# Improving Existing Irrevocable Trusts: Decanting, Reforming and Other Practical Planning Implications

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# Why All Advisers Should Think About Decanting and Other Options

- CPAs
- Wealth Advisers
- Attorneys are the obvious ones but not the only ones

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# Decanting Overview

- Definition: modifying the terms of a trust by distributing its assets to another trust
- The second trust (receiving trust) can be either new or pre-existing
- Decanting can be authorized by the terms of the original trust, state law, or perhaps even by common law.

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# When Might Decanting be Useful?

1. To protect the tax treatment of a trust

2. To correct a drafting error

3. To clarify potential ambiguities

4. To combine similar trusts to reduce administration costs

5. To divide a trust into two or more separate trusts

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# When Might Decanting be Useful?

6. To lengthen the term of a trust.

7. To change trust situs to take advantage of lower tax rates or more favorable trust law

8. To postpone a distribution from the first trust (e.g. principal to beneficiary at age 40 instead of at age 35)

9. To add powers of appointment (e.g., to create a basis step-up at death)

10. To modify or remove powers of appointment in the first trust

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# When Might Decanting be Useful?

11. To add or remove a spendthrift clause

12. To create a special needs trust

13. To create a trust eligible to hold S corporation stock (e.g., an ESBT or QSST)

14. To modify the investment provisions of the first trust (e.g., authorize the trustee to disregard state diversification requirements)

15. To appoint a trust protector for the receiving trust

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# When Might Decanting be Useful?

16. To convert a grantor trust to a non-grantor trust or vice versa

17. To change provisions for appointing or removing trustees

19. To change beneficiaries (e.g., to stretch out IRA distributions by removing older remote contingent beneficiaries)

20. To reduce a beneficiary's distribution rights to permit a beneficiary to qualify for Medicaid

21. To expand the trustee's decision making authority over principal and income

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# Uses of Decanting

## *Caveats*

- Whether decanting can be used for the applications listed on the previous slides may depend on the applicable state's decanting statute

- Some state decanting statutes are much more favorable than others

- Some of the applications may result in unfavorable tax consequences depending on how the tax issues are resolved by the IRS and the courts

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# 7th Annual Trust Decanting State Rankings Chart – Page 1 of 2

| Rank | State | Has Decanting Statute? (50% weight) | Can Decant Trust with Ascert. Standard? (7.5% weight) | Notice to Beneficiaries Required? (7.5% weight) | Can Decant Trust with Ascertainable Standard into Discretionary Trust? (7.5% weight) | Can Remove Mandatory Income Interest? (5% weight) | Allow Power of Appointment in Second Trust to Non-Bene? (2.5% weight) | Can Accelerate Remainder Bene's Interest? (5% weight) | Dynasty Trust State Ranking (7.5% weight) | Domestic Asset Protection Trust State Ranking (2.5% weight) | Total Score |
|---|---|---|---|---|---|---|---|---|---|---|---|
| 1 | SD | §55-2-15 | Yes | No | Yes | Yes | Yes | Yes | Ranked #1 | Ranked #2 | 99.5 |
| 2 | NV | §163.556 | Yes | No | Yes | Yes | Yes | Yes | Ranked #2 | Ranked #1 | 99 |
| 3 | DE | 12, §3528 | Yes | No | No | Yes | Yes | Yes | Ranked #8 (tie) | Ranked #7 | 88.5 |
| 4 | TN | §35-15-816(b)(27) | Yes | No | Yes | No | Yes | Silent | Ranked #3 | Ranked #5 (tie) | 87.5 |
| 5 | NH | §564-B:4-418 | Yes | No, except charitable trusts | Yes | No | Yes | Silent | Ranked #8 (tie) | Ranked #5 (tie) | 84.5 |
| 6 | OH | §5808.18 | Yes | Yes | No | Yes | Yes | No | Ranked #7 | Ranked #3 | 77.5 |
| 7 | MO | §456.4-419 | Yes | Yes, only to beneficiaries of second trust | No | Yes | Silent | Yes | Ranked #10 (tie) | Ranked #4 | 77 |
| 8 (tie) | AK | §13.36.157-159; §13.36.215 | Yes | Yes | No | No | Yes | No | Ranked #4 | Ranked #8 | 72.5 |
| 8 (tie) | IL | 760 ILCS 5/16.4 | Yes | Yes | No | No | Yes | Silent | Ranked #10 (tie) | Not allowed | 72.5 |
| 10 (tie) | IN | §30-4-3-36 | Yes | Yes | Yes | No | Silent | Silent | Unranked | Not yet ranked | 70 |
| 10 (tie) | SC | §62-7-816A | Yes | Yes | No | Yes | Yes | No | Unranked | Not allowed | 70 |
| 10 (tie) | TX | §§112.071 to 112.087 | Yes | Yes | No | No | Yes | Yes | Unranked | Not allowed | 70 |
| 13 | WY | §4-10-816(a)(xxviii) | Yes | No | Yes | Silent | Silent | Silent | Ranked #5 | Ranked #10 | 69 |
| 14 | RI | §18-4-31 | Yes | Yes | Silent | No | Silent | No | Ranked #6 | Ranked #9 | 66.5 |
| 15 | FL | §736.04117 | Yes | Yes | No | No | Silent | Silent | Ranked #12 | Not allowed | 66 |

https://www.oshins.com/state-rankings-charts

| | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| 16 (tie) | AL | §19-3D | Yes | Yes | No | No | Yes | No | Unranked | Not Allowed | 65 |
| 16 (tie) | CA | §19502 | Yes | Yes | No | No | Yes | No | Unranked | Not Allowed | 65 |
| 16 (tie) | CO | §15-16-901-930 | Yes | Yes | No | No | Yes | No | Unranked | Not allowed | 65 |
| 16 (tie) | GA | §53-12-62 | Yes | Yes | Yes | Silent | Yes | No | Unranked | Not Allowed | 65 |
| 16 (tie) | KY | §386.175 | Yes | Yes | No | No | Yes | No | Unranked | Not allowed | 65 |
| 16 (tie) | NM | §46-12-101-129 | Yes | Yes | No | No | Yes | No | Unranked | Not allowed | 65 |
| 16 (tie) | NC | §36C-8B | Yes | Yes | No | No | Yes | No | Unranked | Not allowed | 65 |
| 16 (tie) | VA | §64.2-779.1-.25 | Yes | Yes | No | No | Yes | No | Unranked | Ranked #NR | 65 |
| 16 (tie) | WA | §11.107 | Yes | Yes | No | No | Yes | No | Unranked | Not allowed | 65 |
| 25 | MI | §700.7820a / §556.115a | No | Yes | No | No | Yes | Silent | Unranked | Ranked #12 | 63 |
| 26 (tie) | AZ | §14-10819 | Yes | No | Yes | No | Silent | Silent | Unranked | Not allowed | 62.5 |
| 26 (tie) | MN | §502.851 | Yes | Yes | No | No | No | No | Unranked | Not allowed | 62.5 |
| 26 (tie) | NY | §10-6.6 | Yes | Yes | No | No | Yes | No | Unranked | Not allowed | 62.5 |
| 26 (tie) | WI | §701.0418 | Yes | Yes | No | No | Silent | No | Unranked | Not allowed | 62.5 |

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# Notice 2011-101

- The tax consequences of decanting are presently unclear

- The IRS is considering ways to address the relevant tax issues and in Notice 2011-101 asked for comments on income, gift, estate and GST tax issues raised by decanting

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# Reformation of Trusts to Correct Unfavorable Tax Consequences

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# Reformation Overview

- Definition: Modifying the terms of a Trust by a court order or Non-Judicial Agreement
- Generally Allowed by State Law or the Trust Instrument

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# General Requirements

- There are three requirements for successfully changing unfavorable tax consequences in a trust--
  - The taxpayer must get a state court to agree to reform the trust
  - The IRS must respect the reformation for tax purposes going forward from the date of the reformation
  - In most cases, the IRS must also respect the reformation retroactively back to the date the trust was created (ab initio)

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# State Court Reformation

- The first step in reforming a trust to correct a trust's unfavorable tax consequences is to obtain a court order
- To do so, the taxpayer's case must fall within one of the grounds for reformation under the applicable state's trust reformation statutes
- Although the state statutes differ, the guiding principle is generally to allow reformations to conform a trust to the settlor's intent
- Common grounds for reformation are mistake and scrivener's error

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# Prospective IRS Recognition of the Reformation for Tax Purposes

- In *Commissioner v. Estate of Bosch*, 387 U.S. 456 (1967), the U.S. Supreme Court addressed the issue of whether a state trial court's characterization of property rights (e.g., a reformation) binds a federal court or the IRS in a federal estate tax controversy. The Court concluded that:

- State law as announced by the highest court of the state is to be followed…[But], If there be no decision by that court then federal authority must apply what it finds to be the state law after giving "proper regard" to relevant rulings of other courts of the State. In this respect, it may be said to be, in effect, sitting as a state court.

- In other words, if the state's highest court hasn't spoken on a matter and IRS doesn't think the reformation should have been granted under applicable state law, the IRS won't respect the reformation.

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# Private Letter Rulings

- The IRS has issued numerous private letter rulings allowing trust reformations for scrivener's error or mistake under the *Bosch* standard when there was a genuine error and such a reformation was permitted under state law
- See, for example, PLRs 201544055, 201436036, 201210008, 201147005, 201132017, 201006023, 201006005, 201002013, 200450033, 200311020, 200201020, 200201017, 200144018, 200123055, 200043036, 200024015, 199936029 and 9805025.

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# Prospective Recognition—IRS Skepticism

- The IRS has been taking the position in several recent PLR requests seeking reformation on the grounds of scrivener's error or mistake that the original trust was drafted just as the settlor intended and was reformed solely to obtain a tax benefit.
- In other words, there was a planning error rather than a drafting error so the IRS could refuse to recognize the reformation under *Bosch*.
- Thus, as a condition for granting a favorable ruling, the IRS has sometimes required contemporary evidence of the grantor's intent, like client presentation materials, memos to the lawyer's or accountant's files, or letters or e-mails to the client.

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# Retroactive Recognition

- Even if a reformation is respected prospectively under *Bosch* it may not be given retroactive effect for federal tax purposes
- Under the general rule, a trust reformation relates back to the date the trust was created (ab initio) for the parties to the trust, but is effective only from the date of the reformation for third parties who have acquired rights under the instrument and were not parties to the reformation. (<u>Sinopoulo v. Jones</u>, 154 F2d 648 (10th Cir. 1946); <u>Loggie v. Thomas</u>, 152 F2d 636 (5th Cir. 1945); 53 Corpus Juris Secundum, Reformation of Instruments, p. 1055, § [233
- These third parties could include the IRS if it acquired a right to tax money under the original trust
- Courts have taken this position in nearly every circuit
- (See, for example, *La Meres,* 98 TC 294 (1991); *American Nurseryman Publishing Co.,* 75 T.C. 271, 275 (1980), aff'd by order, (7th Cir. Nov. 23, 1981); *Harris*, 461 F.2d 554, 556 (5th Cir. 1972), aff'g T.C.M. 1971-172; *Van Den Wymelenberg*, 397 F.2d 443, 445 (7th Cir. 1968); *Emerson Institute*, 356 F.2d 824 (D.C. Cir. 1966), cert. denied , 385 U.S. 822 (1966); *Piel*, 340 F.2d 887 (2d Cir. 1965), aff'g T.C.M. 1963-346; *Sinopoulo v. Jones*, 154 F.2d 648 (10th Cir. 1946); Estate of Hill,, 64 T.C. 867 (1975), aff'd in an unpublished opinion , 568 F.2d 1365 (5th Cir. 1978); *Davis*, 55 T.C. 416, 428 (1970); *M.T. Straight Trust*, 24 T.C. 69 (1955), aff'd, 245 F.2d 327 (8th Cir. 1957); *Van Vlaanderen*, 10 T.C. 706 (1948), aff'd , *175 F.2d 389 (3d Cir. 1949); Daine, 9 T.C. 47 (1947), aff'd , 168 F.2d 449 (2d Cir.1948); Eisenberg,* 5 T.C. 856 (1945), aff'd , 161 F.2d 506 (3d Cir. 1947), cert. denied, 332 U.S. 767 (1947) ).

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# Rationale for Decisions

- The main rationale for these decisions was that the IRS shouldn't be deprived of revenue it has acquired a right to when it wasn't a party to the reformation action.
- In La Meres v. Commissioner, 98 TC 294 (1992), the Tax Court explained the reason for the rule as follows:
- While we will look to local law in order to determine the nature of the interests provided under a trust document, we are not bound to give effect to a local court order which modifies the dispositive provisions of the document after respondent (the IRS) has acquired rights to tax revenues under its terms.
- As the Court of Appeals explained in Van Den Wymelenberg v. United States, Were the law otherwise there would exist considerable opportunity for "collusive" state court actions having the sole purpose of reducing federal tax liabilities.
- Furthermore, federal tax liabilities would remain unsettled for years after their assessment if state courts and private persons were empowered to retroactively affect the tax consequences of completed transactions and completed tax years.

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# No Retroactive Recognition--Exceptions

- (1) The *American Nurseryman* line of cases hasn't been followed in the 9th Circuit

- (2) The IRS was a party to the reformation action

- (3) There was no completed transaction from which the IRS acquired a right to revenue prior to the reformation

- (4) The IRS now appears to take the position that reformations for scrivener's error will be given retroactive effect provided that there is clear and convincing evidence of a mistake in drafting the instrument, rather than a drafting error.

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# 9th Circuit Exception

- In *Flitcroft v. Commissioner*, 328 F.2d 449 (9th Cir. 1964), rev'g. 39 T.C. 52 (1962), taxpayers created trusts that were intended to be irrevocable but failed to include provisions to carry out this intent.
- To remedy the problem, the taxpayer sought a reformation in state court to add the required language and notified the IRS of the proposed action.
- The state court reformed the trust and the 9th Circuit held that the trusts were irrevocable for tax purposes as of the date they were created.
- In so holding, the 9th Circuit reasoned that a state court reformation should be given retroactive effect unless there is collusion and the fact that the taxpayer had given the IRS notice of the proposed reformation was strong evidence that there was no collusion in the case
- Although the IRS doesn't generally follow *Flitcroft*, it acknowledged in that *Flitcroft* was controlling in the 9th Circuit on the retroactive application issue (PLR 8912014).

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# IRS is a Party to the Reformation Action

- The *American Nurseryman* rationale doesn't apply unless the IRS has acquired a right to tax revenue and that right to revenue is taken away in a proceeding to which the IRS isn't a party

- If the reformation is made by a federal court and the IRS is named as a party, there is no bar to retroactive application (*Breakiron v. Guidonis*, 106 AFTR2d 2010-5999 (DC Mass., 8/10/2010)).

- This rule should also apply to a state court reformation

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# No IRS Right to Revenue

- There is a line of cases holding that if a mistake in drafting gives the settlor a right to reform the trust on the ground of mistake, there is no completed transfer and the IRS never acquires a right to collect tax.
- Regulations state that a gift is complete and thereby subject to the gift tax only when the donor has "so parted with dominion and control as to leave him with no power to change its disposition (Reg. § 25.2511-2(b)).
- When the donor can avail himself of the equitable right of reformation, the argument is that the donor hasn't parted with dominion and control because there is an equitable right to change the disposition.
- Thus, where a state court permits reformation on account of mistake, the original transaction remains revocable until there is an order reforming it.

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# No IRS Right to Revenue, Cont'd

- The leading case so holding is Dodge v. United States, 413 F.2d 1239, 1243 (5th Cir.1969).
- A number of Tax Court decisions have followed this reasoning--Holland v. Comm'r, T.C. Memo 1997-302 (1997) Touche v. Comm'r, 58 T.C. 565, 569, (1972); Bergeron v. Comm'r, T.C. Memo 1986-587 (1986)).
- In Berger v. United States, 487 F.Supp. 49, 52 (W.D.Pa.1980), the court held that a mistaken transfer isn't a completed gift because of the equitable right of reformation, stating that "[Berger's] gift into trust was incomplete for mistake, [thus] there can be no transfer tax ..." and, in cases of mistake, "courts have relieved taxpayers of gift tax liability on the ground that there existed a right to reformation under the applicable state law upon the production of requisite proof to the courts to establish the basis for reformation."
- In Breakiron v. Gudonis, the court appeared to view this argument favorably but didn't have to use this rational to hold that a reformation had retroactive effect because the IRS was a party to the reformation.

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# Reformations Specifically Authorized by the Internal Revenue Code

- A reformation that is specifically authorized by the Internal Revenue Code avoids both the  prospective and the retroactive recognition issues.

- The most important example is the reformation of a split interest charitable trust under IRC section 2055(e)

- As the IRS stated in PLR 201021038:

- The IRS will generally treat a state court order as controlling with respect to a reformation if the reformation is specifically authorized by the Internal Revenue Code, such as under section 2055(e)(3) which allows the parties to reform a split interest charitable trust in order that the charitable interest will qualify for the charitable deduction as authorized under that statute.

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# Scrivener's Error

- In recent rulings asking for retroactive reformations based on scrivener's error, the IRS has addressed the *Bosch* issue but not the *American Nurseryman* issue, apparently finding it irrelevant
- See, for example, PLRs 201837009, 201843008, 2018 45029, 201944023.
- Note that a scrivener's error is usually a very specific mistake or omission and doesn't include a general failure to accomplish appropriate tax planning, however
- In *Estate of Kraus v. Commissioner*, 875 F2d 597 (7th Cir. 1988) the 7th Circuit suggested that reformations based on scrivener's error or mistake may be an exception to the general rule that reformations aren't to be given retroactive effect

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# Income Tax Issues Identified by Notice 2011-101

1. Whether the distribution of appreciated assets from one trust to another causes the Distributing Trust to recognize gain under IRC § 1001.

2. Whether decanting from a grantor trust to a non-grantor trust is an income realization event

3. Whether decanting from a non-grantor trust to a grantor trust is an income realization event

4. Whether decanting from a grantor trust to another grantor trust is an income realization event.

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# Income Tax Issues Identified by Notice 2011-101

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

6. Whether the distribution of property from one trust to another should be treated as a distribution for purposes of IRC §§ 661 and 662.

7. Whether the tax attributes of the distributing trust (e.g., NOLs, capital loss carryovers, passive loss carryovers) are passed on to the receiving trust

8. Whether a decanting power in a QSST causes loss of QSST status.

9. Whether decanting changes the grantor of a trust.

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# Gift & Estate Tax Issues Identified by Notice 2011-101

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

2. Whether a beneficiary whose interests are diminished as a result of a decanting has made a transfer for estate tax purposes.

3. Whether a decanting power can cause a trust to lose its marital or charitable deduction.

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# GST Tax Issues
# Identified by Notice 2011-101

1. Whether a decanting causes a grandfathered GST trust to lose its GST protection

2. Whether a decanting causes a trust that is exempt from the GSTT by reason of allocating GSTT exemption amount loses its exempt status.

3. Whether decanted trust property that has an inclusion ratio between 0 and 1 in the distributing trust will have the same inclusion ratio in the Receiving Trust.

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

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# Income Tax Impacts of Decanting

## *General Principles*

- The basic rule under IRC § 1001 is that a taxpayer only realizes gain or loss when the taxpayer:
  - (a) sells or disposes of property
  - (b) in exchange for property that is materially different (Reg. § 1.1001-1(a)

  - Under *Cottage Savings*, 499 US 504 (1991), property is materially different if its owners have legal entitlements that differ in kind or extent

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# Income Tax Impacts of Decanting

## *General Principles*

- Several PLRs seem to indicate the Service does not consider the separation of a trust into multiple trusts by reformation a realization event under IRC § 1001.
  - PLR 201536010 – The Service determined judicial severance of a marital trusts into two trusts on a non-pro rata basis would not cause a recognition event for the trusts or beneficiaries.
  - PLRs 201442042-6: In five identical rulings (apparently to parties of the same transaction) determined that a retroactive reformation to correct a "scrivener's error" (rev. trust instead of irrev. Trust) would not incur federal taxation inconsistent with the settlor's intent.

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# Application to Decanting

- Decanting generally doesn't result in a realization event for the distributing trust if the decanting is authorized (1) by the trust's governing instrument or (2) under state law (Reg. § 1.1001-1(h); PLR 200743022)
  - The rationale is that there is no change in the quality of the beneficiaries' interests so the new property isn't materially different
- If the decanting is non-pro rata, the governing instrument or state law must authorize decanting on a non-pro rata basis (PLR 200810019)
- Decanting could be a taxable exchange if it is not authorized by the governing instrument or applicable state law, however (Rev. Rul. 69-486)

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# Gain Recognition by Trust

## *Exceptions*

- Gain recognized on transfer of negative basis assets
  - LLC or partnership interests with a negative capital account (IRC § 752(d))
  - Adding a power of appointment might result in an exchange for materially different assets, triggering gain recognition under *Crane*.

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# Special Case—Decanting from a Grantor Trust to a Non-Grantor Trust

- When grantor trust status terminates during the grantor's life, the grantor is deemed to realize an amount equal to any liabilities held as part of the trust property.
  - *Madorin v. Comm'r.*, 84 T.C. 667 (1985);
  - Reg. § 1.1001-2(c), Example (5);
  - Revenue Ruling 77-402.
- If there are no liabilities there should be no gain recognition

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# Special Case—Decanting from a Non-Grantor Trust to a Grantor Trust

- There is generally no deemed transfer and no income recognition on a decanting from a non-grantor trust to a grantor trust
  - Chief Counsel Advice (CCA) 200923034

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# Special Case—Decanting from One Grantor Trust to another Grantor Trust

- Such a decanting raises no income tax issues provided the receiving trust is taxed to the same settlor as the original trust.
- No recognition event can occur because the owner for federal income tax purposes never changes.
- *See* Rev. Rul. 85-13.

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# Gain Recognition by Beneficiaries

- Probably no gain recognition if the decanting is authorized by the governing instrument or state law (Reg. § 1.1001-1(h))
- IRS may argue that there is gain recognition if there is a material change in a beneficiary's interest
- IRS may also argue that switching from an income or annuity interest to a unitrust interest triggers gain recognition
  - Reg. 1.643(b)-1 provides a switch between methods of determining trust income not specifically authorized by state statute may constitute a recognition event to the trust or its beneficiaries.
  - PLR 200231011—switch from an annuity payments to unitrust payments triggered gain recognition

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# Income Tax Impact

## *Decanting DNI*

- Decanting could be considered a continuation or modification of an existing trust
- Little effect on distributing trust's income tax in either case
  - Continuation
    - The distributing trust and the receiving trust are treated as the same trust for income tax purposes
    - Decanting does not carry out DNI (PLRs 200527007, 200607015, 200723014)
  - Modification
    - The transfer of assets merely carries out the distributing trust's DNI resulting in income to the receiving trust under IRC §662(a)
    - Corresponding distribution deduction for the distributing trust under IRC § 661(a)

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# Effect on Tax Attributes

- The Code and Regulations specifically provide that if a trust is terminated, its unused NOL and capital loss carryovers pass on to the trust's beneficiaries (in this case, the receiving trust).
  - IRC § 642(h); Reg. § 1.642(h)-3(d)

- There is no specific authority on whether beneficiaries succeed to a terminated trust's other tax attributes
  - If the second trust has similar terms and is treated as a continuation of the first trust, there should be carryover (PLR 200607015
  - Even if there are significant differences, the tax attributes should carry over under general tax principles (see, e.g., IRC § 381)

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# Change in Grantor

- Reg. § 1.671-2 provides that that if a trustee transfers property from one trust to another, the grantor of the receiving trust generally remains the same as the grantor of the original trust.

- The only exception appears to be a situation in which the distribution to the receiving trust is pursuant to a power of appointment, in which case the power holder is treated as the transferor

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# QSST

- One of the requirements for a QSST is that it have only one income beneficiary (IRC § 1361(d)(3))

- Decanting is generally allowed only pursuant to a trustee's power to invade corpus of the distributing trust

- The trustee of a QSST could invade corpus only for the benefit of the single income beneficiary

- Thus, a distributing trust that was a QSST could only be decanted to a Receiving Trust for the exclusive benefit of the income beneficiary of the Distributing Trust, avoiding any violation of the QSST qualification requirements.

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# Gift Tax Impacts

*Does decanting trigger gift tax for a beneficiary?*

- Reg. § 25.2512-8 suggests that when a beneficiary consents to or acquiesces in a decanting that reduces the beneficiary's interest, the beneficiary has made a taxable gift

- This conclusion is consistent with Revenue Ruling 81-264, which holds that a taxable gift can occur when a taxpayer allows legal rights to expire

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# Gift Tax Impacts

## *Does Decanting Trigger Gift Tax for a Beneficiary?*

- On the other hand, Regulations §§ 25.2511-1(a) and 25.2511-2(a) require a voluntary act of transfer to have a taxable gift.
- Thus, a taxable gift should occur only if the beneficiary has a legal right to object to the exercise of authority to decant.
- Under the law of most states, beneficiaries would have no such right, so generally there should be no gift
- The IRS so far refuses to rule on whether gift tax is incurred in such a circumstance. *See* Rev. Proc. 2013-3, 2013-1 I.R.B. 113, §5.01(23).

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# Gift Tax Impacts

## *Does Decanting Trigger Gift Tax for a Trustee/Beneficiary?*

- If the trustee has absolute discretion to distribute to herself, she would be treated as having a general power of appointment under IRC §§ 2514 and 2041

- If decanting reduces a trustee/beneficiary's presently exercisable general power of appointment it could cause the beneficiary to incur gift tax. IRC §2514(b), (e); Regs. §25.2514-3(a), (c)(4).

- If the beneficiary's general power of appointment is not presently exercisable, however, it should not cause a taxable gift under IRC 2514.

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# Gift Tax Impacts

## *Does Decanting Trigger Gift Tax for a Trustee/Beneficiary?*

- A trustee or beneficiary might also make a taxable gift even if he or she only has the power to make distributions to others (Reg. § 25.2511-1(g)(2))

- There should be no taxable gift, however, if distributions by the trustee/beneficiary are subject to an ascertainable standard

- However, there are PLRs that arguably suggest otherwise. See, e.g., PLR 8905035, PLR 8535020, PLR 201122007, PLR 9451049, PLR 200243026

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# Gift and Estate Tax Impacts

*Effect on Marital and Charitable Deductions*

- Decanting could result in loss of a marital or charitable deduction
- But most state statutes prohibit decanting if it would have either of these results

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# Estate Tax Impacts

- Decanting could result in estate inclusion if a beneficiary was deemed to make a gift but the gift was incomplete (e.g., because of a limited power of appointment)
  - If power not exercised during life, the gift would be completed at death and the property included in the gross estate under IRC § 2036(a)(2) or 2038
- If decanting would cause a beneficiary to make a taxable gift, but the beneficiary retained a lifetime power over the transferred property, there might be estate inclusion under IRC §2035, 2036, 2037, 2038, 2039 or 2042.

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# GST Tax Impacts

## *Loss of Exempt Status*

- A trust can be GST exempt either because it is a pre-September 25, 1985 grandfathered trust or because it allocates sufficient GST exemption to the trust.

- Regulations provide that a <u>grandfathered</u> GST exempt trust retains its exempt status following a decanting if it qualifies under one of the following safe harbors—
  - Discretionary distribution safe harbor(Reg. § 26.2601-1(b)(4)(i)(A)
  - Trust modification safe harbor (Reg. § 26-2601-1(b)(4)(i)(D))

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# GST Tax Impacts

## *Discretionary Distribution Safe Harbor*

- When the trust became irrevocable, either the terms of the trust instrument or local law (i.e., common law or state statute) authorizes the trustee to make distributions to a new trust
- neither beneficiary consent nor court approval is required for the decanting; and
- the new trust will not suspend or delay the vesting of an interest in trust beyond the federal perpetuities period.

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# GST Tax Impact

## *Trust Modification Safe Harbor*

- The modification doesn't shift a beneficial interest in the trust to a beneficiary occupying a lower generation than the person holding the interest under the original trust; and

- doesn't extend the time for vesting of any beneficial interest in the trust beyond the period provided in the original trust.

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# GST Tax Impact

## *Exemption Allocated to Trust*

- No guidance has been issued on when decanting from a trust exempt from the GST because of exemption allocation loses its exempt status

- The IRS has suggested in rulings, however, that the same two safe harbor tests should apply (PLRS 201134017, 200839025

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# GST Tax Impacts

## *Inclusion Ratio*

- No law directly on point

- It appears that the receiving trust should have the same zero inclusion ratio as the transferor trusts under IRC §2654(b) provided that the receiving trust doesn't extend the time for vesting or shift beneficial interests to a lower generation (PLRs 201134017 and 200839025

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# GST Tax Impacts

## *Change in Transferor?*

- For GSTT purposes, IRC § 2652(a) defines the transferor as
  - (a) in the case of a transfer subject to estate tax, the decedent and
  - (b) in the case of a transfer subject to gift tax, the donor.
- Reg. § 26.2652-1(a) similarly provides that the individual with respect to whom property was most recently subject to gift or estate tax is the transferor for GST tax purposes.
- Thus, if a decanting is subject to gift or estate tax, the transferor can change for GSTT purposes
- Loss of grandfathered status does not change the transferor for GSTT purposes (PLR 9522032).
  - The same rule should apply for loss of exempt status by a trust that is exempt by reason of allocating GST exemption amount

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# Statutory Reformation of CRTs

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# Overview

- Section 2055(e) provides a special statutory process for reforming defective CRTs
- General requirements—
  - The lead interest in the trust must be a reformable interest (IRC section 2055(e)(3)(C))
  - The reformable interest must be converted into a qualified interest (2055(e)(3)(B)
    - A qualified interest is one that meets the requirements for a CRT under section 664 and passes three tests to be discussed later (2055(e)(3)(D))
- There can also be statutory reformations of inter vivos trusts to obtain a charitable deduction
  - Rules similar to the rules of 2055(e) apply (2522(c)(4))

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# Reformable Interest

- The first requirement for a reformable interest is that the trust must be in a form that would have qualified for a charitable deduction under section 2055(a) before enactment of the Tax Reform Act of 1969 (TRA 1969)
- Prior to TRA 1969, a charitable interest in a trust was generally deductible if it was ascertainable and, hence, severable from the non-charitable interests.
- For example, the present value of the charitable remainder interest was deductible in a trust that paid income to a non-charitable lead beneficiary (Reg. section 20.2055-2(a))
- Because the value of an income interest could be manipulated, TRA 1969 amended section 2055 to require that the non-charitable interest must be in the form of an annuity or unitrust interest that meets the requirements of section 664 (2055(e)(3)(c)(i) and 2055(a)(2))
- Thus, the reformation provisions of section 2055(e) can only be used to correct defects relating to the new split interest trust rules created by TRA 1969

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# Reformable Interest, Cont'd

- To qualify as a reformable interest, one of the following must apply--
  - The interest to be reformed must be an annuity or a unitrust interest, or
  - If the interest to be reformed isn't an annuity or unitrust interest, the judicial proceeding to reform the trust must begin within 90 days after the due date of the estate tax return (including extensions) or, if no estate tax return is required, the due date of the trust's first income tax return (2055(e)(3)(C))
- In either case, the original trust must be in a form that would have qualified for a charitable deduction under 2055(a) prior to TRA 1969

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# Non-Charitable Interest is an Annuity or Unitrust Interest

- If the non-charitable interest is an annuity or unitrust interest there is no time limit for beginning the reformation process
- The rationale for this rule is that structuring the interest in this way in the original trust showed an intent to comply with the requirements of section 664
- Thus, a trust with an annuity or unitrust interest can be reformed even if the reformation is started long after the trust was created
- This is true even if the defects were discovered in an IRS audit (*Hall*, 93 TC 745 (1989))

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# Non-Charitable Interest Isn't an Annuity or Unitrust Interest

- In enacting the new split interest trust rules under TRA 1969, Congress was concerned that taxpayers who never intended to comply with the new rules would only seek to reform a defective trust if they were caught on audit by the IRS

- The 90-day rules were designed to prevent this perceived abuse

- The trust would generally be reformed before the IRS had a chance to do an audit

- Expressing the non-charitable interest as an annuity or unitrust interest showed an intent to comply with the new rules, however, so the 90 day rule wasn't necessary

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# Qualified Interest

- A qualified interest is one that meets the requirements for a CRT under section 664 and passes three tests: (1) an actuarial test; (2) an equal duration test; and (3) an effective date test (2055(e)(3)(B)).

  - Actuarial Value Test: The actuarial value of the reformed charitable interest can't vary from the actuarial value of the reformable charitable interest by more than 5% (2055(e)(3)(B)(i))

  - Equal Duration Test: The non-charitable interests must terminate at the same time before and after the reformation (2055(e)(3)(B)(ii))
    - Exception—A term interest of more than 20 years can be reduced to 20 to meet the section 664 term limitation (2055(e)(3)(B) flush language)

  - Effective Date Test: The reformation must be retroactive to the date of the decedent's death for a testamentary trust or, in the case of an inter vivos trust, to the date of creation of the trust (2055(e)(3)(B)(iii)

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# Special Rules

- Special rules are provided for the following—
  - The amount of the charitable deduction for the reformed trust
  - The statute of limitations for assessment of deficiencies following a reformation
  - The tax consequences if all non-charitable interests terminate
  - Trusts failing the 10% minimum remainder interest test

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# Amount of Charitable Deduction for Reformed Trust

- If a trust is successfully reformed, the charitable deduction is the lesser of--
  - (1) the actuarial value of the charitable interest after the reformation, or
  - (2) The amount of the actuarial value prior to the reformation for which a deduction would have been allowable but for the fact that the charitable interest was not in a qualified charitable annuity trust, charitable unitrust, or pooled income (170(f)(7), 2055(e)(3)(E) and 2522(c)(4))

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# Statute of Limitations Following Reformation

- The statute of limitations for assessing  a deficiency on a reformed interest can't expire before the date that is one year after the date on which the IRS is notified that the reformation has occurred (2055(e)(3)(G))

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# All Non-Charitable Interests Terminate

- If an interest in a charitable trust is reformable and all noncharitable interests terminate by the due date (including extensions) of the estate tax return (e.g., because the lead beneficiary dies), no reformation proceeding is necessary

- A deduction is allowed for the reformable interest as if it had met the split interest requirements (2055(e)3)(F))

- In other words, a charitable deduction is allowed even if the trust hasn't been reformed to meet the requirements of section 664

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# Failure to Meet 10% Minimum Remainder Test

- If a CRT fails the to meet the 10% minimum remainder value test, the trust can either be declared void ab initio or reformed by reducing the payout rate and/or the duration of the non-charitable interest to meet the 10% requirement (2055(e)(3)(J))

- The proceeding to reform or void the trust must begin within 90 days after the due date of the estate tax return (including extensions) or, if no estate tax return is required, the due date of the trust's first income tax return

- If the trust is declared null and void no charitable deduction is allowed

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# Disclaimer as an Alternative to Reformation

- In some cases, a qualified disclaimer under section 2518 may be used to eliminate provisions that prevent a trust from qualifying as a CRT
- For example, a non-charitable beneficiary could disclaim a portion of the annuity or unitrust amount necessary to make the trust qualify under section 664.
- In PLR 93411003, the non-charitable beneficiary of a CRT disclaimed her interest in discretionary principal distributions that would have prevented CRT qualification
- Some CRT qualifications can't be fixed with a disclaimer, however
- For example, if a trust gives a non-charitable beneficiary an income interest instead of an annuity or unitrust interest, a disclaimer wouldn't help.

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# IRS Recognition of the Reformation

- As explained earlier, the IRS won't necessarily recognize a state court reformation

- It may refuse to respect the reformation going forward (*Bosch*) or refuse to give it retroactive effect (*American Nurseryman, Straight Trust*, etc).

- However, reforming a trust under the statutory authority of 2055(e)(3) avoids both the prospective and retroactive recognition issues.

- As the IRS stated in PLR 201021038:

- The IRS will generally treat a state court order as controlling with respect to a reformation if the reformation is specifically authorized by the Internal Revenue Code, such as under section 2055(e)(3) which allows the parties to reform a split interest charitable trust in order that the charitable interest will qualify for the charitable deduction as authorized under that statute.

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# The End

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