

Tax Reporting Mechanics of Trust Decanting: Tackling Compliance Issues Absent IRS Guidance

TUESDAY, OCTOBER 22, 2019, 1:00-2:50 pm Eastern

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Background on Decanting and IRS Tax Guidance

What is “decanting”?

- The term “decanting” refers to the pouring of a liquid, such as wine, from one container to another.
- “Trust decanting” generally refers to the distribution of property of one trust to another trust pursuant to a trustee’s discretionary power to distribute property to or for the benefit of the trust’s beneficiaries
 - The rationale is that, if a trustee has the discretionary power to distribute property to or for the benefit of one or more beneficiaries, the trustee has, in effect, a special power of appointment that should enable the trustee to distribute property to a second trust for the benefit of one or more of such beneficiaries.

Background on Decanting and IRS Tax Guidance

Common Law Authority

- In *Phipps v. Palm Beach Trust Co.*, 196 So. 299 (Fla. 1940), the Florida Supreme Court held that the trustee of a trust may exercise its discretionary distribution power by making a distribution to another trust for the benefit of the beneficiary rather than directly to the beneficiary.

The Restatement (Second) of Property

- The Restatement (Second) of Property: Donative Transfers §11.1 9 (Comment d) provides that a trustee's ability to transfer trust property is similar to a special power of appointment, under which a trustee can transfer an interest in property equal to or less than the title authorized under the trust instrument.

Background on Decanting and IRS Tax Guidance

Statutory Authority

- New York enacted the first decanting statute in 1992 (NY EPTL §10-6.6(b)).
- Additional states have also enacted decanting statutes, including Alaska (Alaska Stat. §13.36.157 (2008)); Arizona (Arizona Rev. Stat. Ann. §14-10819 (2012)); Delaware (Del. Code Ann. Tit. 12, §3528 (2012)); Florida (Fla. Stat. Ann. §736.04117 (West. Supp. 2008)); Illinois (760 Ill. Comp. Stat. §5/16.4); Indiana (Ind. Code §30-4-3-36 (2010)); Kentucky (Ky. Rev. Stat. Ann. §386.175); Michigan (Mich. Comp. Laws §§556.115a, 700.78201); Minnesota (Minn Stat. §502.851); Missouri (Mo. Rev. Stat. §456.4-419 (2012)); Nevada (Nev. Rev. Stat. 163.556 (2012)); New Hampshire (N.H. Rev. Stat. Ann. §564-B:4-418 (Lexis Nexis Supp. 2009)); North Carolina (N.C. Gen. Stat. §36C-8-816.1 (2011)); Ohio (Ohio Rev. Code §5808.18 (2012)); Rhode Island (R.I. Gen. Laws §18-4-31); South Dakota (S.D. Codified Laws §55-2-15 (2012)); Tennessee (Tenn. Code Ann. §35-15-816(b)(27) (2007)); Texas (Tex. Prop. Code Ann. §§112.071-112.087); Virginia (VA. Code Ann. §64.2-778.1 (2012)); Wisconsin (Wis. Stat. Ann. §701.0418); and Wyoming (Wyo. Stat. Ann. 4-10-816(a)(xxviii), (b)).
- In 2017 through 2019, New Mexico (NM Stat. § 46-12-201 et seq. (2017)) and Colorado (C.R.S. § 15-16-901 et seq. (2017)), Alabama (Ala. Code §19-3D-1 et seq. (2018)), California (Cal. Prob. 19501 et seq. (2018)), and Washington (R.C.W. §11.107.010 et seq. (2018)) have also enacted statutes, with others updating to model law in the Uniform Trust Decanting Act.
- Legislation is pending in Massachusetts (SB 896).

Background on Decanting and IRS Tax Guidance

Non-Tax Reasons to Decant

- Modify administrative provisions
- Deal with changed family circumstances
- Create a special needs trust
- Provide greater asset protection for beneficiaries
- Change the governing law of the trust
- Limit beneficiary rights to information
- Change trustees or successor trustees
- Include trust protectors or other advisors
- Divide or consolidate trusts
- Correct drafting errors or address ambiguities without court involvement
- Alter investment restrictions (e.g., permit lack of diversification)
- Postpone the termination of a trust

Background on Decanting and IRS Tax Guidance

Tax Reasons to Decant

- Convert a grantor trust to a non-grantor trust, or vice versa
- Grant a beneficiary a power of appointment or change a testamentary power of appointment from general to limited, or vice versa
- Take advantage of state income tax laws that apply to a trust
- Stretch individual retirement account distributions
- Qualify a trust to own stock in an “S” corporation

Background on Decanting and IRS Tax Guidance

IRS Tax Guidance

- In 2011, the IRS put decanting transactions on its no private letter ruling list (Rev. Proc. 2011-3) and requested comments on the tax implications of decanting while stating it was studying such implications.
- In 2012, The American College of Trust and Estate Counsel (“ACTEC”) submitted comments to the IRS providing a great detail of analysis on the income, gift and GST tax issues relating to decanting.
- As of 2019, decanting transactions remain on the no private letter ruling list (Rev. Proc. 2019-3), meaning the IRS will not issue rulings on whether decanting in which there is a change in beneficial interests:
 - Is distribution for which a deduction is allowable under IRC §661 or which requires an amount to be included in the gross income of any person under IRC §662.
 - Is a gift under IRC §2501.
 - Causes a loss of GST exempt status or is a taxable termination or taxable distribution under IRC §2612.

Procedure

General considerations and limitations

- The trustee's discretionary distribution authority must be sufficient under the applicable law.
 - The second trust generally may have as beneficiaries only one or more of the beneficiaries of the first trust.
 - Not all of the beneficiaries of the first trust need to be beneficiaries of the second trust.
 - Limitation of distributions to a standard may restrict ability to decant as desired.
- The trustee exercise of a power to decant generally still must comply with the trustee's fiduciary duties and the terms of the trust instrument.
 - Statutes may require a trustee to determine that the distribution to the second trust is “necessary and desirable” after taking into account the terms and purposes of the first trust and the second trust, and the consequences of the distribution.
 - Statutes may limit a trustee's ability to decant to adjust trustee indemnification, exoneration or compensation.
- Statutes may limit a trustee who is also a beneficiary to decant.
- Statutes may require currently exercisable withdrawal rights and fixed interests in property be preserved.

Procedure

Process

- The authority and decision to decant generally should be memorialized in the records of the first trust.
- Statutes may require notice to beneficiaries before the decanting occurs.
- The Uniform Trust Decanting Act (“UTDA”) requires 60 day notice to:
 - Each settlor, other fiduciary, qualified beneficiary and holder of a presently exercisable power of appointment over the first trust
 - Each person who has the right to remove or replace the fiduciary
 - Each fiduciary of the second trust
 - The Attorney General if the first trust contains a determinable charitable interest
- The notice must:
 - Specify the manner in which the authorized fiduciary intends to exercise the decanting power
 - Specify the proposed effective date for exercise of the power
 - Include a copy of the first trust instrument
 - Include a copy of all second trust instruments

Procedure

Process (cont'd)

- Statutes generally do not require beneficiary consent or court approval for the decanting to be effective, but such consent or approval may be permitted and advisable.
- Trustees should also be aware of other notice and reporting requirements that may apply in connection with decanting, such as the duty to keep beneficiaries reasonably informed about the administration of a trust and requirements to inform or report to beneficiaries upon the creation or termination of a trust.

Continuation of Existing v. Creation of a New Trust

Theory of Continuation

- Under a theory of continuation, a decanting does not result in a material change in the underlying trust arrangement. The decanting is in essence a modification of the trust terms within the authorization of the original trust instrument and applicable law.
- As a result, for tax purposes:
 - A new taxpayer identification should not be necessary
 - The GST tax status of the trust should not change
 - A gift is not made
 - There is no taxable event for income tax purposes

Continuation of Existing v. Creation of a New Trust

Theory of Creation

- Under a theory of creation, a decanting results in a new separate trust or requires a second already-existing separate trust. The initial trust is making a distribution or other transaction with the second trust.
- This could be necessitated by the form of the transaction:
 - Property is decanted to an existing, separate trust
 - Less than all of the property of the initial trust is decanted
 - Property is decanted to multiple trusts
 - There are substantive differences between the first and second trust
- As a result, for tax purposes:
 - A new taxpayer identification may be necessary
 - The GST tax status of the second trust needs to be carefully considered
 - The form of the transaction needs to be carefully examined to avoid implication of a gift
 - A taxable event for income tax purposes could occur

Continuation of Existing v. Creation of a New Trust

When is a new TIN necessary?

- As a matter of convenience
- Change from a grantor trust to a non-grantor trust
- Decanting of less than all of the trust property
- Decanting to multiple trusts

Continuation of Existing v. Creation of a New Trust

When may the GST tax status of the trust change?

- Grandfathered (pre-1986) trusts
 - Discretionary distribution safe harbor (Regs. §26.2601-1(b)(4)(i)(A))
 - » Terms of the governing instrument or applicable state law authorized decanting at the time the trust became irrevocable
 - » Terms of the second trust do not violate the rule against perpetuities that apply to the first trust
 - Trust modification safe harbor (Regs. §26.2601-1(b)(4)(i)(D))
 - » No shift of beneficial interest to a lower generation
 - » No extension at the time for vesting of the trust assets
- Non-grandfather zero-inclusion rate trusts
 - Qualified severance rules (IRC §2642(a)(3))
 - Apply grandfathered trust rules by extension

Continuation of Existing v. Creation of a New Trust

When may there be a gift?

- IRC §2512(b): “Where property is transferred for less than an adequate and full consideration in money or money’s worth, then the amount by which the value of the property exceeded the value of the consideration shall be deemed a gift...”
- If the decanting distribution is made 100% in the trustee’s discretion, there should not be a gift.
- Nevertheless, a gift could be implied when:
 - Beneficiary consent is obtained (or required)
 - Trustee is also beneficiary
 - Court approval is obtained (or required)
 - Beneficiary fails to object (when consent may have been necessary)

Gain Recognition Scenarios

Income tax consequences

- In most cases, there should be no income tax consequences associated with the transfer of assets from one trust to another through the process of decanting.
- But careful consideration needs to be given to the following situations:
 - The IRS could take the position that a beneficiary recognizes gain if the decanting materially changes the beneficiary's interest. *Cottage Savings Ass'n. v. Commissioner*, 499 U.S. 554 (1991).
 - Where the decanted property has a liability against it that exceeds its income tax basis (i.e., a "negative basis"), decanting the property could result in recognition of gain. *Crane v. Commissioner*, 331 U.S. 1 (1947) (holding that "amount realized" includes the discharge of recourse and non recourse indebtedness).
 - Decanting of a partnership or limited liability company interest with a negative capital account could be treated the same as another "negative basis" asset.
 - The conversion of a trust from a grantor trust to a non-grantor trust may cause the trustor to recognize gain in relation to "negative basis" assets.

Gain Recognition Scenarios

Income tax consequences – additional considerations

- If the second trust is treated a separate trust, it is important to consider whether the tax attributes of the initial trust are carried forward to the second trust under the distributable net income (“DNI”) rules.
- Decanting a domestic trust to a foreign trust could cause gain recognition under IRC §684.

Changing of Situs

Why would you change a trust's situs?

- State income tax
- Governing law
 - Directed trusts
 - Extended or no perpetuities period
 - Asset protection
 - Ability to limit disclosure requirements
- Administrative efficiency

Changing of Situs

How do you change a trust's situs?

- Appoint fiduciary in new jurisdiction
- Make trust governed by applicable law of new jurisdiction
- Actually administer trust in new jurisdiction
- Review specific laws of connected jurisdictions to address further entanglements

Changing of Situs

Why use decanting?

- Decanting can enable a clean break from the existing jurisdiction and establishment in the new jurisdiction.
- A variety of factors are involved in determining the income tax nexus of a trust:

No Tax	Settlor	Beneficiary	Trustee	Administration	Property
Alaska	Alabama*	Alabama*	Alabama*	Colorado	California
Florida	Arkansas*	California	Arkansas*	Hawaii*	Georgia
Nevada	Connecticut	Delaware*	California	Idaho*	Idaho*
New Hampshire	Delaware*	Georgia	Delaware*	Indiana	Iowa*
South Dakota	Idaho*	Hawaii*	Arizona	Iowa*	Michigan*
Texas	Illinois	Idaho*	Hawaii*	Kansas	New Jersey*
Washington	Louisiana	Massachusetts*	Idaho*	Louisiana	New York*
Wyoming	Maine	Michigan*	Iowa*	Maryland	
	Maryland	Missouri*	Massachusetts*	Mississippi	
	Massachusetts*	North Carolina	Michigan*	Montana	
	Michigan*	North Dakota*	New Jersey*	New Mexico	
	Minnesota	Ohio*	New Mexico	Oregon	
	Missouri*	Rhode Island*	New York*	South Carolina	
	Nebraska	Tennessee	Oregon	Utah	
	New Jersey*			Virginia	
	New York*				
	North Dakota*				
	Ohio*				
	Oklahoma				
	Pennsylvania				
	Rhode Island*				
	Utah				
	Vermont				
	Virginia				
	Washington, D.C.				
	West Virginia				
	Wisconsin				

*Multiple factors considered in determining nexus.

Filing Requirements

GST Tax

- No filing is required if GST tax status does not change.

Filing Requirements

Gift Tax

- No filing is required if no gift.
- A gift tax return (Form 709) may be filed reporting a gift of no value to begin the limitations period.

Filing Requirements

Income Tax - No reporting

- No change in filing if decanting is treated as a continuation of the initial trust.
- A decanting from a grantor trust to a non-grantor trust should not require tax reporting by the grantor absent “negative basis” assets. Following the decanting, income and deductions will be reported by the non-grantor trust.
- The IRS has ruled that the transfer of all the assets from one non-grantor trust to another is ignored for income tax purposes and does not result in a distribution of DNI from the first trust to the second trust, if the substantive terms of the trusts are substantially identical. PLRs 20072314, 200607015, 200527007.

Filing Requirements

Income Tax - Reporting

- If the decanting is not disregarded, the distribution of trust assets from one trust to another should carry out a share of the initial trust's DNI under IRC §661(a).
 - This should not increase aggregate net income
 - It may result in shift of income and deductions among the trusts
- Upon termination, a trust's net-operating loss ("NOL") carryovers and capital loss carryovers pass to the trust's beneficiaries.
 - It is unclear if other tax attributes pass as well via decanting
 - Also, if the initial trust does not terminate, the rules would not apply

Filing Requirements

Income Tax – Gain recognition

- If the decanting results in a material change to a beneficiary's interest, the beneficiary will need to report the gain on the beneficiary's individual returns.
- If a grantor trust transfers "negative basis" assets to a non-grantor trust, the grantor may need to report the gain on the grantor's individual returns.
 - The relief of debt results in gain to the extent it exceeds basis.
 - The transfer of a negative capital account may be treated as relief of debt.
- If a non-grantor trust transfer "negative basis" assets to another non-grantor trust, the initial trust may need to report the gain on the trust returns.