse party or with adverse party.* If a power of appointment can be exercised in favor of the donee, the donee's estate, or the creditors of either, the power is a general power even if the donee can only exercise the power with the joinder of a nonadverse party. *If the power can only be exercised with the joinder of an adverse party, however, the power is not a general power.* An adverse party is a person who has a substantial beneficial interest in the trust or other property arrangement that would be adversely affected by the exercise or nonexercise of the power in favor of the donee, the donee's estate, or the creditors of either; a nonadverse party is a person who does not have such an interest."

In accord with the Third Restatement above is the Uniform Power of Appointment Act, §205(b) "If a powerholder may exercise a power of appointment only with the consent or joinder of an adverse party, the power is nongeneral". As of November 2018, the UPOAA has been passed in MT, NV, UT, CO, NM, MO, IL, VA, NC and is currently introduced in Kentucky.

withdrawn is a small taxable gift (if the power holder does in fact exercise the right beyond what he or she would have received otherwise), under the theory that the remainderman/consenting party is depleting his or her potential eventual wealth. This is similar to the argument that remaindermen agreeing to non-judicial settlement agreements or otherwise acquiescing to amendments that benefit the income beneficiary and deplete their interests are also making a gift, and is also similar to the argument that the exercise of a lifetime limited power of appointment by a beneficiary may also involve a taxable gift.<sup>188</sup> This is probably not a concern for many, because the value of any interest being given up would be low in the first place, 99.9% don't worry about gift tax and the annual exclusion would cover most situations anyway.

As mentioned elsewhere herein, a change between grantor and non-grantor trust tax status is usually a non-event tax-wise,<sup>189</sup> but the government has staked out one situation where taxation could be triggered: situations where partnerships with negative capital accounts (colloquially known as “negative basis”) or debt in excess of basis are involved.<sup>190</sup> Generally, whenever a donee assumes a debt as part of a gift, there is realized gain to the extent the debt exceeds the donor's basis.<sup>191</sup> If a trust is comprised of such assets, the parties should consider this issue and perhaps find ways around it before any decanting, non-judicial settlement or other toggling is done to change tax status. This might entail paying off some of the debt or making additional contributions to the partnership/LLC prior to the change, or simply siphoning off and bifurcating the trust assets and only changing status on the non-“negative basis” assets.

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<sup>188</sup> For a discussion of these issues with multiple case citations, see the white paper entitled, *The Optimal Basis Increase and Income Tax Efficiency Trust*, Part VII, originally published in 2013, available for download at [www.ssrn.com](http://www.ssrn.com).

<sup>189</sup> E.g. the seminal Rev. Rul. 85-13 which changed from non-grantor to grantor trust tax-free.

<sup>190</sup> Treas. Reg. §1.1001-2(c), Example (5); *Madorin v. Comm'r*, 84 T.C. 667 (1985); Rev. Rul. 77-402. For situations outside of “negative basis” scenarios, see the other citations noted in the prior sections of this paper, such as CCA 2009-23024.

<sup>191</sup> See, e.g., *Malone v. United States*, 326 F. Supp. 106 (D.C. Miss. 1971), aff'd, 455 F.2d 502 (5th Cir. 1972).

## x) Advantage – Better Step up in Basis for Marital Trusts and OBITs Upon Death of Primary Beneficiary?

Marital trusts generally receive a new basis at the surviving spouse's death.<sup>192</sup> Bypass trusts generally would not, unless the beneficiary decedent held a general power of appointment. With the advent of skyrocketing exclusion amounts and portability, attorneys have begun adding formula testamentary general powers of appointment to trusts to soak up the ability of otherwise unused applicable exclusion amount to increase basis for the remaindermen.<sup>193</sup> Other practitioners have transitioned to overusing QTIPs for step up (down), despite the many drawbacks to this design.

Here is an overlooked potential drawback of such trusts that could be quite significant.<sup>194</sup> IRC §1014(b)(9) and (b)(10), which grant the "step up" in basis to date of death values at the death of such beneficiaries, has an interesting claw back people usually ignore:

"if the property is acquired before the death of the decedent, the basis shall be the amount determined under subsection (a) reduced by the amount allowed to the taxpayer as deductions in computing taxable income under this subtitle or prior income tax laws for exhaustion, wear and tear, obsolescence, amortization, and depletion on such property before the death of the decedent."

The most common and easily understandable application of this code section is receiving a gift from a decedent that is brought back into the donor's estate under a string section such as IRC §2036: e.g. John gives Gary an apartment building with the

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<sup>192</sup> IRC §1014(b)(4) if a general power is exercised, or §1014(b)(9) if a general power is unexercised as regards to marital trusts under §2056(b)(5). See IRC §1014(b)(10) if a QTIP election under §2056(b)(7) were made causing inclusion under §2044. If the estate tax is repealed, the adjustment in basis at death for QTIPs may go with it, since §1014(b)(10) and (b)(9) require estate inclusion, but it may remain for exercised general powers which have no such requirement for estate inclusion in §1014(b)(4).

<sup>193</sup> See *Ed Morrow and the Optimal Basis Increase Trust (OBIT)*, LISI Estate Planning Newsletter #2080 (March 20, 2013), updated version at Morrow, Edwin P., *The Optimal Basis Increase and Income Tax Efficiency Trust: Exploiting Opportunities to Maximize Basis, Lessen Income Taxes and Improve Asset Protection for Married Couples after ATRA (Or: Why You'll Learn to Love the Delaware Tax Trap)*. Available at SSRN: <https://ssrn.com/abstract=2436964> or <http://dx.doi.org/10.2139/ssrn.2436964>.

<sup>194</sup> I did not consider this issue until reading it raised in *Structuring Ownership of Privately-Owned Businesses: Tax and Estate Planning Implications*, by Steven Gorin, which is available by emailing the author at [sgorin@thompsoncoburn.com](mailto:sgorin@thompsoncoburn.com) from version printed 3/28/2017, Section II.H.2.d. "Caution re: Depreciable Property Held in a Nongrantor Trust That Is Included in the Grantor's, Surviving Spouse's, or Other Beneficiary's Estate" pages 240-241.

understanding that John can continue living there until his death. Gary depreciates the property for three years and then John dies, with the property brought back into his estate under §2036. To paraphrase §1014(b)(9), Gary will have acquired the property from the decedent before the death of the decedent and accordingly the basis is the date of death basis as we would expect under §1014, but reduced by the depreciation that Gary had taken in the three years between the time of the gift and the date of death.

Let's extrapolate this to a more common situation and potentially nefarious application:

Example: John Doe leaves his business and real estate portfolio of \$40 million to his wife Jane in the John Doe Trust, for which a QTIP election is made. The John Doe Trust takes \$15 million of depreciation after John's death and before Jane's death, at which point the business and real estate portfolio is now worth \$50 million and continues in trust for John and Jane's children. Applying §1014(b)(9) and (10) to this situation leads us to conclude the John Doe Trust arguably acquired property "before the death of the decedent" (here, Jane) and will receive a new date of death basis, but, because the John Doe Trust was allowed to take depreciation deductions of \$15 million, the basis is arguably reduced from \$50 million to only \$35 million.<sup>195</sup> This could be a *substantial* loss to the trust beneficiaries – not only for the additional income caused over the depreciable or amortizable life of the property, but the additional long term capital gains tax when sold – at 33% combined federal and state - \$5 million of tax.

By contrast, if the QTIP were a BDOT as to spouse, the John Doe Trust would not have acquired the property before the death of the decedent. For income tax purposes, Jane would have acquired the property before her death and been deemed the owner of 100% for income tax purposes, not a prorated amount, as a BDOT would be disregarded for income tax purposes. Additionally, if the John Doe Trust, regardless of tax status, were to pass to different taxpayers other than the John Doe Trust, for example, BDOT trust(s) for children, the property would not have been acquired by them before the death of the decedent. It is only where the taxpayer does not change

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<sup>195</sup> The benefit of the depreciation deduction is split between the trust and the beneficiary under IRC §642(e) and §167(d) per the trust instrument or if no specific provisions, apportioned on the basis of trust income allocable between the beneficiary and trust. Thus, if the clawback applied, it would only apply to a portion of depreciation that could vary every year, depending on the trust income and distributions. So if \$8 million depreciation were taken by the spouse and \$7 million by the trust, the clawback would presumably apply, if at all, to the \$7 million allowed to the trust as the taxpayer that received the property before the death of the decedent.

at death that this is potentially an issue.<sup>196</sup> The examples in the regulation do not address such a scenario.<sup>197</sup>

While the plain language of the statute indicates this result because it does not require that property be acquired “from the decedent”, the regulations *do* seem to provide this additional requirement: “The basis of property described in section 1014(b)(9) which is acquired **from a decedent** prior to his death shall be adjusted for depreciation, obsolescence, amortization, and depletion allowed the taxpayer on such property for the period prior to the decedent's death.”<sup>198</sup> Applying the additional language of the regulation that was not supplied by the statute, our typical QTIP trust scenario does not seem as dangerous, since the property in the John Doe Trust was not acquired from a decedent (Jane) prior to her death (it was acquired by the trust). In other words, for the depreciation claw back language to apply there must have been a transfer of the property (complete or incomplete gift) during life from the decedent. A surviving spouse triggering §2519 might do that, but this is relatively rare.<sup>199</sup>

Still, some may disagree with my optimistic analysis of the regulation above, in which case the above BDOT solutions would be a significant additional reason to prefer a BDOT design where depreciable property would be a significant part of the trust estate.

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<sup>196</sup> Similar to this is an upstream optimal basis increase trust, which is an irrevocable grantor trust in which an older generation beneficiary is granted a testamentary formula general power of appointment and the grantor might remain the deemed taxpayer after death despite estate inclusion and a new basis. See discussion in Part V of the Optimal Basis Increase Trust cited above at [www.ssrn.com](http://www.ssrn.com). Whether trusts are new taxpayers based on a change in beneficiaries or terms is an interesting question, and has been debated in recent years in the IRS's request for and ACTEC/AICPA's and other group's responses to questions about the tax effects of decanting. The IRS does not encourage, nor do most practitioners apply for, a new EIN for an irrevocable trust just because a beneficiary dies. And even if a new EIN is obtained, this would not necessarily be evidence there is a new taxpayer. One can make an argument that, for example, the John Doe Trust fbo Jane is fundamentally a different taxpayer than the John Doe Trust fbo Child, since the fundamental relationship has changed, but I confess to no particular confidence as to the outcome on that issue.

<sup>197</sup> Treas. Reg. §1.1014-6(a)(3) examples 1 and 2, Treas. Reg. §1.1014-2(a)(4). Treas. Reg. §1.1014-2(b)(2): “\*\*\*Property acquired prior to the death of a decedent which is includible in the decedent's gross estate, such as property transferred by a decedent in contemplation of death, and property held by a taxpayer and the decedent as joint tenants or as tenants by the entireties is within the scope of this paragraph.”

<sup>198</sup> Treas. Reg. § 1.1014-6(a)(1).

<sup>199</sup> Some LISI articles discussing the intentional proactive use of §2519 to trigger a gift of a QTIP but allow the spouse to remain a beneficiary, but without discussion of the above issue: *David Lane: Using a QTIP Trust to Preserve the Large Equivalent Exemption If There Is No Clawback*, LISI Estate Planning Newsletter #2003 (Sept. 10, 2012), *Pennell: The Advantages of Year-End Gifting*, LISI Estate Planning Newsletter #1718 (Nov. 29, 2010).

## y) Understanding Partially Released (Lapsed?) or Modified Powers over Income Under §678(a)(1)(2) – Rights over Taxable Income

Another advantage to using a §678(a)(1) power over *taxable income* rather than *corpus* is that the entire debate of whether a lapse is a release and what is partial release simply becomes a moot question, unless for some reason the current withdraw power over income is later eliminated.<sup>200</sup> This is because the power over the taxable income renews every year unless a cessor clause applies.

Let's take our same hypothetical beneficiary, Kristin, who inherits \$2 million in trust. She only has the unfettered right to withdraw taxable income – initially, this is \$0. None of the trust is subject to creditors. If she is sued over the next year, the most that would be exposed, under an absolute worst case scenario, would be the taxable income rights accrued. As discussed above, this right could be drafted so as not to vest until the end of the year and could be subject to a cessor (forfeiture) clause to protect against creditors prospectively and in most states and situations protected under lapse rules, so

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<sup>200</sup> Recent PLRs 2000-22035, 2001-04005, 2001-47044, 2009-49012 and 2010-39010 involve 5/5 powers and rights to withdrawal that lapse (or partially lapse) with the IRS implying or specifically concluding that §678(a)(2) applies. For discussion, see *The Beneficiary Defective Inheritor's Trust ("BDIT"): Finessing the Pipe Dream*, Richard A. Oshins, CCH Practical Strategies, November 2008, makes a convincing argument that a lapse should be considered a release, as does J. Blattmachr, Mitchell Gans and Alvina Lo, *A Beneficiary as Trust Owner: Decoding Section 678*, 35 ACTEC Journal 106, at 114 (Fall 2009). Also, Howard Zaritsky cites even more PLRs that I have not confirmed for this proposition that a lapse is a release for §678 purposes in *The Year in Review: An Estate Planner's Perspective on Recent Tax Developments*, TM Estates, Gifts and Trusts Journal (BNA) (1/13/2011): PLRs 2010-39010; 2007-47002; 2001-47044; 2001-04005; 2000-22035; 2000-11058, 200011054–200011056; 199942037; 199935046–199935047; 9812006; 9810006–9810008; 9810004; 9809005–9809008; 9745010; 9739026; 9625031; 9535047; 9504024; 9450014; 9448018; 9320018; 9311021; 9226037; 9140047; 9034004; 9009010; 8936031; 8827023; 8805032; 8701007; 8613054; 8521060; 8342088.

So why doubt all the above highly distinguished authors and dozens of PLRs? Because both the statute, regulation (§1.678(a)-1) and the legislative history (S. REP. No. 83-1622, at 87 (1954)) imply an affirmative action is required on the part of the deemed owner and there is no mention of lapses. It's like saying a qualified disclaimer is a release (it's not) – sometimes different words have different meanings, and Congress clearly knew the difference between the words "lapse" and "release" in drafting IRC §2041 and §2514. Perhaps the IRS will someday get tired of issuing PLRs on this and simply issue a regulation or revenue ruling that can be relied on. Many excellent tax attorneys are more certain and comfortable than I that lapse=release (and further, that partial lapse=partial release), however, and BDITs have certainly passed through audit without ill effect, but I still consider a lapse being deemed the same as a release for Section 678 to be uncertain at best, despite the many PLRs (which can only be relied on by the taxpayer issued the ruling).

as a practical matter, provided these measures are added, the entire \$2 million plus any income is going to be protected.<sup>201</sup>

The vast majority of the time the trust will not have over 5% in taxable income in a given year, and unless high inflation returns, the trustee can easily keep the taxable income under 5% by simply not churning the account, investing in tax efficient funds, using buy-hold strategies, etc. If you ask any professional portfolio manager they will tell you that in today's investing environment there is a much greater challenge prudently investing to safely achieve 5% taxable income than there is avoiding it!

Additionally, the beneficiary will almost always want to withdraw at least some minimum amount from the trust. Even if someone took a vow of poverty, they'd probably want to at least withdraw some portion in order to pay income taxes and make charitable donations. In our example above, if the trust makes 6% taxable income, \$120,000, and Kristen does not need nor want any of the funds, but uses her power to send \$15,000 from the trust to the IRS and state to go towards taxes, and \$5,000 to her favorite charity or donor advised fund, the \$100,000 remaining that lapses is now within the "five and five" power/lapse protection. When a grantor trust makes a charitable deduction, the individual receives the deduction on Schedule A, subject to the same limitations as any other individual charitable deduction.

Worst case scenario in our above case, which is highly unlikely, if Kristin took not a dime, then \$20,000 would be considered to be a contribution to the trust for estate and gift tax purposes. Any gift would likely be incomplete due to retained powers, but even though this would cause estate inclusion of a portion, this would be less than 1% ( $20,000/2,120,000 = 0.94\%$ ), and the vast super-majority of the population does not have a taxable estate, especially after the recent tax reform.

Similarly, depending on the state, only this small amount would likely be subject to creditors in most states (in many states, all of it would be protected). This would still

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<sup>201</sup> There are always exceptions, even to irrevocable third party created spendthrift trusts. California, e.g., may allow courts to access up to 25% of anticipated trust distributions to a debtor, plus prior withheld distributions that should have been made. See article on recent California Supreme Court case here: <https://www.linkedin.com/pulse/california-supreme-court-weakens-protection-trusts-edwin-morrow>. Many states have spendthrift trust exceptions for alimony and child support. For a recent interpretation of Cal. Prob. Code 15305 and piercing a third party created spendthrift trust in California for a beneficiary's delinquent child support *in spite of a cessor clause*, see *Pratt v. Ferguson*, 3 Cal. App. 5th 102 (Cal. App. 4th Dist. Sept. 6, 2016) (though the cessor clause, called a "shutdown clause" by the court, was clearly deficiently drafted). Bankruptcy decisions in this area are often quite favorable and uphold the efficacy of such provisions, see, e.g., *Safanda v. Castellano*, 2015 U.S. Dist. LEXIS 54458 (N.D. Ill. Apr. 27, 2015), *Bank One Trust Co. v. United States*, 80 F.3d 173 (6th Cir. 1996). State and federal taxes and restitution orders that create liens have special rules, see footnote 158.

be a great asset protection result – much better than all net income trusts and trusts with ordinary five and five powers and light years ahead of outright bequests or trusts with general withdrawal/powers of appointment over the entire principal. But even this worst case could be ameliorated. To avoid a lapse and high income causing a slim but increasing portion of the trust to be self-settled, we could also borrow a concept from *Crummey* trusts commonly known as a hanging power.

In an ordinary *Crummey* trust with hanging powers, the hang often creates an asset protection Achilles' Heel, because in early years the "hang" is often increasing by \$23,000 or so a year as the trust is initially funded, causing more to be exposed to a young beneficiary's creditors every year until the corpus is sufficiently enlarged (e.g. \$28,000 is contributed, \$5,000 lapses, \$23,000 "hangs"). By contrast, this feature in our BDOT trust would be more of a beneficial safety valve – the mechanism is the same, but we're typically starting with an entire inheritance.

Let's go back to our example, but incorporate a hanging power into Kristin's trust such that her ability to withdraw \$20,000 does not lapse, and in year two, the trust makes only \$90,000 of taxable income ( $\$90,000/\$2,120,000 = \text{approx. } 4.25\%$ ). In year two, Kristin therefore has the power to withdraw the current year's taxable income of \$90,000 plus the \$20,000 hanging power from the prior year (\$110,000). This is within 5% of the new corpus value ( $\$2,210,000 \text{ times } 5\% = \$110,500$ ), so at the end of year two even if Kristin does not take a dime from the trust, the entire amount lapses within the five and five protection and no part of the trust would be deemed to be contributed by her for estate/gift tax purposes, and under most state laws, no part would be considered self-settled for creditor protection purposes.

## **z) Effect of a Cessor (Forfeiture) Clause on §678(a)(2) Taxation and S Corporation Status**

As mentioned above, with a §678(a)(1) withdrawal power over income, we don't need to worry about lapses, releases and the like – unless creditors appear on the horizon and the power is removed, in which case the conversion of the trust to a non-grantor trust is probably far down on the beneficiary's list of priorities! Let's go back to our example of Kristin above. Kristin co-signed on a loan for her brother's start up and real estate venture that failed, he filed bankruptcy and now the creditors are coming after her – and her trust. The trust can have either preconditions on the right coming into existence in the first place, automatic forfeitures based perhaps on involuntary assignment or bankruptcy, or the trust can have some kind of trust protector provision to enable removal.<sup>202</sup> Let's assume the former – Kristin's withdraw right is removed (or does not come into existence through precondition) and it becomes an ordinary third party discretionary spendthrift non-grantor trust, perhaps adding the ability for the trustee to also make payments to her children or any spouse as long as no separation or divorce is initiated. If she files bankruptcy, in most states the entire trust is protected and excluded.<sup>203</sup> If the judgment in question created a restitution order or tax lien, which as a general rule is a nastier situation for a debtor than an ordinary judgment, the lien would not attach if rights were removed or failed to come into existence prior to the lien attaching, but would attach even to a discretionary trust without withdrawal rights (even if the beneficiary disclaims).<sup>204</sup>

If the power is affirmatively removed by a third party, is the trust *still* a beneficiary-deemed owner trust per §678(a)(2) rather than §678(a)(1)? Probably not. IRC §678(a)(2) seems to require some action undertaken *by the beneficiary/power holder, not* by a trust protector, trustee or change pursuant to the terms of the trust, or at least *inaction* through a lapse.<sup>205</sup> A non-judicial settlement agreement might be such an

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<sup>202</sup> *Restat 3d of Trusts*, § 57 “Forfeiture for Voluntary or Involuntary Alienation”.

Except with respect to an interest retained by the settlor, the terms of a trust may validly provide that an interest shall terminate or become discretionary upon an attempt by the beneficiary to transfer it or by the beneficiary's creditors to reach it, or upon the bankruptcy of the beneficiary.”

<sup>203</sup> 11 U.S.C. §541(c)(2)

<sup>204</sup> See discussion of this and the recent case of *United States v. Harris*, 854 F.3d 1053 (9th Cir. Cal. Apr. 20, 2017) in short article at <https://www.linkedin.com/pulse/9th-circuit-attaches-third-party-discretionary-trust-lien-morrow>, and other CLE materials from author regarding clauses to avoid attachment of such liens.

<sup>205</sup> As mentioned prior, whether a lapse or partial lapse can trigger §678(a)(2) is debatable under the plain meaning of the statute, even with dozens of PLRs holding that a lapse is the same as a release, but many accomplished authors and commentators in this field are

action, since it would require some action by the beneficiary, but a trustee's decanting would not. Merely allowing her withdrawal power to lapse as to taxable income and/or 5% in prior years may not be enough to make her a grantor of lapsed portions for income tax/grantor trust purposes – for her to be deemed the owner requires that she have a current power, that she partially release or otherwise modify such a power pursuant to §678(a)(2) or that she exercise the power in favor of another trust with typical 671-677 retained interests.<sup>206</sup> However, there is a strong likelihood that a lapse is a “partial release” if other lesser withdrawal powers are retained (such as a lifetime limited power of appointment, power limited to ascertainable standard). At least according to several PLRs, if grantor trust powers are retained (e.g. lifetime limited power of appointment subject to HEMS), any lapses of income retained in the trust from prior years would make Kristin increasingly a partial beneficiary deemed owner under §678(a)(2) even if the current power is removed.<sup>207</sup>

However, if Kristin is able to dodge the bullet and protect her \$2 million trust due to a cessor clause, she should be quite happy that it converts to a fully or mostly non-grantor trust! Any cessor clause can have provisions under which the withdrawal power might later be added back into the trust, through a trust protector or otherwise.<sup>208</sup>

Remember that if the withdrawal power over all income is removed either through a cessor clause or by trust protector or otherwise, the trust would no longer qualify as an S corporation owner (unless an ESBT election had already been made as a backup),

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comfortable concluding that lapse=release for §678(a)(2) purposes. See the various articles cited in footnote 3.

<sup>206</sup> Treas. Reg. 1.671-2(e)(6), Example 9.

<sup>207</sup> PLR 9034004 described the calculation as follows: “During each succeeding year in which A fails to exercise her power, A will be treated as the owner of an increasing portion of corpus of T. For purposes of determining the increase in her deemed ownership her current withdrawal power for any particular year will cause an increase in the amount of corpus which she is treated as owning equal to the product of the amount which she could withdraw multiplied by a fraction the numerator of which is the portion of trust corpus which she is not already treated as owning and the denominator of which is the total of trust corpus from which the withdrawal could be made. Discretionary distributions made by the trustee from corpus will be treated as coming from both the portion of corpus which the beneficiary is treated as owning and from the portion which she is not treated as owning in the same ratio as the fraction mentioned above.” PLR 2000-22035 and PLR 2001-04005 followed this.

<sup>208</sup> *Restat 3d of Trusts*, § 57, comment d. “Solvency as a condition precedent. The terms of a trust can validly provide that a beneficiary who is not the settlor shall be entitled to the principal of the trust or other benefits only after the beneficiary becomes financially solvent or receives a discharge in bankruptcy.”

and in such event the trustee should timely file an electing small business trust (ESBT) election to enable the S corporation status to continue.<sup>209</sup>

Moreover, although conversions from grantor to non-grantor trust are not usually taxable events, care should be taken to clean up any installment sales or “negative basis” property that might trigger a taxable event prior to conversion to non-grantor trust status.<sup>210</sup>

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<sup>209</sup> See Treas. Reg. §1.1361-1(m)(2)(iii), referencing (j)(6)(iii)(C) - it must be filed within 2 months and 15 days after the trust ceases to be a grantor trust. IRC §1361(c)(2) provides an even longer period - two years - for a BDOT, provided the beneficiary is deemed owner of all the income, but that’s only if the beneficiary deemed owner dies.

<sup>210</sup> See Treas. Reg. §1.1001-2(c), Example 5.

## aa) Application of Designated Beneficiary Qualified Plan/IRA See Through Trust Rules to BDOTs

Much of middle class taxpayers' assets are tied up in a home and retirement plans. We've previously discussed the various advantages that BDOT status has for the §121 personal residence capital gains tax exclusion. What about qualified plans and IRAs and so called "see through trusts"? How would such clauses cohabitate with so called "conduit" and "accumulation" trusts?

Some practitioners argue that the best practice for large retirement plans is to simply have such assets pay outright or use a separate trust as a receptacle, to better assure "see through trust" status.<sup>211</sup>

How would a beneficiary withdrawal right affect qualification as a see through trust? Could it replace a typical distribution clause or must it be used in conjunction with other required distribution clauses?

To answer this, let's divide into the two "flavors" of compliance for such trusts, as indicated by the two examples noted in the Regulations, which are commonly referred to by practitioners as "accumulation trusts" and "conduit trusts".<sup>212</sup>

A withdrawal power over taxable income cannot replace a conduit clause in a trust, though it can certainly co-exist with one. First, Roth IRA distributions are usually not taxable. If a BDOT withdrawal power over taxable income were the only provision used, the beneficiary would not have to actually receive the entire Roth IRA distribution to the trust, therefore the trust would not qualify under the conduit trust safe harbor. Second, even for traditional retirement plan distributions, a withdrawal power permits the beneficiary to accumulate the income by refusing to withdraw the entire amount. Accumulations offend the conduit clause safe harbor. However, if a typical conduit clause were added that forced distributions from retirement plans paid to trusts to then be distributed to beneficiaries to the extent not withdrawn, any concurrent withdrawal power would not harm conduit trust status in any way.

There is an argument to be made that since a withdrawal power causes grantor status under §678 and Rev. Rul. 85-13 and its successor rulings ignore grantor trusts

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<sup>211</sup> See *Using Standalone or Separate Trusts Solely to Receive Retirement Benefits*, by Edwin Morrow, Nov/Dec 2007 Journal of Retirement Planning, at [http://ultimateestateplanner.com/wp-content/uploads/2014/07/UsingStandaloneTrusts\\_JORP\\_Nov2007.pdf](http://ultimateestateplanner.com/wp-content/uploads/2014/07/UsingStandaloneTrusts_JORP_Nov2007.pdf), and *Ensuring the Stretchout*, by Phil Kavesh and Ed Morrow, Journal of Retirement Planning, July/Aug 2007, at [http://ultimateestateplanner.com/wp-content/uploads/2014/07/EnsuringTheStretchout\\_JORP\\_July2007.pdf](http://ultimateestateplanner.com/wp-content/uploads/2014/07/EnsuringTheStretchout_JORP_July2007.pdf).

<sup>212</sup> Treas. Reg. §1.401(a)(9)-5, Q&A7(c)(3), Examples 1 and 2 respectively.

for income tax purposes, that the trust should be ignored for see through trust designated beneficiary rules as well and hence use the beneficiary power holder's life expectancy for the RMD payout calculations without regard to any of the uncertain and complicated see through trust regulations.<sup>213</sup> Indeed, some PLRs have permitted an inherited IRA to be transferred to a grantor trust.<sup>214</sup> However, despite the compelling argument that such a trust should still qualify as a designated beneficiary, with such a large amount at stake and little firm guidance, it's safest to simply keep your standard conduit or accumulation trust clauses in the trust to control retirement benefits.

Regarding accumulation trusts, the analysis is similar. Generally at some point to qualify under accumulation trust rules, the distributions and any accumulations in trust attributable to such distributions must at some point go outright to named living persons. A provision to permit withdrawal of the income as distributions are made is not exactly the same. Thus, while a beneficiary deemed owner withdrawal power over taxable income does not offend or interfere with accumulation trust provisions, it does not replace them. It is still wise to examine the trust and make sure any accumulations eventually go to an individual outright and that the trust otherwise qualifies under accumulation trust rules.

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<sup>213</sup> Rev. Rul. 85-13, 1985-1 C.B. 184, concludes that if a grantor is treated as the owner of a trust, the grantor is considered to be the owner of the trust assets for federal income tax purposes.

<sup>214</sup> In PLR 2011-16005, the IRS ruled that a proposed transfer of inherited IRAs to a special needs trust will not cause recognition of income in respect of a decedent (IRD) by the beneficiary, reasoning that, because the special needs trust was a grantor trust for income tax purposes, its assets are deemed to be owned by the beneficiary. See also PLR 2006-20025, PLR 2008-26008.

**bb) Adapting to Special Needs Trusts, Medicaid qualification**

A §678(a) power would *not* work in a special needs trust scenario – the income from the trust would be considered a countable resource to the beneficiary. Although in theory one could give such a §678(a) power to a sibling or someone other than the special needs beneficiary, this is probably contrary to the settlor’s intent, impairs protection for the special needs beneficiary, and may cause *higher* income taxation among the family unit – not only would a special needs beneficiary be in a lower bracket typically, but qualifying non-grantor trusts for special needs beneficiaries (a “qualified disability trust”) even receive an additional personal tax exemption.<sup>215</sup> If the original grantor is still living, traditional grantor trust status for these work well, but it’s probably best to stick to ordinary non-grantor status upon the death of the original grantor for such trusts.

Of course, as with any trust, a BDOT can simply convert to a non-grantor discretionary special needs trust with appropriate poison pills upon certain triggers (and/or with preconditions at inception), causing the trust to be excluded as a countable resource.

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<sup>215</sup> IRC §642(b)(2)(C), tied to the personal exemption under IRC §151, which adjusts annually for inflation and is \$4,050 in 2017, much higher than the \$100 exemption for typical complex trusts. Despite eliminating most personal exemptions for years 2018-2025, tax reform retained this benefit and the exemption will be \$4,150 in 2018 for qualifying trusts, see §11041(b) of the Tax Cuts and Jobs Act.

### **cc) Advantage - BDOTs Cascading Into Increasing BDITs Funded with Far More than \$5,000**

This article has only touched on the more well-known cousin to the BDOT, the BDIT, but despite its limitations (principally, funding with only \$5,000), it has a few advantages over the BDOT, principally that it *probably* remains a grantor trust post-lapse without any need for a current withdrawal right.

However, should the circumstances merit the additional complexity, the BDOT (or any trust with a 5/5 power) could use any lapsed amounts to create an increasingly large BDIT. The BDOT can provide that to the extent any taxable income is not withdrawn and lapses, that amount upon lapse shall go into a separately accounted for trust. This trust would grant a subset of the prior withdrawal power to enable the lapse to be “partial” for §678(a)(2) purposes rather than full, such as a lifetime power to withdraw limited to health, education and support, coupled with one or more §672-§677 powers, such as the power of the trustee to distribute income to the beneficiary and/or spouse and for the beneficiary to swap assets, similar to a BDIT.

The beauty of this would be that the amounts in the newly created subtrust would probably be funded with *much* more than \$5,000, yet the trust would retain all the advantages of the BDIT (beneficiary deemed owner status, and the new subtrust need not contain a withdrawal power over income because of §678(a)(2)). This assumes, of course, as discussed previously, that the IRS continues to regard a lapse as a “partial release” under §678(a)(2). While this conclusion is not 100% certain, it cannot hurt to build in this option.

## dd) Advantage – Intervivos BDOTs as Alternative to Installment Sales to BDITs and IGTs and/or Super Charged Credit Shelter

Most of this article has concentrated on trust designs *after* the settlor's death, but of course settlors can draft and fund a BDOT during lifetime, just as they would a BDIT. It may be useful for tax shifting (e.g. see above section on §199A). With either a BDIT or BDOT, a settlor must avoid all of the various rights and powers that cause grantor trust status to a settlor under §671-677, which would trump §678(a).<sup>216</sup> What differentiates a BDIT and BDOT is that if the settlor only grants a power over only the income later to accrue, there would be no qualification for the gift tax annual exclusion, as there would be no present interest. By contrast, BDITs usually grant an immediate power over the entire \$5,000 corpus which would qualify for the annual exclusion.

For example, if a settlor gifted \$1,000,000 into an irrevocable trust, avoiding §671-677 grantor powers, but granted a beneficiary a power over taxable income only, not the entire corpus, and the trust made \$40,000 of taxable income during the remainder of the year, the gift would probably not qualify for the annual exclusion.<sup>217</sup> However, all of the taxable income would be taxable to the beneficiary power holder under §678(a)(1).

Similarly, if a settlor transferred \$1,000,000 into an irrevocable trust that was otherwise an *incomplete gift*, non-grantor trust (a.k.a. ING), but then the trust distribution committee granted a beneficiary or beneficiaries a withdrawal right over income, it might similarly shift the income taxation. Granting the unfettered withdrawal right would

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<sup>216</sup> IRC §678(b), Treas. Reg. §1.678(b)-1.

<sup>217</sup> Actually, any interest wherein the beneficiary has the right to all taxable income **would** qualify for the annual exclusion, but based on the actuarial value of the life interest rather than the entire amount. Treas. Reg. §25.2503-3:

“(b) An unrestricted right to the immediate use, possession, or enjoyment of property or the income from property (such as a life estate or term certain) is a present interest in property. An exclusion is allowable with respect to a gift of such an interest (but not in excess of the value of the interest). If a donee has received a present interest in property, the possibility that such interest may be diminished by the transfer of a greater interest in the same property to the donee through the exercise of a power is disregarded in computing the value of the present interest, to the extent that no part of such interest will at any time pass to any other person (see example (4) of paragraph (c) of this section).”

However, if we have a forfeiture clause or trust protector clause that could theoretically later terminate that interest, it may not qualify under this section, so don't count on it. If someone wanted to still receive the annual exclusion for the gift, one could back out what amount of corpus would be necessary to create a fair market value of the income interest of only \$15,000 (or \$30,000 married with gift splitting) and negate the forfeiture clause as to that amount, or simply the entire amount in the first year, but I doubt that complexity would ever be worth it.

complete the gift over the amount of income withdrawable, just as a distribution to any party other than the settlor would.

This permits much greater “seed gift” than a BDIT, making it much more viable for the beneficiary to sell higher value assets to the trust, without the need for complicated guarantees whenever there is scant collateral or seed capital to justify a loan. If we use a 9:1 ratio as reasonable, this would mean the beneficiary could sell \$9 million of assets to the trust. From the beneficiary’s standpoint, provided they have a relative that might gift or leave them assets in trust, this is far superior to a sale to a typical IGT, because the beneficiary deemed owner retains access to the income from the funds (unless and until a cessor clause is activated), while still retaining the estate/gift and asset protection benefits of an IGT.

Some argue that a settlor may be able to establish a domestic asset protection trust (DAPT) using a law such as the Ohio Legacy Trust Act and remain a beneficiary without IRC §§ 2036 or 2038 applying, but the IRS has refused to rule on this issue when asked to in private letter rulings.<sup>218</sup> Moreover, there may still be cross-state conflict of laws questions regarding DAPTs if the settlor resides in a different state.

A BDOT might also be compared with “super-charged credit shelter trusts”, which are simply intervivos QTIP trusts. Those must be rigidly drafted to qualify for QTIP, are leaky from an estate and GST standpoint due to the required payment of income, and no cessor or floating spouse clause can apply to them during the spouse’s lifetime, making them more susceptible to creditors. Decanting and ability to amend must be very limited. There is an opportunity cost in using them because they are not outside of either spouse’s estate until after the first death, whereas other trusts can leverage the gift tax exclusion or save state income/estate tax or provide better asset protection.

The one caveat with any intervivos BDOT (or BDIT or ING for that matter) that would not apply to an IGT, is that even with a perfectly drafted trust, it is still possible through transactions with the settlor or settlor’s spouse or through misadministration of the trust to trigger grantor trust rules under §671-677, which would then override §678.<sup>219</sup> This could also be an advantage, as loans to a settlor or settlor’s spouse (and cancellation) could switch taxation from the beneficiary to the settlor and back.

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<sup>218</sup> The IRS has acknowledged that such a transfer is a completed gift, Rev. Rul. 77-378, and admits that the mere power to reimburse a settlor for taxes does not by itself result in estate inclusion in Rev. Rul. 2004-64, but has refused to rule on the issue of eventual inclusion in the settlor’s estate, see PLR 9837007 and PLR 2009-44002.

<sup>219</sup> E.g., *SEC v. Wyly*, 56 F. Supp. 3d 394 (S.D.N.Y. Sept. 24, 2014), holding that fast and loose administration at behest of and for the benefit of settlors caused grantor trust status under §674(a).

## ee) **Advantage - Beneficiary Deemed Owner Trust Reporting**

Grantor trusts can often get by with using the deemed owner's social security number without having to obtain a separate EIN.<sup>220</sup> While this is typical for a revocable living trust, and certainly an option for irrevocable grantor trusts, including BDOTs, there may be reasons to use a separate EIN, even if the deemed owner is the sole trustee.

Primarily, a deemed owner for income tax purposes should still want a separate EIN for asset protection purposes. While an irrevocable trust should certainly be considered a different entity for creditor protection *regardless* of its taxpayer ID number, it would not be unheard of for a writ of garnishment served on a financial institution against a deemed owner to inadvertently freeze any accounts using the owner's social security number. While the difference in ownership for state debtor/creditor law might be sorted out in a hearing, why tempt the potential issue, hassle and expense? Would you trust a local judge used to hearing garden variety debtor-creditor cases to understand grantor trust taxation?

Secondarily, even filing a mostly blank Form 1041 with the box appropriately checked for "grantor trust" and information attached would have a beneficial effect of starting the statute of limitations, if for any reason the IRS were to someday question the reporting status of the trust.<sup>221</sup>

Lastly, corporate trust departments, whether acting as trustee, co-trustee or even merely as agent for trustee managing some investments, and financial institutions seem to prefer or sometimes even require a different EIN (even when in most cases there is an option to report income under a social security #).

That said, many value the simplicity of avoiding a tax filing. If a grantor trust such as a BDOT changes status to a non-grantor trust, it should obtain a new EIN even if it already has one.<sup>222</sup>

### **State Income Tax Differences**

There may be state income tax nuances that favor one method or the other. For example, apparently in Tennessee there are additional reasons to favor a grantor trust (or BDOT) using the beneficiary deemed owner's social security number.<sup>223</sup>

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<sup>220</sup> Treas. Reg. §1.671-4(b). See also Treas. Reg. §301.6109-1 regarding EINs for trusts.

<sup>221</sup> IRC §6501(a), (c)(3), *Paschall v. Comm'r*, 137 T.C. 8 (T.C. 2011).

<sup>222</sup> See Treas. Reg. §301.6109-1(a)(3).

<sup>223</sup> See blog article *Tennessee Now Recognizes Grantor Trusts*, by attorney Brian Howard dated August 19, 2013 at

Many states do not want a state Form 1041 equivalent filed for a grantor trust.<sup>224</sup> Some do.<sup>225</sup> Others are fine with attaching a copy of the federal 1041 information.<sup>226</sup> Others have some kind of hybrid in between, such as only being required to file if a portion is non-grantor or if there are non-resident beneficiaries.<sup>227</sup>

Many practitioners would be surprised at their state's treatment of when grantor trusts must file an informational return – very few simply follow the federal rules on reporting.<sup>228</sup> It is not guaranteed that just because a federal Form 1041 is not required for a grantor (or beneficiary deemed owner) trust that the state will not require one. Although the practical effect may be muted if the beneficiary deemed owner declares the income on their state return, it would still be prudent to research state law for grantor trust filing requirements.

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<https://www.tennesseeestateplanninglaw.com/2013/08/articles/irrevocable-trusts/tennessee-now-recognizes-grantor-trusts>

<sup>224</sup> E.g., see North Carolina Department of Revenue's announcement that "Grantor Trust Returns No Longer Required" at <https://www.ncdor.gov/taxes/estate-trusts/grantor-trust-returns-no-longer-required>.

<sup>225</sup> E.g., see Minnesota's directions here: [http://www.revenue.state.mn.us/businesses/fiduciary/Pages/I\\_need\\_more\\_information\\_about\\_grantor\\_trusts.aspx](http://www.revenue.state.mn.us/businesses/fiduciary/Pages/I_need_more_information_about_grantor_trusts.aspx).

<sup>226</sup> E.g., see Indiana's FAQs re grantor trusts at <https://www.in.gov/dor/files/fiduciary-faq.pdf>.

<sup>227</sup> E.g. see Louisiana Department of Revenue's guidance for filing fiduciary income tax returns for grantor trusts at <https://revenue.louisiana.gov/FiduciaryIncomeTax>: "Grantor trusts as defined in R.S. 47:187 will be required to file only if part of the income is taxable to the trust or if there are nonresident beneficiaries." Of course, grantor trusts as defined in that statute only speak to income being distributable to the grantor, there is no discussion of trusts that are deemed taxable to grantors or beneficiaries through Section 678 withdrawal rights or other powers or rights held by the grantor or spouse.

<sup>228</sup> Pennsylvania is the most extreme state in its divergence. Unless the trust is revocable, grantor trusts are treated as completely separate taxpayers regardless of federal filing status. See the *Pennsylvania Department of Revenue Income Tax Guide, Chapter 14 on Estates, Trusts and Decedents*: [https://www.revenue.pa.gov/FormsandPublications/PAPersonalIncomeTaxGuide/Documents/pit\\_guide\\_chapter\\_14.pdf](https://www.revenue.pa.gov/FormsandPublications/PAPersonalIncomeTaxGuide/Documents/pit_guide_chapter_14.pdf). While this status seems disadvantageous at first, it will ultimately land a BDOT beneficiary in the same place as if it were taxed directly, since the trust would credit and/or pay the income to the beneficiary and thus the trust would have no separate income and the beneficiary would pay PA tax on it (if a PA resident), or only the source income (if a non-resident). See guide linked to above.

## ff) Decanting/Appointing to a BDOT (v. a BDIT)

Many taxpayers are beneficiaries of trusts in which they have a lifetime or testamentary limited power of appointment. Be aware that if a power holder appoints to a trust that grants a beneficiary a presently exercisable general power of appointment (a.k.a. PEG power), this will trigger the Delaware tax trap (IRC §2041(a)(3) if testamentary, IRC §2514(e) if lifetime) under most state laws. The Delaware tax trap causes a taxable gift (if lifetime) or estate inclusion (if testamentary), similar to a general power of appointment.

A BDIT, which grants a presently exercisable power of withdrawal over corpus, would fall into this category. Appointing to someone's revocable living trust would likely fall into this category. A BDOT that only granted a power over future income would not.

However, as discussed earlier in this white paper, there may be advantages to fashioning a BDOT power to be over the greater of taxable income or 5% of the corpus. Appointing to a trust with a "five and five" power will likely trigger the Delaware tax trap over 5% of the amount appointed. It may depend on exactly how the power is drafted. Does the beneficiary have the immediate, presently exercisable power to withdraw 5%? Or does the beneficiary only have the right to withdraw 5% at the end of the first taxable year of the trust? Parsing through the Delaware tax trap can be complicated. There are still aspects that are unclear, and there is only one reported case on the issue.<sup>229</sup>

Triggering estate inclusion is optimal in many cases where a decedent has ample applicable exclusion amount and a step up in basis is desired. If that is not the case, however, one should take care to avoid appointing to any trust (e.g. BDOT) that grants a power of withdrawal, and the beneficiary's withdrawal right should be pared back accordingly to curb any that are considered presently exercisable.

Some have raised the spectre of a trustee's exercise of a *fiduciary* limited power of appointment as potentially triggering the Delaware tax trap. Decanting would be such an exercise. However, it is highly unlikely that these two tax code sections could be stretched so as to cause a trustee's exercise of its fiduciary power to be subject to gift/estate tax.

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<sup>229</sup> See discussion in the white paper "Optimal Basis Increase and Income Tax Efficiency Trust", Part III.i-Part III.o.

## gg) Easier Tax Elections for BDOT Property/Transactions

Generally, the deemed owner makes the various tax elections regarding trust income, which may be administratively advantageous since the beneficiary need not bother the trustee with such issues (and, which a trustee might otherwise charge extra for analyzing). This makes it easier for beneficiaries to deal with tax-free exchanges (including condemnations), electing S corporation status, opting out of installment sale treatment, Section 179 expensing (which is verboten to non-grantor trusts/estates as discussed elsewhere herein)<sup>230</sup> and other elections.<sup>231</sup>

In one relatively recent Revenue Ruling, the deemed owner sold a property and the irrevocable trust purchased the replacement property within the prescribed time, and the IRS ruled that: "Whether replacement property is purchased by the grantor or by the grantor's trust is of no consequence for purposes of section 1033, therefore, since the grantor is treated as the owner of the property."<sup>232</sup>

In another ruling discussing tax-free exchanges under IRC §1031, the IRS ruled that "(2) A taxpayer may exchange real property for an interest in the Delaware statutory trust described above [deemed to be a grantor trust] without recognition of gain or loss under § 1031, if the other requirements of § 1031 are satisfied."<sup>233</sup>

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<sup>230</sup> See IRS Form 4562 for the Section 179 election.

<sup>231</sup> For example, Rev. Rul. 70-376 held that the deemed owner must make the election for tax-free exchange of an involuntary conversion/condemnation under IRC §1033: "Under section 671 and section 677(a) of the Code, in the instant case, the grantor, not the trust, is the "taxpayer" with respect to the gains realized on the sale of the real estate in question, since it is he that is required to include the gain in income and pay any tax that may be due thereon.

Accordingly, under the facts in the instant case, it is held that the grantor is the taxpayer who may make the election in accordance with the provisions of section 1033 of the Code with respect to the gain realized on the sale of the real estate."

<sup>232</sup> Rev. Rul. 88-103, which supplemented and amplified Rev. Rul. 70-376 above.

<sup>233</sup> Rev. Rul. 2004-86.

## Frequently Asked Questions from Seminars, Emails

1. Which elements of the various applications of BDOTs are less certain/have the greatest risk of adverse tax rulings?
2. Which elements of BDOTs have the greatest risk from an asset protection standpoint?
3. What if we grant the beneficiary the right to withdraw “income”, but then grant the trustee the discretion to allocate between income and principal pursuant to state Uniform Principal and Income Act (new version Uniform Fiduciary Income and Principal Act)?
4. Is there a difference between granting an independent trustee or trust protector to remove the withdrawal right? What if the beneficiary or an adverse party has that right?
5. Is there any issue with granting the beneficiary a limited lifetime or testamentary power of appointment? How would this be treated?
6. Can or should the trustee have parallel powers concurrent to the withdrawal right to distribute income and/or principal?
7. Are there any additional concerns from an investment management perspective?
8. Should we get an EIN or use the BDOT beneficiary’s social security number?

## Comparison of Various Basic Trust Design Options for Married Couples

[Companion chart to "The Optimal Basis Increase and Income Tax Efficiency Trust" \(https://ssrn.com/abstract=2436964\).](https://ssrn.com/abstract=2436964)

(For simplicity, this chart does not compare inter vivos SLATs, QTIPs, or other lifetime gifting options, though SLATs may also be adapted)

(Some "traditional" bypass or marital trusts may have more features than indicated, this chart compares the "ordinary" common trust for spouse)

(Some benefits may be limited/constrained by available applicable exclusion amounts. Assumes that "OBIT" or "Bypass" are only funded to AEA)

"AEA"=available applicable exclusion amount, \$5.45 million in 2016, \$5.49 million in 2017, \$11.18 million in 2018, minus prior taxable gifts

Key Features	Outright Will /Trust (w/port.)	Traditional Bypass	Traditional QTIP	Traditional GPOA marital	Optimal Basis and Income Tax Efficiency Trust ("OBIT")	OBIT w/ BDOT Clause
<b>Basis Treatment at Death of Surviving Spouse</b>						
1 <b>"Step up" in basis at 2nd death</b> (Rev. Proc. 2016-49 clarifies re QTIP)	yes	no	yes	yes	yes* (up to AEA)	yes
2 <b>Avoids "Step down" in basis on 2nd death</b>	no	yes	no	no	yes	yes* (ex. lapse> 5%)
3 <b>Avoid potential lesser basis step up when fractional interests (LLC, TIC, etc) in trust &amp; outright, at 2nd death</b>	n/a	no	no	yes	yes* (up to AEA)	yes* up to AEA
<b>Basis Treatment at Death of Beneficiary (Child)</b>						
4 <b>"Step up" in basis on child's death</b> (if dynastic style, protective trust, to extent still GST exempt)	yes	no	no	no	yes (up to <i>child's</i> AEA)	yes
5 <b>Typically avoids "step down" in basis on child's death</b> (if dynastic style, protective trust, to extent GST exempt)	no	yes	yes	yes	yes	yes* (except as to current power/>5%)
<b>Ongoing Income Tax Treatment and Flexibility</b>						
6 <b>Capital Gains Able to Escape Income Tax Rate Trap of 43.4%/40.8% 2017/2018 (ST) or 23.8% (LT) &gt; \$12,500</b>	n/a	no	no	no	yes	yes
7 <b>Ability to spray income to lower tax bracket beneficiaries or possibly even charity</b>	no	no	no	no	yes	no
8 <b>Ability to spray capital gains as well per §1.643(a)-3</b>	no	no	no	no	yes	no
9 <b>Ability for "above the line" charitable deduction</b> (must be from gross income, not UBTI, per § 642c, §681)	no	no	no	no	yes	yes* (if partial)
10 <b>Ability for spouse to "gift" tax free w/ lifetime LPOA</b> (*it would be nominal gift unless collateral power)	no	no	no	no	yes*	yes*
11 <b>Ability for better tax treatment for special assets</b> (personal residence, small business stock, §179 etc.)	yes	no	no	no	no	yes

	Outright	Bypass	QTIP	GPA Marital	OBIT	OBIT/BDOT
<b>Asset Protection Considerations</b>						
12 <b>Inherited Principal protected from creditors</b> (*assumes not protected category 401(k), IRA, homestead..)	<b>no*</b>	yes	yes	yes	<b>yes</b>	yes*, exc. >5% lapse
13 <b>Income from inherited assets protected from creditors</b>	<b>no</b>	yes* if discretionary	<b>no</b> (require net income be paid)	<b>no</b>	<b>yes</b>	no*, but can cut off
14 <b>Protection from divorce, remarriage, squandering, spousal elective share, ERISA/REA, dower, etc.</b>	<b>no</b>	yes	yes	yes	<b>yes</b>	yes
15 <b>Better incapacity/management capability</b>	<b>no</b>	yes	yes	yes	<b>yes</b>	yes
16 <b>Potential Medicaid/govt benefits advantage</b>	<b>no</b>	yes	some	<b>no*</b> (estate recovery)	<b>yes</b>	no* (but could shift)
<b>Federal Estate/Gift/GST Tax Features</b>						
17 <b>Inherited assets escape estate tax at 2nd death</b>	<b>no</b>	yes	<b>no</b>	<b>no</b>	<b>yes</b>	yes* (ex.current)
18 <b>May increase surv. spouse's estate over AEA, causing a required Form 706 and Forms 8971 w/ \$0 basis issues</b>	<b>yes</b>	no	<b>yes</b>	<b>yes</b>	<b>unlikely</b> (depends on cap)	unlikely
19 <b>Allows dynastic GST use at first death (reverse QTIP)</b>	<b>no</b>	yes	yes	<b>no</b>	<b>yes</b>	no
20 <b>Avoids need for timely filed 706/portability to exploit 1st decedent spouse's \$5.49/\$11.18 estate/GST exclusion</b>	<b>no</b>	yes	<b>no</b>	<b>no</b>	<b>yes</b>	yes
21 <b>Can save millions in add'l estate tax in event of simultaneous death if one spouse's estate &gt; \$5.49/\$11.18m</b>	<b>no</b>	yes	yes	yes	<b>yes</b>	yes
22 <b>Surviving spouse can remarry w/o jeopardizing first spouse's use of exclusion (losing DSUE)</b>	<b>no</b>	yes	<b>no</b>	<b>no</b>	<b>yes</b>	yes* (exc. Current)
23 <b>Enables disclaimer funding while keeping narrow POA</b>	n/a	<b>no</b>	yes (see <i>Lassiter</i> case)	yes	<b>yes</b>	yes
24 <b>Enables disclaimer within 9 months of 2nd Death</b>	yes	<b>no</b>	<b>no</b>	yes	yes* but only to extent of	yes* GPOA
<b>State Estate &amp; Income Tax Features</b>						
25 <b>Inherited assets escape state estate tax at 2nd death</b>	<b>no</b>	yes*	<b>no*</b>	<b>no</b>	<b>yes*</b>	yes
	(*to extent trust is not subject to separate state QTIP or included via formula GPA)					
26 <b>Ability to spray income to beneficiaries in low/no tax state</b>	<b>no</b>	if added	<b>no</b>	<b>no</b>	<b>yes</b>	no*
27 <b>Ability to shelter trust income from state income tax for trust income (incl CG) not K-1'd to beneficiary</b> See separate charts on avoiding state trust income tax	<b>no</b>	depends state	<b>no</b>	<b>no</b>	<b>depends on state</b>	no
	acct. income is taxed to bene					

**Creditor Protection for Assets Subject to Presently Exercisable General Powers of Appointment (Including *Crummey*, "Five and Five" or Other Withdrawal Powers) Pre and Post Lapse in Trust**  
***Companion Chart to Article/Presentation "IRC § 678 and the Beneficiary Deemed Owner Trust (BDOT)" by Ed Morrow***

"5/5" refers to the greater of five percent or \$5,000 referred to in IRC Sections 2514(e) and 2041(b), a.k.a. "five and five power"

"+Ann" refers to the annual exclusion under IRC Section 2503(b), currently \$14,000, adjusted annually for inflation (probably \$15,000 in 2018)

"x2" refers to twice the annual exclusion if the donor is married (or in some states, if election to split gift)

In some states, if the trust qualifies under DAPT statute, there may even be greater protection than below. This chart assumes non-DAPT trust.  
 For information on DAPT statutes: <http://www.actec.org/assets/1/6/Shaftel-Comparison-of-the-Domestic-Asset-Protection-Trust-Statutes.pdf>

Note that statutes often refer to "power to withdraw" or "power of withdrawal" separately from "presently exercisable power of appointment".  
 All powers of withdrawal are presently exercisable general powers of appointment. The reverse is *mostly* true, but it's possible to have a presently exercisable GPOA that is not a power of withdrawal (e.g. a presently exercisable power to appoint a remainder interest to one's estate).  
 Those kinds of powers would be rare, however, so for most intents and purposes the two terms are equivalent.

<u>State</u>	<u>State Statute with Hyperlink</u>	<u>Level of Protection</u>			<u>Loopholes, Exceptions or Unique Features in Statute</u>  (and where applicable excerpt from statute)
		<u>Current Power Protected</u>	<u>5/5 + Ann Protected</u>	<u>Unlimited Lapse Protected</u>	
			Lapses		
<b>Alabama</b>	<a href="#">Ala Code §19-3B-505(c)(2)</a>	No	Yes	No	Follows UTC §505(b): "(c) For purposes of this section: (1) during the period the power may be exercised, the holder of a power of withdrawal is treated in the same manner as the settlor of a revocable trust to the extent of the property subject to the power; and (2) upon the lapse, release, or waiver of the power, the holder is treated as the settlor of the trust only to the extent the value of the property affected by the lapse, release, or waiver exceeds the greater of the amount specified in Section 2041(b)(2), 2503(b), or 2514(e) of the Internal Revenue Code of 1986, in each case as in effect on January 1, 2007, or as later amended.

<b>Alaska</b>	<a href="#">AS §34.40.115</a>	Yes, unless exercised	Yes	Yes	Not a UTC state: "The property that a donee of a power of appointment is authorized to appoint is <i>not subject</i> to the claims of the creditors of the donee <i>except</i> to the extent that a donee of an inter vivos or testamentary power of appointment (1) is permitted by the donor of the power to appoint the property to the donee, the creditors of the donee, the donee's estate, or the creditors of the donee's estate; <i>and</i> (2) <i>effectively exercises the power</i> of appointment in favor of the donee, the creditors of the donee, the donee's estate, or the creditors of the donee's estate."
<b>Arizona</b>	<a href="#">ARS §14-10505(B)(2)</a>	No	Yes	Yes	Protects lapsed withdrawal rights without limitation and substantially modifies its version of UTC 505(b): "B. For the purposes of this section: 1. During the period the power may be exercised, the holder of a power of withdrawal is treated in the same manner as the settlor of a revocable trust to the extent of the property subject to the power. 2. On the lapse, release or waiver of a power of withdrawal, the holder is not, by reason of any such power of withdrawal, treated as the settlor of the trust."
<b>Arkansas</b>	<a href="#">AR Code § 28-73-505(b)(2)</a>	No		Yes	Substantially modifies UTC 505(b): "(b) For purposes of this section: (1) During the period the power may be exercised, the holder of a power of withdrawal is treated in the same manner as the settlor of a revocable trust to the extent of the property subject to the power. (2) On the lapse, release, or waiver of a power of withdrawal, the holder of a power of withdrawal is not, by reason of any such power of withdrawal, treated as the settlor of the trust."
<b>California</b>	<a href="#">Cal Prob Code § 15309</a>	No	Probably	Probably	Not a UTC state. See substantial discussion of California law in the accompanying article. "Probably" indicates that while the statute and common law may lead one to conclude a lapse does not make the beneficiary a settlor under California law, California courts are notoriously pro-creditor and may create new law. Regardless, even third party spendthrift trusts that are not deemed self-settled may be subject to attachment of up to 25% of distributions under California law, plus any overdue distributions. Might a court extrapolate from and extend this rule to permit attachment of 25% of any amounts that could have been withdrawn? See <i>Carmack v. Fealy</i> discussion in material, where a court permitted a creditor to attach overdue distributions.

<b>Colorado</b>	<a href="#">Univ. Nat'l Bank v. Rhoadarmer, 827 P.2d 561 (Colo. App. 1991) cert. den. (3/3/1992)</a>	Yes, unless exercised	Yes	Not a UTC state, follows common law. <i>Univ. Nat'l Bank v. Rhoadarmer</i> , 827 P.2d 561 (Colo. App. 1991) cert. den. (3/3/1992), appears to still be good law in Colorado, holding that neither an unexercised 5&5 withdrawal right nor trust property with respect to which the withdrawal power had lapsed could be attached. Paradoxically, a mandatory distribution that has not yet been distributed may be attached: <i>Beren v. Beren (In re Estate of Beren)</i> , 2013 COA 166 (Colo. Ct. App. Dec. 5, 2013).
<b>Connecticut</b>			Probably	Not a UTC state. Could find no clear law on point, so this chart assumes it would probably follow common law rather than 3d rest.
<b>Delaware</b>	<a href="#">12 Del. C. § 3536(c)(1)</a>	Yes, unless exercised	Yes	Not a UTC state. Delaware has strong protection for unexercised powers of appointment in 3536(a)(4) "Further, a beneficiary of a trust shall not be considered a trustor of the trust merely because of a lapse, waiver, or release of the beneficiary's right to withdraw all or a part of the trust property." and 3536(d)(2)
<b>District of Columbia</b>	<a href="#">D.C. Code § 19-1305.05</a>	No	Yes	Follows UTC §505(b): "(b) For the purposes of this section: (1) During the period the power may be exercised, the holder of a power of withdrawal is treated in the same manner as the settlor of a revocable trust to the extent of the property subject to the power; and (2) Upon the lapse, release, or waiver of the power, the holder is treated as the settlor of the trust only to the extent the value of the property affected by the lapse, release, or waiver exceeds the greater of the amount specified in section 2041(b)(2) or 2514(e) of the Internal Revenue Code of 1986, or section 2503(b) of the Internal Revenue Code of 1986, in each case as in effect on the effective date of this chapter [March 10, 2004], or as later amended.
<b>Florida</b>	<a href="#">Fla Stat. Ann. § 736.0505(2)(b)</a>	No	Yes, Ann Excl x2	Follows UTC 505(b), but increases protection: "(2) For purposes of this section: (a) During the period the power may be exercised, the holder of a power of withdrawal is treated in the same manner as the settlor of a revocable trust to the extent of the property subject to the power. (b) Upon the lapse, release, or waiver of the power, the holder is treated as the settlor of the trust only to the extent the value of the property affected by the lapse, release, or waiver exceeds the greater of the amount specified in: 1. Section 2041(b)(2) or s. 2514(e); or 2. Section 2503(b) and, <b>if the donor was married at the time of the transfer to which the power of withdrawal applies, twice the amount</b> specified in s. 2503(b),

<b>Georgia</b>	<a href="#">GA Code § 53-12-83</a>	No	Yes	Not a UTC state, but borrows some provisions and has substantial protection nonetheless: "The holder of a power of withdrawal, during the period that the power may be exercised, shall be treated in the same manner as the settlor of a revocable trust to the extent of the property subject to the power. <b>The lapse, release, or waiver of a power of withdrawal shall not cause the holder to be treated as a settlor of the trust.</b> "
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<b>Hawaii</b>		Maybe	Probably	Not a UTC state. Could find no clear law on point, so this chart assumes it would probably follow common law rather than 3d rest.
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<b>Idaho</b>	<a href="#">Idaho Code § 15-7-502(5)</a>	No	Yes	Not a UTC state, but has adopted substantially similar protection to UTC 505(b): "(5) A beneficiary of a trust shall not be considered a settlor of a trust merely because of a lapse, waiver or release of: (a) A power described in subsection (6) of this section; or (b) The beneficiary's right to withdraw a part of the trust property to the extent that the value of the property affected by the lapse, waiver or release in any calendar year does not exceed the greater of the amount specified in: (i) Section 2041(b)(2) or 2514(e) of the Internal Revenue Code of 1986, as amended; or (ii) Section 2503(b) of the Internal Revenue Code of 1986, as amended."
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<b>Illinois</b>	<a href="#">760 ILCS 5/16.2</a>	No	Yes	No	Legislature currently considering the UTC, HB 2526, which includes an unmodified UTC 505(b) as introduced. Until then, the current statute is substantially the same: "Lapse of power to withdraw. A beneficiary of a trust may not be considered to be a settlor or to have made a transfer to the trust merely because of a lapse, release, or waiver of his or her power of withdrawal to the extent that the value of the affected property does not exceed the greatest of the amounts specified in Sections 2041(b)(2), 2514(e), and 2503(b) of the Internal Revenue Code."
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<b>Indiana</b>	<a href="#">Irwin Union Bank &amp; Trust Co. v. Long, 312 N.E.2d 908 (1974)</a>	Yes, unless exercised	Yes	Yes	Not a UTC state, follows common law. In <i>Irwin Union Bank &amp; Trust Co. v. Long</i> , 160 Ind.App. 509, 312 N.E.2d 908 (1974), a beneficiary let his right to withdraw 4% of the corpus (a presently exercisable power of appointment) of a trust lapse. There was no statute on point equivalent to UTC. The court, citing II Scott on Trusts, § 147.3 and 62 Am. Jur. 2d, Powers, § 107, which parallels the second restatement above, held the assets of the trust (not even 4%, much less a higher percentage due to prior years' lapses) were not available to creditors.
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Iowa	<a href="#">Iowa Code §633A.3105</a>	No	Yes	Yes	Not a UTC state, but has many parallel provisions in its trust code. There seems to be no analogy, however, to UTC 505(b). Iowa Code § 633A.3 clearly allows creditor access to any presently exercisable general power of appointment, but is silent as to lapses. One law review article analyzing Iowa common law citing cases <i>Ober v. Seegmiller</i> , 160 N.W. 21, 23–24 (Iowa 1916), <i>Darling v. Dodge</i> , 206 N.W. 266 (Iowa 1925) and <i>Ober v. Dodge</i> , 231 N.W. 444, 447 (Iowa 1930) concluded thus regarding lapses: "Iowa Code section 633A.3105 states that property of a trust is chargeable to the creditors of a "presently exercisable" general power of appointment holder. Thus, to the extent that a Crummey-type right of withdrawal is the same as a general power of appointment*** then Iowa Code section 633A.3105 overrules these cases, but <b>only during the withdrawal period. When a beneficiary's right of withdrawal period passes, section 633A.3105 is no longer determinative, and the Ober and Darling cases could be expected to provide residual protection to the beneficiaries.</b> " ASSET PROTECTION (FOR THE RICH AND NOT) IN IOWA, by David M. Repp., Drake Law Review.
Kansas	<a href="#">Kan. Stat. Ann. §58a-505(b)</a>	No	Yes	No	Follows UTC 505(b) with an extra provision for spouses: "(b) For purposes of this section: (1) During the period the power may be exercised, the holder of a power of withdrawal is treated in the same manner as the settlor of a revocable trust to the extent of the property subject to the power; (2) upon the lapse, release, or waiver of the power, the holder is treated as the settlor of the trust only to the extent the value of the property affected by the lapse, release, or waiver exceeds the greater of the amount specified in section 2041(b)(2) or 2514(e) of the federal internal revenue code of 1986, as in effect on December 31, 2002; or section 2503(b) of the federal internal revenue code of 1986, as in effect on December 31, 2002; and (3) this subsection shall not apply to the lapse of powers held by the spouse of a person occurring upon the death of such person."
Kentucky	<a href="#">Kentucky RS §386B.5-040(2)</a>	No	Yes	Yes	UTC state but with substantial debtor/trust friendly modification of UTC 505(b): "(a) During the period the power may be exercised, the holder of a power of withdrawal is treated in the same manner as the settlor of a revocable trust to the extent of the property subject to the power; and (b) Upon the lapse, release, or waiver of the power, <i>the holder is not treated as the settlor</i> of the trust." See also <i>St. Matthews Bank v. De Charette</i> , 259 Ky. 802 (Ky. 1935)

<b>Louisiana</b>	<a href="#">LA Rev Stat § 9:2004</a>	No	Yes	Yes	Not a UTC state or even common law state but does have a trust code and an exception regarding lapsed general powers: "§2004. Seizure by creditor; general rule. A creditor may seize only: (1) An interest in income or principal that is subject to voluntary alienation by a beneficiary. (2) A beneficiary's interest in income and principal, to the extent that the beneficiary has donated property to the trust, directly or indirectly. A beneficiary will not be deemed to have donated property to a trust merely because he fails to exercise a right of withdrawal from the trust."
<b>Maine</b>	<a href="#">18-B ME Rev Stat § 505(2)</a>	No	Yes	No	Follows UTC 505(b): "2. Holder of power. For purposes of this section: A. During the period the power may be exercised, the holder of a power of withdrawal is treated in the same manner as the settlor of a revocable trust to the extent of the property subject to the power; and B. Upon the lapse, release or waiver of the power, the holder is treated as the settlor of the trust only to the extent the value of the property affected by the lapse, release, or waiver exceeds the greater of the amount specified in the federal Internal Revenue Code of 1986, Section 2041(b)(2) or 2514(e) or the federal Internal Revenue Code of 1986, Section 2503(b), in each case as in effect on July 1, 2005, or as later amended."
<b>Maryland</b>	<a href="#">MD Est &amp; Trusts Code § 14.5-507</a>	Yes	Yes	Yes	Maryland is a UTC state but like many did not pass UTC 505(b) and substantially modified its statutes to be more protective of presently exercisable powers (and, presumably, lapses thereof): "Power of appointment. (a) Not deemed property interest; foreclosure or attachment prohibited. -- (1) A power of appointment held by a person other than the settlor of the trust is not a property interest. (2) A power of appointment described in paragraph (1) of this subsection and property subject to that power of appointment may not be judicially foreclosed or attached by a creditor of the holder of the power.

<b>Massachusetts</b>	<a href="#">ALM GL ch. 203E, § 505</a>	No	Probably	Probably	Massachusetts is a UTC state but only passed a portion of UTC 505 and left the lapse discussion of 505(b) out of its version of the trust code entirely, leaving the answer to common law. MA does have some case law on GPOAs, one case, <i>State Street Bank &amp; Trust Co. v. Reiser</i> permits creditors of an estate access to assets subject to a decedent debtor's testamentary general powers of appointment if the decedent created the power, but others do not allow access if a third party created the power: <i>Shattuck v. Burrage</i> , 229 Mass. 448, 118 N.E. 889 (1918); <i>Crawford v. Langmaid</i> , 171 Mass. 309, 50 N.E. 606 (1898), but I could find no law as to the effect of lapses of a Crummey, 5/5 or other presently exercisable GPOA.
<b>Michigan</b>	<a href="#">Michigan MCL § 700.7506(c)(3)</a>	No	Yes	Yes	UTC State with debtor-friendly modifications of UTC 505(b): "(3) A trust beneficiary is not considered a settlor merely because of a lapse, waiver, or release of a power of withdrawal over the trust property."
<b>Minnesota</b>	<a href="#">Minn. Stat. § 501C.0505</a>  <a href="#">Minn. Stat. § 502.86, §502.87</a>	No	Probably	Probably	Minnesota is a UTC state but omitted 505(b) from its version.  Minnesota has a separate power of appointment act that is not based on UPOAA. Note that Minn. Stat. 502.86, Subd. 2 allows creditor access to a presently exercisable general power but Subd. 3 protects such assets from creditors if a power is subject to a condition, such as consent of a non-adverse party, until such condition is met. Minn. Stat. 502.80 specifically provides that "(a) The common law of powers remains in full force and effect and supplements the provisions of this chapter, unless explicitly modified or displaced by this chapter."
<b>Mississippi</b>		Probably	Probably	Probably	Mississippi is a UTC state but omitted Article 5 dealing with creditor issues and does not have UTC 505(b) equivalent. Various bar study groups have recommended adoption of UPOAA to clarify such points, see <a href="http://www.sos.ms.gov/Policy-Research/Documents/1Tentative.pdf">http://www.sos.ms.gov/Policy-Research/Documents/1Tentative.pdf</a>
<b>Missouri</b>	<a href="#">RSMo § 456.5-505.6</a>	No	Yes	No	UTC state that follows UTC 505(b): "6. For purposes of this section: (1) During the period the power may be exercised, the holder of a power of withdrawal is treated in the same manner as the settlor of a revocable trust to the extent of the property subject to the power; and (2) Upon the lapse, release, or waiver of the power, the holder is treated as the settlor of the trust only to the extent the value of the property affected by the lapse, release, or waiver exceeds the greater of the amount specified in Sections 2041(b)(2), 2514(e) or 2503(b) of the Internal Revenue Code."

[Mo. Rev. Stat § 456.1105](#)

Missouri has passed the UPOAA but has modified Section 503.

**Montana**

[Mt. Stat. §72-38-505\(2\)](#)

No

Yes

No

Follows UTC 505(b): "(2) For purposes of this section:  
(a) during the period the power may be exercised, the holder of a power of withdrawal is treated in the same manner as the settlor of a revocable trust to the extent of the property subject to the power; and  
(b) upon the lapse, release, or waiver of the power, the holder is treated as the settlor of the trust only to the extent the value of the property affected by the lapse, release, or waiver exceeds the greater of the amount specified in section 2041(b)(2) or 2514(e) of the Internal Revenue Code of 1986, or section 2503(b) of the Internal Revenue Code of 1986, in each case as in effect on the effective date of this chapter or as later amended."

[MT Code § 72-7-503](#)

Also passed UPOAA §503, which parallels UTC § 505(b)

**Nebraska**

[Neb. Stat. §30-3850](#)

No

Yes

No

b) For purposes of this section:  
(1) during the period the power may be exercised, the holder of a power of withdrawal is treated in the same manner as the settlor of a revocable trust to the extent of the property subject to the power; and  
(2) upon the lapse, release, or waiver of the power, the holder is treated as the settlor of the trust only to the extent the value of the property affected by the lapse, release, or waiver exceeds the greater of the amount specified in section 2041(b)(2), 2503(b), or 2514(e) of the Internal Revenue Code as defined in section 49-801.01.

**Nevada**

[Nevada's NRS § 163.5559\(3\)](#)

No

Yes

No

Not a UTC state, but Nevada's NRS § 163.5559(3) provides that "a beneficiary of a trust shall be deemed to not be a settlor of a trust because of a lapse, waiver or release of the beneficiary's right to withdraw part or all of the trust property if the value of the property which could have been withdrawn by exercising the right of withdrawal in any calendar year does not, at the time of the lapse, waiver or release, exceed the greater of the amount provided in 26 U.S.C. 2041(b)(2), 26 U.S.C. 2503(b) or 26 U.S.C. 2514(e), as amended, or any successor provision."

[NV SB 454 - effective Oct 1, 2017](#)

Nevada has passed the UPOAA, keeping language similar to Sections 502-503, which have similar import to above. "Sec. 52. 1. Except as otherwise provided in subsection 2,

appointive property subject to a general power of appointment created by a person other than the powerholder is subject to a claim of a creditor of:

- (a) The powerholder, to the extent the powerholder's property is insufficient, if the power is presently exercisable; and
- (b) The powerholder's estate, to the extent the estate is insufficient, subject to the right of a decedent to direct the source from which liabilities are paid.

[NV Rev Stat § 166.015](#)

A trust might potentially come under Nevada's Spendthrift Trust Act (its DAPT statute), in which case additional protections may apply even if the powerholder/beneficiary is deemed a settlor.

<b>New Hampshire</b>	<a href="#">N.H. Rev. Stat. Ann. §564-B:5-505(b)</a>	No	Yes	Yes	"(b) During only the period that the power may be exercised, the holder of a power of withdrawal is treated in the same manner under this section as the settlor of a revocable trust to the extent of the property subject to the power." By express omission of lapse language that is present in most state's version of 505(b) and insertion of "only", it is highly likely that NH law protects a powerholder from being a settlor post-lapse. If any NH attorneys think otherwise, let me know.
<b>New Jersey</b>	<a href="#">NJS.3B:31-39.b(2)</a>	No	Yes	No	"b.For purposes of this section: (1)during the period the power may be exercised, the holder of a power of withdrawal is treated in the same manner as the settlor of a revocable trust to the extent of the property subject to the power; and (2)upon the lapse, release, or waiver of the power, the holder is treated as the settlor of the trust only to the extent the value of the property affected by the lapse, release, or waiver exceeds the greater of the amount specified in section 2041(b)(2) or 2514(e) of the federal Internal Revenue Code of 1986 (26 U.S.C. s.2041(b)(2) or 26 U.S.C. s.2514(e)), or section 2503(b) of the federal Internal Revenue Code of 1986 (26 U.S.C. s.2503(b)), in each case as in effect on the effective date of this act, or as later amended."

<b>New Mexico</b>	<a href="#">NM Stat § 46A-5-505(b)</a>	No	Yes	No	Follows UTC 505(b): "B. For purposes of this section: (1) during the period the power may be exercised, the holder of a power of withdrawal is treated in the same manner as the settlor of a revocable trust to the extent of the property subject to the power; and (2) upon the lapse, release or waiver of the power, the holder is treated as the settlor of the trust only to the extent the value of the property affected by the lapse, release or waiver exceeds the greater of the amount specified in Section 2041(b)(2), 2514(e) or 2503(b) of the Internal Revenue Code of 1986, as amended."
<b>New Mexico</b>	<a href="#">NM Stat § 46-11-503</a>				Also passed UPOAA §503, which parallels UTC § 505(b)
<b>New York</b>	<a href="#">NY CLS EPTL § 10-7.2</a>	No	Yes	Yes	NY is not a UTC state - its statute clearly subjects presently exercisable general powers to creditors, but is silent on lapses. Presumably it would follow common law and not deem the lapsing powerholder to be the settlor and protect such assets. There is a bill introduced to codify this (revising NY EPTL §7-3.1(a) and CPLR §5205(c)) which states that "it is declaratory of existing New York law": 2017 Bill Text NY A.B. 5432.
<b>North Carolina</b>	<a href="#">N.C. Gen Stat. § 36C-5-505</a>	No	Yes	Yes	"(b) For purposes of this section, with respect to a power of withdrawal over property of a trust exercisable by a holder of the power other than the settlor of the trust, both of the following shall apply: (1) The property subject to the exercise of the power shall be subject to the claims of the creditors of the holder only when and to the extent that the holder exercises the power. (2) The lapse, release, or waiver of a power shall <i>not</i> be deemed to be an exercise of the power and shall not cause the holder to be treated as a settlor of the trust."
	<a href="#">N.C. Gen. Stat. § 31D-5-503</a>				N.C.'s version of the UPOAA Section 503 mirrors the above: "Power to withdraw. (a) For purposes of this Article, a power to withdraw property from a trust is treated as a presently exercisable general power of appointment to the extent of the property subject to the power to withdraw. (b) The lapse, release, or waiver of a power to withdraw property from a trust shall not be deemed to be an exercise of the power."

<b>North Dakota</b>	<a href="#">N.D. Code §59-13-05</a>	No	Yes	No	"2. For purposes of this section during the period the power may be exercised, the holder of a power of withdrawal is treated in the same manner as the settlor of a revocable trust to the extent of the property subject to the power and, upon the lapse, release, or waiver of the power, the holder is treated as the settlor of the trust only to the extent the value of the property affected by the lapse, release, or waiver exceeds the greater of the amount specified in section 2041(b)(2) or 2514(e) of the Internal Revenue Code of 1986, or section 2503(b) of the Internal Revenue Code of 1986, or corresponding future provisions of federal tax law."
<b>Ohio</b>	<a href="#">Ohio R.C. §5805.06(B)(2)</a>	No	Yes, x2	No	"(B) For purposes of this section, all of the following apply: (1) The holder of a power of withdrawal is treated in the same manner as the settlor of a revocable trust to the extent of the property subject to the power during the period the power may be exercised. (2) Upon the lapse, release, or waiver of the power of withdrawal, the holder is treated as the settlor of the trust only to the extent the value of the property affected by the lapse, release, or waiver exceeds the greatest of the following amounts: (a) The amount specified in section 2041(b)(2) or 2514(e) of the Internal Revenue Code; (b) If the donor of the property subject to the holder's power of withdrawal is not married at the time of the transfer of the property to the trust, the amount specified in section 2503(b) of the Internal Revenue Code; (c) If the donor of the property subject to the holder's power of withdrawal is married at the time of the transfer of the property to the trust, twice the amount specified in section 2503(b) of the Internal Revenue Code."
<b>Oklahoma</b>	<a href="#">Okla. Stat. §60-175.85</a>	Yes, unless exercised	Yes	Yes	"F. A power of appointment in any trust is personal in nature and cannot be attached or forced to be exercised by a creditor or a court regardless of the presence of a spendthrift provision. A power of appointment is not a property interest."

<b>Oregon</b>	<a href="#">Oregon ORS §130.315(3)</a>	No	Yes, x2	No	Follows UTC 505(b) but doubles for annual exclusion gifts by married couples: "(3) Upon the lapse, release or waiver of a power of withdrawal, the property of the trust that is the subject of the lapse, release or waiver becomes subject to claims of creditors of the holder of the power only to the extent the value of the property exceeds the greater of: (a) The amount specified in section 2041(b)(2) or 2514(e) of the Internal Revenue Code, as in effect on December 31, 2012; (b) The amount specified in section 2503(b) of the Internal Revenue Code, as in effect on December 31, 2012; or (c) Twice the amount specified in section 2503(b) of the Internal Revenue Code, as in effect on December 31, 2012, if the donor was married at the time of the transfer to which the power of withdrawal applies.
<b>Pennsylvania</b>	<a href="#">20 Pa. C.S.A. §§ 7703</a>	No	Yes	No	Pennsylvania mimics UTC §505(b) in a roundabout way by first defining power of withdrawal to exclude annual exclusion/5&5 powers in 20 Pa. C.S.A. §§ 7703, and then carving out in a different code section at 20 PA Cons Stat § 7748: "Trust property that is subject to a power of withdrawal, during the period the power may be exercised and after its lapse, release or waiver, may be reached by a creditor or an assignee of the holder of the power whether or not the interest of the holder in the trust is subject to a spendthrift provision."
<b>Rhode Island</b>	<a href="#">RI Gen L § 34-22-13</a>	Yes, unless exercised	Yes	Yes	Not a UTC state and statute follows common law; "§ 34-22-13 Powers as subjecting property to creditors. Except to the extent that a donee shall appoint to his or her estate or to his or her creditors, §§ 34-22-11 and 34-22-12 shall not be construed to subject to the claims of creditors of the donee the property which the donee is authorized to appoint."
<b>South Carolina</b>	<a href="#">SC Code § 62-7-505(b)</a>		Probably.	Probably	SC is a UTC state but did not include UTC 505(b) but replaced it with something else and left open whether a lapse is protected or not. I could find no reported case but presume it would follow common law and not consider a lapse to create a self-settled trust and/or be attached. If any SC attorneys know of any law or why 505(b) was omitted please let me know.

South Dakota	<a href="#">South Dakota CL §55-1-26</a>	Yes, unless exercised	Yes	Yes	SD is not a UTC state and the law appears to be even more debtor friendly than common law: <i>“Judicial foreclosure of beneficial interests, powers of appointment, and reserved powers prohibited--Creditors may not reach powers of appointment or remainder interests. Regardless of whether or not a trust contains a spendthrift provision: (1) No beneficial interest, power of appointment, or reserved power in a trust may be judicially foreclosed; (2) No creditor may reach a power of appointment or a remainder interest at the trust level. The creditor shall wait until the funds are distributed before the creditor may reach the funds; and (3) No power of appointment is a property interest.”</i>
Tennessee	<a href="#">Tenn. Code Ann. §35-15-505(b)</a>	Yes, but limited to 5/5+ann	Yes	Yes	UTC state, but with substantial debtor-friendly modifications to UTC 505(b): <i>“(b) For purposes of this section during the period a power of withdrawal may be exercised or upon the lapse, release, or waiver of the power, the holder is treated as the settlor of the trust only to the extent the value of the property affected by the lapse, release, or waiver exceeds the greater of the amount specified in § 2041(b)(2) or 2514(e) of the Internal Revenue Code of 1986 (26 U.S.C. § 2041(b)(2) and § 2514(e)), or § 2503(b) of the Internal Revenue Code of 1986 (26 U.S.C. § 2503(b)), in each case as in effect on July 1, 2004, or as later amended.”</i> While this appears to foreclose protection beyond 5/5+ann. excl similar to the UTC, also note Tenn. Code Ann. §35-15-505(e): <i>“For purposes of subdivision (a)(2) and subsection (g), a person who is the holder of a power of withdrawal is not considered a settlor of the trust by failing to exercise that power of withdrawal or letting that power of withdrawal lapse.”</i>
Texas	<a href="#">Texas Property Code § 112.035(e)</a>	No	Yes	No	<i>“(e) A beneficiary of the trust may not be considered a settlor merely because of a lapse, waiver, or release of:</i> (1) a power described by Subsection (f); or (2) the beneficiary's right to withdraw a part of the trust property to the extent that the value of the property affected by the lapse, waiver, or release in any calendar year does not exceed the greater of the amount specified in: (A) Section 2041(b)(2) or 2514(e), Internal Revenue Code of 1986; or (B) Section 2503(b), Internal Revenue Code of 1986.”

**Utah**      [Utah Code § 75-1-502](#)      Yes      Probably\*      Possibly\*      Utah is a UTC state and followed UTC 505(b) until 5/9/2017 when it was deleted from the code at the same time Utah passed the Uniform Powers of Appointment Act, though it substantially modified that particular section and kept closer to common law. Reading section 503 together with 502 is a bit confusing in trying to determine the effect of a lapse: "75-10-502. Creditor claim -- Power not created by powerholder.  
(1) The property subject to a general or a nongeneral power of appointment not created by the powerholder, including a presently exercisable general or nongeneral power of appointment, is exempt from a claim of a creditor of the powerholder or the powerholder's estate. The powerholder of such a power may not be compelled to exercise the power and the powerholder's creditors may not acquire the power, any rights thereto, or reach the trust property or beneficial interests by any other means. A court may not exercise or require the powerholder to exercise the power of appointment."

[Utah Code §75-10-503](#)

Utah Code 75-10-503: "Power to withdraw.  
(1) For purposes of this part, and except as otherwise provided in Subsection (2), a power to withdraw property from a trust is treated, during the time the power may be exercised, as a presently exercisable general power of appointment to the extent of the property subject to the power to withdraw.  
(2) On the lapse, release, or waiver of a power to withdraw property from a trust, the power is treated as a presently exercisable general power of appointment only to the extent the value of the property affected by the lapse, release, or waiver exceeds the greater of the amount specified in 26 U.S.C. Sec. 2041(b)(2) and 26 U.S.C. Sec. 2514(e) or the amount specified in 26 U.S.C. Sec. 2503(b)." Query: if PEGs are protected per section 502 above, then why did they bother adding section 503(2) and what import does it have?

<b>Vermont</b>	<a href="#">14A V.S.A. § 505(b)</a>	No	Yes		UTC state that follows UTC 505(b): "(b) For purposes of this section: (1) during the period the power may be exercised, the holder of a power of withdrawal is treated in the same manner as the settlor of a revocable trust to the extent of the property subject to the power; and (2) upon the lapse, release, or waiver of the power, the holder is treated as the settlor of the trust only to the extent the value of the property affected by the lapse, release, or waiver exceeds the greater of the amount specified in Section 2041(b)(2) or 2514(e) of the Internal Revenue Code of 1986, or Section 2503(b) of the Internal Revenue Code of 1986, in each case as in effect on the effective date of this title."
<b>Virginia</b>	<a href="#">Va. Code § 64.2-747(B)</a>	No	Yes, x2	No	UTC state that follows 505(b) but doubles annual exclusion amount for married donor: "B. For purposes of this section: 1. During the period the power may be exercised, the holder of a power of withdrawal is treated in the same manner as the settlor of a revocable trust to the extent of the property subject to the power; and 2. Upon the lapse, release, or waiver of the power, the holder is treated as the settlor of the trust only to the extent the value of the property affected by the lapse, release, or waiver exceeds the greatest of (i) the amount specified in § 2041(b)(2) or 2514(e) of the Internal Revenue Code of 1986, (ii) the amount specified in § 2503(b) of the Internal Revenue Code of 1986, or (iii) two times the amount specified in § 2503(b) of the Internal Revenue Code of 1986 if the donor was married at the time of the transfer to which the power of withdrawal applies."
	<a href="#">Va. Code §§ 64.2-2736, 64.2-2737</a>				Virginia's UPOAA mirrors its UTC provision noted above.
<b>Washington</b>	<a href="#">RCW § 11.95.160</a>	No	Yes	Yes	Not a UTC state. "Lapse of a power—Intent not to exercise a power—Treatment. A person shall not be treated as having made a disposition in trust for the use of that individual by reason of a lapse of a power of withdrawal over the income or corpus of a trust created by another person. For this purpose, notification to the trustee of the trust of an intent not to exercise the power of withdrawal shall not be treated as a release of the power of withdrawal, but shall be treated as a lapse of the power."

<b>West Virginia</b>	<a href="#">W.V. Code § 44D-5-505(b)</a>	No	Yes	No	UTC state which follows UTC 505(b): "(b) For purposes of this section: (1) During the period the power may be exercised, the holder of a power of withdrawal is treated in the same manner as the grantor of a revocable trust to the extent of the property subject to the power; and (2) Upon the lapse, release or waiver of the power, the holder is treated as the grantor of the trust only to the extent the value of the property affected by the lapse, release or waiver exceeds the greater of the amount specified in Section 2041(b)(2), Section 2503(b) or Section 2514(e) of the Internal Revenue Code."
<b>Wisconsin</b>	<a href="#">Wisc. Stat. §701.0505(2)(b)</a>	No	Yes, x2	No	Follows UTC 505(b) but doubles for annual exclusion if election made to split gifts: "(b) A beneficiary of a trust may not be considered a settlor solely because of a lapse, waiver, or release of any of the following: 1. A power described under par. (c). 2. The beneficiary's right to withdraw part of the trust property, to the extent that the value of the property affected by the lapse, waiver, or release in any year does not exceed the greater of the following: a. The amount referenced in section 2041 (b) (2) or 2514 (e) of the Internal Revenue Code. b. The amount referenced in section 2503 (b) of the Internal Revenue Code for each individual other than the beneficiary who makes a transfer to the trust or who is deemed to make a transfer to the trust pursuant to an election to split gifts under section 2513 (a) of the Internal Revenue Code."
<b>Wyoming</b>	<a href="#">WY Stat § 4-10-505.1</a>	Yes, unless exercised	Yes	Yes	UTC state but completely replaced UTC 505(b) with codification of common law: "4-10-505.1. Power of appointment or withdrawal; claims of power holder's creditors. (a) Property of a trust that the holder of a power of appointment is authorized to appoint may not be reached or attached by creditors or assignees of the power holder except to the extent that the power holder: (i) Is authorized under the power to appoint the property to himself, his creditors, his estate or the creditors of his estate; and (ii) Exercises the power of appointment in favor of himself, his creditors, his estate or the creditors of his estate. (b) Property of a trust that may be withdrawn by a person holding a power to withdraw from the trust may not be reached or attached by creditors or assignees of the power holder unless and until the power holder withdraws the property from the trust."

N/A	<a href="#">Uniform Trust Code §505(b) (while 32 jurisdictions have passed the UTC, many have modified this section, see above)</a>	No	Yes	No	(b) For purposes of this section: (1) during the period the power may be exercised, the holder of a power of withdrawal is treated in the same manner as the settlor of a revocable trust to the extent of the property subject to the power; and (2) upon the lapse, release, or waiver of the power, the holder is treated as the settlor of the trust only to the extent the value of the property affected by the lapse, release, or waiver exceeds the greater of the amount specified in Section 2041(b)(2) or 2514(e) of the Internal Revenue Code of 1986, or Section 2503(b) of the Internal Revenue Code of 1986, in each case as in effect on [the effective date of this [Code]] [, or as later amended].
N/A	<a href="#">Uniform Trust Code §103(11) (definitions section that defines "power of withdrawal" used in §505(b) above)</a>				UTC §103(11): "Power of withdrawal" means a presently exercisable general power of appointment <i>other than</i> a power: <b>*** (B) exercisable by another person only upon consent of the trustee</b> or a person holding an adverse interest." [thus, not all general powers are susceptible to creditors even under UTC states, enabling "hanging powers" that require trustee consent to avoid a gift taxable lapse yet remain protected from creditors]
N/A	<a href="#">Uniform Powers of Appointment Act §§502-503 (as of August 2017, 8 states have passed the UPOAA: CO, MO, MT, NV, NM, NC, UT, VA with bills introduced in KY, IL)</a>	No	Yes	No	Caution: First, if your state is considering this uniform act, there are several reasons beyond the scope of this article/chart to avoid or substantially modify it. If your state has already passed it, your state may have omitted (e.g. CO) or substantially changed this section (e.g. UT, NC), so be careful to check your state's version specifically. "SECTION 503. POWER TO WITHDRAW. (a) For purposes of this [article], and except as otherwise provided in subsection (b), a power to withdraw property from a trust is treated, during the time the power may be exercised, as a presently exercisable general power of appointment to the extent of the property subject to the power to withdraw. (b) On the lapse, release, or waiver of a power to withdraw property from a trust, the power is treated as a presently exercisable general power of appointment only to the extent the value of the property affected by the lapse, release, or waiver exceeds the greater of the amount specified in 26 U.S.C. Section 2041(b)(2) and 26 U.S.C. Section 2514(e) or the amount specified in 26 U.S.C. Section 2503(b), [on the effective date of this [act]][as amended]."

Note, when I leave a conclusion blank or speak about "common law" above, applicable where the state has no specific statute on point, the Second Restatement below is the most accurate depiction of the common law, the later Restatements often attempt to aspirationally rewrite the law rather than "restate" on these points. However, a state supreme court could always decide to chart its own course in the absence of statute.

<u>N/A</u>	<a href="#">Restat 2d of Prop: Donative Transfers, § 13.2</a>	Yes, unless statute says otherwise	Yes	Yes	"§ 13.2 <i>Creditors of the Donee -- Unexercised General Power Not Created by Donee</i> . Appointive assets covered by an unexercised general power of appointment, created by a person other than the donee, can be subjected to payment of claims of creditors of the donee, or claims against the donee's estate, but <i>only to the extent provided by statute</i> ." See also 3 Scott & Ascher §14.11.3.
<u>N/A</u>	<a href="#">Restat 3d of Trusts, § 56</a>	No	No	No	"b. ***Trust property subject to a presently exercisable general power of appointment (a power by which the property may be appointed to the donee, including one in the form of a power of withdrawal), because of the power's equivalence to ownership, is treated as property of the donee of the power. It can therefore be subjected to the satisfaction of the claims of the donee's creditors."
	<a href="#">Restat 3d of Trusts, § 58, Comment f</a>	No	No	No	The newest restatement clearly considers a Crummey or other powerholder of a withdrawal power or presently exercisable general power of appointment to be a settlor upon lapse, release or renunciation (regardless of 5/5, annual exclusion), but does not if the powerholder disclaims, but can cite no case or state statute for this proposition. It makes no difference or distinction between a qualified disclaimer pursuant to IRC 2518 (gift/estate tax rule), and a disclaimer pursuant to state law, which is often much easier to comply with (e.g. there is often no 9 month rule, often no pre-acceptance taint). This section of the "restatement" does not appear to be the law in ANY state, but the UTC incorporated parts of it. If ever followed by a state, Section 58 opens up opportunity (or abuse), because it would allow one to be a beneficiary of their own Crummey trust without being considered self-settled under state law (if all contributions are covered by the power), since all the powerholders would be considered the settlors. A contributor to a trust is <i>not</i> a settlor (under restatement 3d and also UTC 103(15)) if other parties have a power of withdrawal/PEG power/GPOA, meaning it is not self-settled as to the <i>contributor</i> even if he/she is beneficiary, a conclusion that many readers likely doubt but has been followed by bankruptcy court in <i>In re Reuter</i> , 499 B.R. 655, 671 (Bankr. W.D. Mo. Sept. 12, 2013). In the context of <i>upstream</i> optimal basis increase trusts, wherein a settlor grants a testamentary GPOA to an older parent or relative - if the Restatement 3d is followed, the original settlor is disregarded/removed as settlor at the power holder's death and the powerholder becomes the settlor, this would enable the original settlor to be a beneficiary without being considered self-settled. See discussion in Part V.j. of <i>The Optimal Basis Increase Trust</i> , available at <a href="https://ssrn.com/abstract=2436964">https://ssrn.com/abstract=2436964</a> .

# **Strategic Trusts, IRC Sec. 831b Captives, ESOPs: Saving Income, Estate and GST Tax**

## **Exhibits**

**Strafford Webinar  
January 8, 2020**

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# Strategic Trusts, IRC Sec. 831b Captives, ESOPs: Saving Income, Estate and GST Tax Exhibits

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## EXHIBIT 1

### OPTIMIZE TOTAL TAX SAVINGS EXAMPLE

H passed away and left \$3,000,000 in a B Trust when the exemption was \$5,000,000. His Deceased Spouse Unused Exemption (“DSUE”) is \$2,000,000. W passed when the exemption for her was \$5,500,000, her estate was worth \$4,000,000, and the value of assets in B Trust is \$5,500,000.

Upon W’s passing:

\$5,500,000 exemption for W.

Less \$4,000,000 (of W’s estate)

\$1,500,000 excess exemption available to W

Plus \$2,000,000 of H’s DSUE

\$3,500,000 Total excess exemption available to W’s estate.

The Power of Appointment may be used on \$3,500,000 of assets in B Trust to get a step up in basis on the assets which remain in the B Trust. (That will normally save income tax for the beneficiaries.) In this case, the basis is \$3,000,000.

The first formula appoints \$3,500,000 of assets in the B Trust since that will not create any estate tax.

The second formula selects the specific assets to be appointed so those which have the largest appreciation (difference between value and basis) are appointed.

## EXHIBIT 2

### Optimize the (Credit Shelter) Bypass Trust (the “B” Trust)

Married clients may optimize their B Trust now to maximize estate and income tax savings and achieve important nontax goals. Clients may add a Double Formula General Power of Appointment (“DF Power”) to convert the unneeded portion of the transfer tax exemption when a surviving spouse passes away to save income tax for beneficiaries of the B Trust.

Example: B Trust with a DF Power (funded when Husband (“H”) passed) has assets worth \$4,000,000 when the surviving spouse (“W”) passes. All assets in the B Trust bypass estate tax when W passes. W’s personal taxable estate is \$3,000,000 and is exempt from estate tax because her estate tax exemption is \$5,340,000. The \$5,340,000 exemption less \$3,000,000 of taxable estate leaves an **“unused exemption amount” (“UEA”)** of \$2,340,000.

The UEA of \$2,340,000 may be “appointed” by W through the use of a DF Power. The DF Power over \$2,340,000 of the \$4,000,000 in the B Trust causes that \$2,340,000 to be (metaphysically) deemed part of W’s taxable estate which **causes the \$2,340,000 to receive a step up in basis at W’s death.** This uses the full exemption amount available at W’s passing.

The B Trust is not affected otherwise by the DF Power. The remaining \$1,660,000 in Trust B (\$4,000,000 less \$2,340,000) remains exempt from estate tax but has a carryover basis. **DF Power planning saves income tax for beneficiaries of the B Trust after W passes,** normally the children and grandchildren. Many Wills and Living Trusts include a B Trust.

The amount of Trust B over which the DF Power is exercisable **will not be known until after W passes.** It depends on the amount of UEA available at the second spouse’s passing, which is determined by her exemption amount and the amount of W’s taxable estate.

If the DF Power were extended to all of the B Trust assets then that would step up basis on all assets in the B Trust but the \$1,660,000 would be included in W’s taxable estate. Since the estate tax normally costs more than the income tax cost of not stepping up basis on the \$1,660,000, it is better to not make that portion appointable to save the most total tax. First, save the more costly estate tax and second use the UEA to save income tax.

When H passed, his estate got a step up in basis on assets which were then transferred to Trust B. Assets in Trust B have now appreciated. Without optimization (by using a DF Power), \$2,340,000 of assets in Trust B would retain the lower basis (value when H passed). By using a DF Power, the B Trust **assets which increased in value the most over their value at H’s death,** up to \$2,340,000, will **receive a step up** to reduce income taxes for beneficiaries.

The “A” Trust is the “marital deduction” trust, most often a QTIP trust. Normally, the assets from the estate of the first spouse will be transferred to (fund) the B Trust and any assets over the exemption amount will be transferred to the A Trust to defer any estate taxes.

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### EXHIBIT 3

#### BASIS AND TRANSFER TAX EXAMPLE

- I. H1 and W1 bought a shopping center as community property for \$1,000,000 twenty (20) years ago. It was worth \$20,680,000 in 2014. The lifetime estate tax exemption then was \$5,340,000 per person.
  - A. Cost basis is \$1,000,000. Assume no tax adjustments to basis so tax basis remains \$1,000,000.
  - B. Capital gains if sold in 2014 was \$19,680,000 (\$20,680,000 - \$1,000,000).
  - C. Assume that they have made no prior taxable gifts but do gift their annual exclusion amount each year.
    1. If they gifted the shopping center to children in 2014
      - a. Gift tax would be \$4,000,000. Computed: \$20,680,000 less exemption of \$10,680,000 (\$5,340,000 for each spouse) = \$10,000,000 x 40%.
      - b. Capital gain would be \$19,840,000 if children sold it soon thereafter. Donor's basis is **carried over** to Donees.
      - c. At a 23.8% tax rate (15% + 5% + 3.8%) the capital gains income tax would have been \$4,721,920.
    2. If it passed to children after both H1 and W1 passed away (assuming current value remains the same) in 2014
      - a. Estate tax would be \$4,000,000.
        - i. \$20,680,000 value less exemption (\$10,680,000 (or \$5,340,000 per spouse)) = \$10,000,000 taxable estate
        - ii. \$10,000,000 x 40% = \$4,000,000
      - b. If children sell it the next day, their capital gains is zero. The **basis is stepped up to market value** for **assets** in the parents' **estates**.

## EXHIBIT 4

### BASIS AND TRANSFER TAX EXAMPLE IN A COMMUNITY PROPERTY STATE

- I. H2 and W2 have a community property estate of \$4,000,000 with a tax basis of \$2,000,000.
  - A. H2 dies in 2014 and his B Trust is funded with \$2,000,000.
    1. Zero estate tax because it is less than the \$5,340,000 2014 exemption.
    2. The tax basis of all of the assets is stepped up to the 2014 value of \$4,000,000, half in H2's B Trust and half to W2 in her name.
  - B. Assume that when W2 passes (many years later) the value of her half plus what is in the B Trust is \$6,000,000.
    1. H2's half is in the B Trust and is exempt from estate tax when W2 passes.
      - a. B Trust has "**carryover basis**" of  $\$4,000,000 \div 2$  (H2's half in trust) or \$2,000,000.
      - b. W2's basis is \$3,000,000 – her half is stepped up.
    2. If children sell it all soon after parents' deaths, their capital gain is \$1,000,000 (\$6,000,000 less \$5,000,000 basis).
    3. Heirs pay 15-23.8% income tax on \$1,000,000 capital gain.
    4. If no B Trust and all was in W2's estate, the basis would be \$6,000,000 with no capital gain on sale by children. The B Trust's carryover basis caused income tax when the B Trust assets were sold.
    5. But the B Trust provided divorce and asset protection for the surviving spouse.
    6. By including the General Power of Appointment provisions in their Wills or Living Trust, H2's B Trust and W2 get both the full step up in basis for all assets in and out of the B Trust and they have divorce and asset protection for the surviving spouse.

## **EXHIBIT 5**

### How a Spouse May Lose Portability

DSUE = Deceased Spouse's Unused Exemption

1. Surviving Spouse does not file a timely Estate Tax Return.
2. Surviving Spouse does file a timely Estate Tax Return, but:
  - a. H1 passes with an Estate value of \$1,000,000 and Exemption \$5,000,000
  - b. H1's DSUE is \$4,000,000
  - c. W marries H2.
  - d. H2 passes with a DSUE of \$0.
  - e. When W passes she has no DSUE to use.
  - f. H1's DSUE is preempted by deceased H2's DSUE.

## **EXHIBIT 6**

### Some Portability Risks & Shortcomings Compared to Using a B (Bypass) Trust

- 1) No portable DSUE if timely estate tax return electing portability is not filed. CYA.
- 2) Surviving spouse may lose the DSUE due to remarriage and passing of second spouse.
- 3) No divorce or asset protection for surviving spouse to protect from second spouse or their family.
- 4) No help in qualifying for Medicaid Nursing Home.
- 5) No protection from guardianship if survivor is incapacitated.
- 6) No running of statute of limitations on valuation of discounted or hard to value assets for the DSUE amount.
- 7) Surviving spouse may not be able to manage assets without help of a trustee.
- 8) Surviving spouse may be susceptible to undue influence from family, friends, second spouse or con artists.
- 9) Not protect appreciation from estate tax when second spouse passes.
- 10) No GST portability.
- 11) No portability for U.S. Residents (green card) who are not U.S. Citizens.
- 12) Estate tax return normally costs more than the B Trust.
- 13) In states with a widow's share (election), a portion of the surviving spouse's estate may pass to his or her subsequent spouse, and the surviving spouse's descendants then lose all or part of their inheritance.
- 14) In states with a state estate tax, a portion of the surviving spouse's estate may be taxed which would not have happened if the B Trust was used.

## EXHIBIT 7

### **Portability Malpractice Risks Practitioners Should Consider**

By Martin M. Shenkman, Esq. and Robert Keebler, CPA

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#### **Introduction**

Portability has been trumpeted by some in the media as one of the most significant estate planning benefits of The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010. Practitioners know otherwise. But knowing is not enough. Portability creates a number of significant malpractice risks which practitioners may be best advised to guard themselves against. While most practitioners have focused on understanding the mechanics of portability, the first estate tax returns for 2011 decedents will be filed October 1, 2011 and the focus needs to shift to compliance and exposure issues. Consider the following potential traps:

#### **Portability Malpractice Risk No. 1 – Not Cautioning Clients About Limitations of Portability**

Most practitioners have dismissed portability as an affirmatively planning option far preferring more tried and true planning. This is because portability does not apply to state estate tax, the GST tax, and does not address post death appreciation. Significantly, portability provides none of the asset protection a properly funded bypass trust will provide clients. However, merely relying on traditional bypass trust planning does not get practitioners out of the malpractice woods. Practitioners should communicate with clients the need to monitor title to assets, continue to use bypass trust and related planning, and not to dismiss estate planning merely because of the potential for using portability.

## **Portability Malpractice Risk No. 2 – Not Filing to Preserve Portability**

An executor can only elect to permit the surviving spouse to use decedent's unused exclusion amount by filing a “timely and complete” Form 706. Practitioners will need to assure that the deadline is not missed, or at least properly extended, so that the election is not inadvertently lost. IRC Sec. 2010(c)(5)(A).

A “complete” return may not be simple or inexpensive:

- Information regarding marital status of decedent should be entered on Part 4 Form 706 - General Information.
- If decedent had more than one marriage the return must provide name and Social Security Number of each former spouse, dates the marriages ended, and how the marriage ended by: annulment, divorce decree, or death of spouse. This data may not be easily available.
- If a prior marriage ended in death and the predeceased spouse died after 2010, the return should indicate on the explanation line whether the executor of the estate of the predeceased spouse elected to allow the decedent to use the deceased spouse’s unused exclusion amount.
- It is not yet clear how the term “completed” will be defined. Might some level of disclosure of assets and corroboration of asset values be necessary to support the validity of the election?

## **Portability Malpractice Risk No. 3 – Not Addressing Executor Vindictiveness**

In a typical blended family children from a prior marriage might receive most assets on the first death. The surviving spouse from a second or later marriage might want to take advantage of portability (or perhaps should even if they don’t understand it).

The children from the prior marriage may choose not to have portability elected out of spite if a return is filed. If the children who are the executors intentionally don’t want portability to apply the practitioner must be proactive to assure that this is the case.

Will this create any exposure for the executor because of his or her fiduciary duty to the surviving spouse? Does the mere status as the one who can benefit from the portability election suffice to create a potential duty even if the surviving spouse is not otherwise a beneficiary? Is it worth the risk? Should executors generally be advised to inform the surviving spouse of the

potential for portability in all cases? If the heirs won't benefit (i.e. the spouse is not an heir) perhaps offering the surviving spouse the opportunity to cover the cost of filing if the return otherwise does not have to be filed may suffice to protect the executor. However, does this create an ongoing liability for the executor since the statute never ends? A typical "Receipt and Release" does not address this exposure.

The statute provides:

*“Examination of Prior Returns After Expiration of Period of Limitations With Respect to Deceased Spousal Unused Exclusion Amount.—Notwithstanding any period of limitation in section 6501, after the time has expired under section 6501 within which a tax may be assessed under chapter 11 or 12 with respect to a deceased spousal unused exclusion amount, the Secretary may examine a return of the deceased spouse to make determinations with respect to such amount for purposes of carrying out this subsection.”*

#### **Portability Malpractice Risk No. 4 – Not Assuring Non-Election**

In some situations the executor may not wish to keep the statute of limitations open on the return, even if it only pertains to the portability issue. How can the executor address the continuing liability of the open statute of limitations? What if the executor cannot justify (or the heirs object) to the costs of properly filing a “complete” return (e.g., the costs of appraisals) and the executor fears the open statute of limitations that might come back to haunt him or her?

If the executor does not want portability to apply several options exist:

- Attach a statement to the Form 706 indicating that the estate is affirmatively not making election under Section 2010(c)(5) to have portability apply.
- Enter “No Election under Section 2010(c)(5)” on top of page 1 Form 706.
- Not filing “timely and complete” Form 706 will prohibit the surviving spouse's use of the decedent's unused exemption. However, if the executor feels strongly about not-electing perhaps one of the affirmative approaches should be used.

If a Form 706 is filed and portability is not intentionally chosen not to apply, it will be default.

### **Portability Malpractice Risk No. 5 – Not Maintaining Adequate Records**

Estate tax returns making the portability election, along with all supporting documentation should be saved indefinitely because of the unlimited statute of limitations. IRC Sec. 2010(c)(5)(B).

The first to die spouse's filing to elect portability keeps the statute of limitations open as to that first spouse's return. Corroboration of asset values may be needed decades later to support the position taken on the first return. Practitioners should give copies of all relevant supporting documents to the appropriate clients and inform them of the obligation to retain those records. Importantly, the executor may not be the person needing these records in the future. Consider the situation of the typical blended family again. A child from the decedent's first marriage may be the executor but the new spouse will be the one to use portability. Does the practitioner have to receive approval or a waiver to provide that spouse with the records the surviving spouse, not the executor will actually need?

The surviving spouse's estate will have to attach the predeceased spouse's Form 706 and a calculation of the unused exclusion amount. Will this return be available?

### **Portability Malpractice Risk No. 6 – DSUEA and Gift Tax Returns**

It may be advisable for practitioners to attach a schedule to any gift tax return listing the source of all prior DSUEAs and their use to assure that the records are available and not lost.

If a client has DSUEA from a prior deceased spouse, should that be used prior to marriage to a new spouse? If the new spouse dies prior to the use of the prior DSUE that prior DSUEA will be lost. Perhaps practitioners should document that they have advised clients with a DSUEA to use it for gift purposes before the new spouse dies.

The statute provides:

*“...deceased spousal unused exclusion amount” means the lesser of— (A) the basic exclusion amount, or (B) the excess of— (i) the basic exclusion amount of the last such deceased spouse of*

*such surviving spouse, over (ii) the amount with respect to which the tentative tax is determined under section 2001(b)(1) on the estate of such deceased spouse.”*

### **Portability Malpractice Risk No. 7 – Not Obtaining Disclosures in Prenuptial Agreements**

If a client is to marry the value of a portable exemption will depend on what actions the new spouse has previously taken with respect to lifetime gifts. Disclosure in a prenuptial agreement, or an acknowledgement that the disclosures are not being pursued may be critical for practitioners to obtain.

### **Portability Malpractice Risk No. 8 – Not Having Sign off of the Desire not to Elect**

If the executor does not wish to elect portability practitioners should consider having the executor, and perhaps others, sign off affirmatively acknowledging that they do not wish to elect portability. To protect the executor it might be advisable to have a receipt and release from the beneficiaries or others who might benefit acknowledging that it is not being elected. This could be problematic if the new spouse is not a beneficiary. Another approach might be to suggest that the estate offer the new spouse, whether or not a beneficiary, the right to pay for the cost of the Form 706 if it is not otherwise required, so that an election may be made.

### **Portability Malpractice Risk No. 9 – Not Having Sufficient Corroboration**

If the executor does not wish to incur the cost of formal appraisals since no tax is due practitioners should consider a warning letter to address the risk of an adjustment in the future on the amount that is portable. For example, if the decedent owned real estate and the estate was only worth approximately \$2 million the executor might be willing to file a return to secure portability but not willing to justify the cost of a MAI appraisal of the real estate. If instead a appraisal from a website or local broker might be used to save costs. Practitioners should consider documenting that they have advised the executor of the potential liability that could occur decades later from such savings.

## Exhibit 8

**Compare two** examples of a \$20 Million (“M”) investment portfolio which compounds income at a 5% internal rate of return in trust for 35 years:

(1) Without the Special Trust, in a regular portfolio, **income is taxable** to the client so it grows to \$57M;

(2) In the portfolio in the Special Trust, **income compounds tax-free** to \$114.6M because the **40% income tax** shifts to the client. The grantor trust creates a \$37.84M tax-free gift to the Trust and an equal amount of “tax burn” which saves \$15.136M of estate tax and \$15.136M of gift tax. It allows the trust to compound tax-free income. This **doubles the wealth** to \$114.6M and **saves an additional \$45.84M estate tax**. Total wealth increased by \$95.872M after paying the tax outside of the trust.

**Goal: Sale & Tax Burn Reduce Client’s Asset Bucket Only to the Exempt Amount For Later Basis Step Up Swap**

**Special Trust Maximizes Tax-Free Transfers and Compounding to Increase Wealth**



Bottom line: Double wealth due to compounding in 35 years. Redouble in 14 years and redouble wealth again and again in approximately every 14 years so wealth grows 200%, 400%, and 800%. The net increase in wealth due to tax-free compounding of income is \$19.76M after paying the income tax outside of the trust. The gift tax saved is \$15.136M, or a total savings of \$34.896M without including the estate tax saved.

If you assume a 10% IRR, wealth doubles approximately every 7½ years. If you assume an 8% IRR, wealth doubles approximately every 9 years.

This illustrates the power of compounding.

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## Exhibit 9

### Additional Techniques for Eligible Clients to Step Up Basis Often by Causing Estate Tax Inclusion

1. A tax independent trustee may distribute low basis assets to the surviving spouse beyond the H.E.M.S. standard.
2. Clayton QTIP Trust or other QTIP Trust.
3. LEPA (Life Estate Power of Appointment) Trust to include assets in the survivor's estate to get a step up in basis.
4. Third party to grant surviving spouse a general power of appointment with a B Trust for low basis assets to cause estate inclusion.
5. Supercharged Credit Shelter Trust<sup>sm</sup> so B Trust becomes a Grantor Trust for income tax purposes for the surviving spouse.
  - a. May sell low basis assets with taxes paid by the surviving spouse to get estate burn.
  - b. May swap low basis assets with surviving spouse for high basis assets in the trust to get step up at the surviving spouse's passing.
  - c. One commentator, Jonathan Blatmacher, thinks the Grantor B Trust will get a step up at surviving spouse's passing.
6. Non-fiduciary power to grant a general power of appointment to surviving spouse which may be exercised arbitrarily.
7. Decant trust so appreciated assets will be in the survivor's estate. Texas law would not allow this if original trust had a HEMS standard. Consider moving Trust situs to a state with a more liberal decanting statute.
8. Late QTIP election if the "B" Trust also qualified as QTIP eligible to cause estate inclusion

9. Swap asset with Grantor Trust of client to trade high basis owed by client for low basis assets in the trust.
10. "Delaware Tax Trap."
11. Transmute separate property into community property in a community property state for spouse who passed first.
12. Gift low basis assets to surviving spouse.
13. Reverse Planning using a Grantor Trust for income tax purposes.
14. Convert a traditional IRA to a Roth if it saves (income and/or transfer) taxes.
15. Buy a Life Insurance Policy and hold it until the insured passes away with no income tax.
16. Equity strip: Incur mortgage debt and invest the funds so long as the debt will be deducted as an administrative expense under §2053 (and if the investment return exceeds the interest rate).
17. For non-community property states, use a special Community Property Trust pursuant to Tennessee, South Dakota, or Alaska law for when the first spouse passes away.
18. Optimize saving of income tax and transfer tax using a double formula GPOA for low basis assets in the "B" Trust.

## EXHIBIT 10

# Wealth Building & Preservation Trust

Designed to be easily used to achieve the following potential benefits<sup>1</sup>

- **Increase wealth and investible assets** since retained trust income and asset appreciation may both compound tax-free at **higher pre-tax rates of return** than at lower after-tax rates.
- Clients may have their cake (**save taxes**) and eat it, too (**control, use, access, and spend** trust assets for their health, education, maintenance, and support (“HEMS”), a tax safe harbor). **Clients benefit first** during their lifetime as **beneficiary and trustee** and may **still save** income tax, estate tax, gift tax, and generation skipping (grandchildren’s) (“GST”) tax.
- May be used to supplement and enhance existing tax, estate, and investment plans. Clients may retain their CPA and investment, insurance, and other advisors.
- A client-friendly trust for cash value and other life insurance due to no gift tax for cash to pay premiums, no estate or GST tax for policy proceeds, no annual notices, no separate accounts, and no client annual ILIT administration. To save tax, include a separate tax independent trustee for policies who the client may replace whenever desired.
- Clients may be able to **lock in now** tax saving bona fide valuation discounts. This opportunity may disappear for families when the next D.C. regime change occurs.
- Clients have transferred businesses, realty projects, entities, and investments to this trust free of tax, which can help them avoid estate tax on those assets and on their appreciation. **Clients retained control and management** of their businesses and other trust assets.
- A valid micro captive insurance company owned by this trust may save significant amounts of business insurance premium costs and income taxes provided by Congress, which increases the cash those micros may invest in publicly traded securities and use for reserves. Estate taxes related to the captive may also be avoided by using this trust. IRS said micro captives are legal but warned about promoters who sell defective captives.
- **Potentially save more than taxes** by protecting the wealth of elders who become vulnerable:
  - After a client’s second or subsequent marriage. The divorce rate is highest for individuals who are age 50 or older; and/or
  - From financial abuse by con artists and dishonest “friends”, relatives, and caregivers. Losses from financial elder abuse are increasing in frequency and magnitude.
  - This trust may provide a better and less stressful alternative to a prenuptial agreement.

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<sup>1</sup> **How much and when a client may benefit depends on their unique facts, goals and choices and then current applicable tax law.** All taxes mentioned herein are U.S. federal taxes. **Past performance is no guarantee of future success.** Some benefits may occur faster than others.

- Help clients avoid an estate tax lien which adds cost and delay to sell estate realty.
- Discretionary trust distributions (approved by a tax independent trustee) may be made tax-free to beneficiaries without reducing clients' tax exemptions, thereby creating room for additional basis step up to save more income tax.
- Allow clients to transfer more to this trust since they may **access**, receive, use, and spend trust assets for themselves for their maintenance and support. The longer clients and their family use this trust, the more they may save and benefit.
- Help families owning a family entity such as an **LLC** or **partnership to avoid** the new expansive interpretation by all Tax Court Judges of IRC §2036(a)(2) which is now being raised in estate tax audits. That interpretation will cause many families with such an entity to pay substantial additional unexpected estate taxes.
- Clients have flexibility to make some, but not all, changes to the trust's provisions if clients later want to do so without losing the trust's non-tax and tax benefits.

Democrats have proposed to increase income tax rates and reduce the estate tax exemption to \$2 or \$3.5 million and to increase estate tax rates up to 77%. That would force more families to pay estate and GST taxes and increase the amounts owed for those taxes. Democrats have also proposed (1) to significantly restrict or eliminate tax savings for families (a) claiming bona fide valuation discounts and (b) from using grantor trusts and dynasty trusts, (2) to increase income and payroll tax rates, and (3) to enact new taxes, including a "wealth tax."

An opportunity exists now to lock in (grandfather) some current and future significant tax savings. This window will likely shrink when there is another D.C. regime change or when **deficits** and the costs to pay for Social Security, Medicaid, and Medicare (which grow faster than our economy) force Congress to raise taxes.

The Wall Street Journal warned that "the most **dangerous** domestic problem facing America's federal government is the rapid growth of its budget **deficit** and national **debt**." (Feldstein, Martin, "The Debt Crisis is Coming Soon", *Wall Street Journal*, 22 March 2019.)

Compare for yourself how much may be saved and the potential return on fee investment by using this trust compared to other tax and estate plans. The time to fix the roof is when the sun is shining.

I have helped clients in many states where I am licensed to practice law. Clients may save time by meeting and consulting with me from their office or home via video and/or audio teleconferencing.

You may contact me by phone or email if you ever have any questions.

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## **EXHIBIT 11**

### **Some Non-Tax Benefits of Life Insurance**

- Balance estate when some family members do not work in the business
- Income replacement for wage earner
- Allows insured and spouse to spend more during lifetime since survivor is provided for
- Provides liquidity to facilitate Buy Sell arrangements
- Liquidity for the business if bank accelerates loans at client's death
- Pay off mortgage or other debt for surviving spouse
- Lender when loans may not otherwise be available (JC Penney)
- An asset class with less risk and volatility
- Fund for special needs of a loved one
- Fund college education for children or grandchildren
- Family Bank Trust for better business asset protection
- Add option to pay for long term care
- Fund a reverse mortgage for the surviving spouse
- Helps clients (especially wives) sleep better

## EXHIBIT 12

### Some Tax Advantages of Life Insurance

- Normally, no income tax on death benefits
- No income tax on cash value income buildup Income earned may be borrowed income tax-free if not an MEC or used to pay premiums
- Beneficiaries may use proceeds to pay (1) income tax on inheritance and (2) the proposed wealth tax if it ever passes or artificially intelligent robots cause unemployment
- Save estate tax with a Life Insurance Trust (ILIT)
- Life insurance loans for tax-free retirement cash
- Pay income tax for Roth conversion of survivor
- Strip out vs. stretch out large IRA to save income and estate tax with an ILIT and no RMDs
- Cover tax increase risks in certain techniques such as GRATs if client passes away during their term
- Fund a charity using income tax deductible premiums
- Obtain deductible premiums in an ESOP for an S corporation to pay the seller for his or her stock

**EXHIBIT 13**

**IRC § 678 and the Beneficiary Deemed Owner Trust (BDOT)**

*Exploiting Opportunities to Simplify and Lessen Income Taxation of Trusts and Improve Asset Protection Through the Use of Targeted Powers of Withdrawal that Shift Taxation to Beneficiaries and Away from Fiduciary Income Tax System*

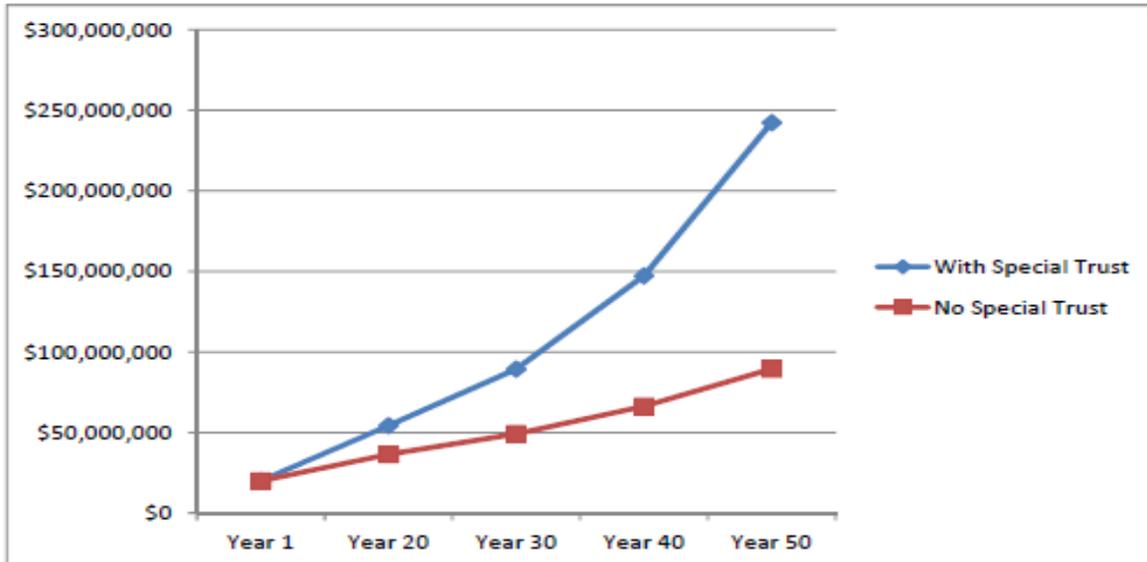
*By Edwin P. Morrow III, J.D., LL.M. (tax)*

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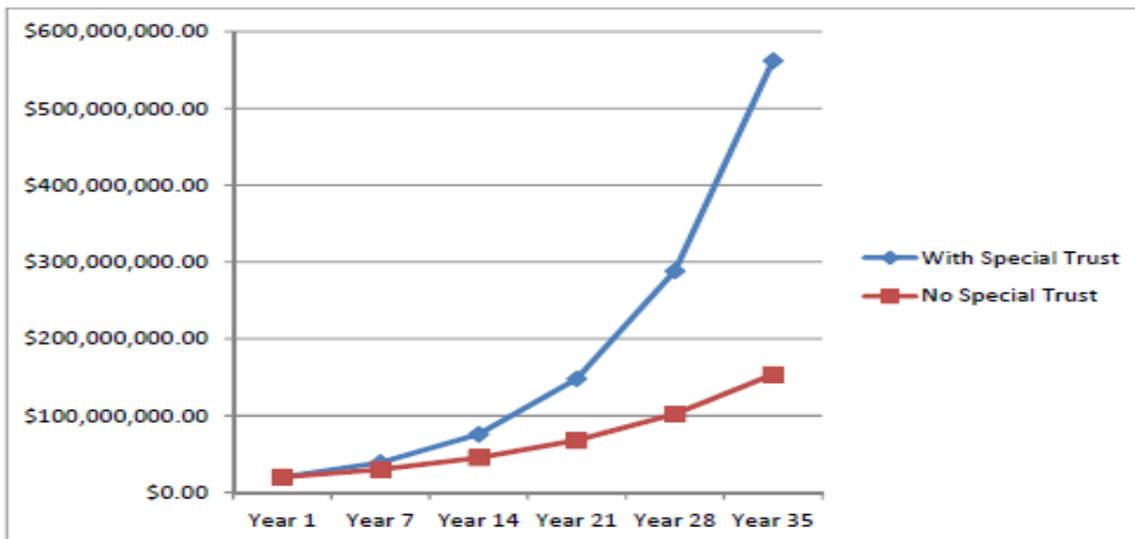
**SEE SEPARATE PDF FILE MARKED AS EXHIBIT 13**

## EXHIBIT 14

**Assuming a 5% Pretax Rate of Return and a 3% After Tax Rate**



**Assuming a 10% Pretax Rate of Return and a 6% After Tax Rate**



- Size Matters**
- IRR
  - Time
  - Beginning Assets

Even though the annual income tax is paid by the client from his or her non-trust bucket (??). The advantages are (1) higher compounded income tax-free and (2) when the income tax is paid, tax burn (??), and (3) a transfer (gift) tax-free gift from the client to his or her trust.