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 the Fiduciary Income Tax System[1]

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Appendix: 50 State Chart on Creditor Protection for Powers of Withdrawal/Lapse

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.[2] 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. Settlors 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.[3]

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

[2] 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.

[3] 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.

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.

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 their access, 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 ramifications 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**

This paper will primarily address how §678 operates when 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.[4] Thus, the only grantor trust provision that could apply to a trust after 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). IRC §678 could equally apply to an intervivos trust if all grantor trust triggering powers, rights and dealings (such as borrowing) were released and/or otherwise eliminated during the settlor's lifetime. For most of this paper, it is assumed 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.[5] 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.[6] Unfortunately, such a trust usually offers the same asset protection benefits as a revocable trust – close to ***none***![7] This is why QTIPs are the more commonly used version of marital trust, especially for blended families.

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[4] Rev. Rul. 75-267, Rev. Rul. 57-51, Treas. Reg. §1.671-4(h).

[5] IRC §2056(b)(5).

[6] 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.

[7] This is discussed in more detail in sections II.g-i on the asset protection effect of presently exercisable general powers of appointment and their lapses. While there are states that protect such assets, applicability would be uncertain 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 the various states' lapse provisions/protections in the accompanying chart.

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). If this power were allowed to lapse, the taxation thereafter is less clear, as well be discussed later herein.

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.[8] Releasing such a power without retaining any power that would make the gift incomplete would cause a taxable gift.[9] 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.[10]

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 often 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 "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.

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, whereas *testamentary* powers would *not* in the vast majority of states. See, *Uniform Probate Code* § 2-205(1)(A).

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.

[8] 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).

[9] IRC §2514(b).

[10] 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. By "taxable income" herein I am using a shorthand to mean both taxable income attributable to accounting income and taxable income attributable to principal (corpus), which is usually capital gains, rather than any defined term under IRC §63, §643 or otherwise.

If the right to withdraw is only exercisable with the required consent of a trustee or any other party such as a committee, it would not be exercisable "solely by himself". That said, there are some outlier cases where trustee/beneficiaries have been deemed to own income where they are either trustee with de facto power over income and/or have the same power under a reciprocal structure.[11] These are not reliable cases to base a plan on, however.

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.[12]

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[11] *United Food & Commercial Workers Unions v. Magruder Holdings, Inc.*, Case No.: GJH-16-2903 (D. Md. Mar. 27, 2019), in which a district court held that various trusts that granted the beneficiaries (who were also trustees) a power to withdraw income and principal, *even though limited to ascertainable standards*, still triggered IRC Section 678 and were therefore grantor trusts as to those beneficiaries (beneficiary deemed owner trusts), because those limitations were ignored in practice.
In a similar older pre-§678 case, *Flato v. Commissioner of Internal Revenue*, 195 F.2d 580 (5th Cir. 1952), siblings were cross-trustees of each other's irrevocable trust, with the power to distribute income – the tax court found and circuit court agreed that "although the distributions of trust income were to be made at the `discretion' of the trustees, the intention of the grantors was that the beneficiaries could have what they wanted of the trust income", therefore they "could have what they wanted of the trust income" and that they "requested and got such amounts of trust income as they desired" and, since the beneficiaries possessed such command over the distribution of the income of the trusts, such income, whether distributed or not, is taxable to them." While interesting, these cases cannot be relied on proactively for planning purposes.

[12] 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

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.[13]

It is easy to ignore or misinterpret the "power ***to vest*** the income" portion of §678(a)(1). There are many cases, PLRs and articles about withdrawal powers over corpus, yet very few articles about a power of withdrawal only over income. 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

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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. A division between accounting income and other income is also possible for grantor trusts under Sections 671-677, see e.g., *Glenn E. Edgar v. Comm.*, 56 TC 717, 07/08/1971, where grantor taxed only on ordinary income, was denied use of trust capital loss.

[13] 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 fail to trigger §678. 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.howardmobley.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 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 the application of §678(a).

the seminal case upon which the statute was based had no right to withdraw underlying principal.[14]

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"?

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 purposes**."[15] [emphasis added] [note: §678 is in Subpart E and of course Treas. Reg. §1.678(a)-1 is part of regulations under subpart E, both of which refer to *income* without any further modifier and therefore refer to any income determined for tax purposes (e.g. incl. capital gains), not to income for trust accounting purposes.][16]

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[14] *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*.

[15] 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…"

[16] 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."

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.[17] This is the source of significant confusion among practitioners.[18]

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[17] 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.***"

[18] 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 and inescapable, 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 "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

If "income" in subpart E grantor trust rules only referred to accounting income, it would open up tremendous room for abuse and some examples in the regulations even under other grantor trust code sections would make no sense.[19] Not only do the regulations clearly treat "income" for IRC §677(a) as including capital gains, but revenue rulings do as well.[20]

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),

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income attributable to corpus – if it does, whether through a power over accounting income, income attributable to corpus or both, then §678(b) says that §671-677 controls.

[19] E.g., IRC §677 provides that:

> "(a)General rule The grantor shall be treated as the owner of any portion of a trust, whether or not he is treated as such owner under section 674, **whose income** without the approval or consent of any adverse party is, or, in the discretion of the grantor or a nonadverse party, or both, may be—
> (1)distributed to the grantor or the grantor's spouse;
> (2)held or accumulated for future distribution to the grantor or the grantor's spouse; or***"

Treas. Reg. §1.677(a)-1(g), Example 2, is clear that "income" in subpart E does not refer to just accounting income but **must** include capital gains and other income allocable to corpus:

"Example 2. G creates a trust which provides that the ordinary income is payable to his adult son. Ten years and one day from the date of transfer or on the death of his son, whichever is earlier, corpus is to revert to G. In addition, G retains a discretionary right to receive $5,000 of ordinary income each year. (Absent the exercise of this right all the ordinary income is to be distributed to his son.) G retained no other right or power which would cause him to be treated as an owner under subpart E (section 671 and following). Under the terms of the trust instrument and applicable local law capital gains must be applied to corpus. During the taxable year 1970 the trust had the following items of income and deductions:

Dividends: $10,000
Capital gain: $2,000
Expenses allocable to income: $400
Expenses allocable to corpus: $200

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.*)***"*

Obviously, the regulation assumes that "income" for §677(a) *includes any capital gains*.

[20] See, e.g., Rev. Rul. 66-161: "Section 1.677(a)-1(f) of the Income Tax Regulations provides, in part, that if **income** is accumulated in any taxable year for future distribution to the grantor, section 677(a)(2) of the Code treats the grantor as an owner for that taxable year. Thus, if **income (including capital gains)** of a trust is to be accumulated for ten years and then will be, or at the discretion of the grantor may be, distributed to the grantor, the grantor is treated as the owner of the trust from its inception. ***

Since the terms of the trust indenture provide that capital gains are to be added to corpus which is to revert to the grantor, **the grantor is treated as the owner under section 677(a) of the Code of that portion of the trust to which the capital gains are attributable**."

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.[21]

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.[22]

But a trust could easily define the withdrawal right to include all income subject to taxation 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 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.[23] 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.[24]

Failing to take the withdrawable income is not relevant to the §678 analysis, nor is renouncing the right to prior income (usually).[25] Such a power has even been ruled effective

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[21] See Uniform Principal and Income Act, §409, §404.

[22] 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.

[23] For example, in *U.S. v. De Bonchamps*, 278 F.2d 127 (9th 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 is even clearer in the *Campbell* case discussed later herein.

[24] 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.

[25] *Grant v. Commissioner*, 174 F.2d 891 (5th 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

when held by a minor even where there was no court-appointed guardian with authority to exercise it.[26]

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.[27] 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.[28] For trusts that are partial grantor, partial non-grantor trusts (e.g., five and five power trusts), the analysis might be more complicated.[29]

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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 became aware of her withdrawal power after W's death.

[26] Rev. Rul. 67-241. 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 (9th Cir. 1970). IRC §678(a) is similar – also 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 (7th 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.

[27] Rev. Rul. 67-241.

[28] Treas. Reg. §1.671-2(e)(2)(ii).

[29] 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.

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.[30] The son's wife was to get $10,000/yr, and the son could withdraw any income above that. The son was a co-trustee and could distribute corpus to himself, but only with the consent of the other corporate trustee. The trustees 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:

> [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

[30] *Mallinckrodt v. Nunan*, 2 T.C. 1128 (T.C. 1943), *aff'd* 146 F.2d 1 (8th Cir. 1945). The legislative history of section 678 indicates Congress' intent to implement the principles of *Mallinckrodt*. H.R. Rep. No. 1337, 83rd Cong., 2d Sess. 63 (1954). 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 (8th 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 have been 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). Consider this quote from another pre-§678 case:

> "It is well established, of course, that where income is subject to one's unfettered command and he is free to enjoy it at his own option, he may be taxed on such income whether he elects to enjoy it or not. *Corliss v. Bowers*, 281 U.S. 376, 50 S.Ct. 336, 74 L.Ed. 916. This principle is not limited to the grantor of a trust, but is equally applicable to the beneficiary of a trust. *Bunting v. Commissioner of Internal Revenue*, 6 Cir., 164 F.2d 443; *Grant v. Commissioner of Internal Revenue*, 5 Cir., 174 F.2d 891. The incidence of taxation may not be avoided by mere "legal paraphernalia which inventive genius may construct", *Helvering v. Clifford*, 309 U.S. 331, 60 S.Ct. 554, 556, 84 L.Ed. 788, but the Court must look to the "whole nexus of relations between the settlor, the trustee and the beneficiary", *Helvering v. Elias*, 2 Cir., 122 F.2d 171, 172, and if it concludes that in spite of the form resorted to in effecting a transaction, the results thereof give the beneficiary command over the distribution of the income of a trust, such income is taxable to the beneficiary." *Flato v. Comm.*, 195 F.2d 580, 582 (5th Cir. 1952).

> 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."[31]

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 unilaterally 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."[32]

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), petitioners are deemed to be *the owners of the capital gains income* from the King Trusts."[33]

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,

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[31] *Mallinckrodt, 146 F.2d 1,* 5.

[32] *Campbell v. Commissioner*, T.C. Memo 1979-495, affirmed by unpublished court order, (8th Cir. 9/29/1980)

[33] *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.

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:[34] 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.[35] 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.[36] 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."[37]

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[34] 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).

[35] PLR 2016-33021.

[36] 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).

[37] *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 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, it is my opinion that Trust #2 should 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

Note that, just 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*.

Older PLRs are similar.[38] In three similar PLRs, the son of settlor had the unfettered right to withdraw "any portion of the income of the Trust Estate as [Taxpayer], acting alone, shall direct. The right to withdraw income under this [section of Trust] shall be noncumulative and shall lapse as to each taxable year on the last day of the taxable year to which the right of withdrawal applies." While these PLRs did not describe or discuss how "income" was defined in the document, it seems probable that this meant only accounting income, hence the IRS ruled that: "Based solely on the facts and representations submitted, we conclude that Taxpayer is the owner of ***the income portion*** of Subtrust A under §§ 671 and 678 for the first x taxable years of Trust's existence." (i.e. probably *not* the owner of the income attributable to corpus, such as 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."[39] Thus, a beneficiary can be deemed the owner for income tax purposes of the accounting income, as in the *Goldsby* case *and PLRs 2010-38004-2010-38006*, 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, except for the $10,000 attributed to spouse*).[40] None of

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attributed to Trust #1 along with its income and deductions, since a distribution may be a deduction under IRC §661.

[38] PLRs 2010-38004, 2010-38005, 2010-38006.

[39] Treas. Reg. 1.672-3(b).

[40] 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 (accounting) 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.

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."[41]

Simple Example of Application of a "See Through" Beneficiary Deemed Owner Trust §678(a)(1) Triggering Provision

To understand the practical basics, let's examine a basic trust with $2 million, generating $40,000 of unrealized capital gains, $45,000 of capital gains, $5,000 of capital losses and $40,000 of interest and dividends. With a fully §678(a) trust in which the beneficiary can withdraw all taxable income, including net 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 the taxable income ($80,000, reporting capital gains, losses, dividends and interest accordingly), 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*.[42]

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). Unlike phantom income from a QSST, however, the beneficiary may withdraw up to $80,000 to pay for this, which would be a non-event income tax-wise.

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

[41] *Harrison v. Schaffner*, 312 U.S. 579 (1941), quoted by the *Mallinckrodt* case.

[42] 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.

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 after only $13,450.[43] 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.[44] 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.).

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[43] This is for 2022. This bracket, like all individual income tax brackets under IRC §1, adjusts annually for inflation. Rev. Proc. 2020-45 contains the inflation adjustments for 2021 and Rev. Proc. 2021-45 for tax year 2022. The top rate for long-term capital gains has a slightly different threshold: $13,700 for 2022.

[44] *Domo v. McCarthy*, 612 NE2d 706, 709 (Ohio 1993). These are also referred to as "cessor" clauses, e.g., in the recent *Castellano* case. The seminal U.S. Supreme Court case upholding them, *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.*

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), as well as other obscure unanswered questions.

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 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, But Not All – Possible, but Usually not Ideal

What if a beneficiary has a power to withdraw less than all of the income? If the beneficiary had a cap on the withdrawal right, then she would only be taxable to the cap, and expenses would be prorated accordingly (regardless of whether she actually takes the income withdrawable). 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.[45] 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 above the trust's top tax rate bracket, or even 28% rate bracket ($12,500 or $6,000 respectively in 2017), or even reference an external criteria, such as income to a point until his/her taxable income exceeds the beneficiary's top income tax bracket.[46]

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

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[45] Treas. Reg. §1.671-3(a)(2). Treas. Reg. § 1.671-2(d) provides that "Items of income, deduction, and credit not attributed to or included in any portion of a trust of which the grantor or another person is treated as the owner under subpart E are subject to the provisions of subparts A through D (section 641 and following)."

[46] 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.

portion, depending on which portion is getting the income so attributed.[47] 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 the protection of Rev. Rul. 85-13 which disregards transactions between a grantor/beneficiary and a trust over which they are the sole deemed owner for income tax purposes. Only a portion of such a transaction may be disregarded, or a transaction may even trigger gains over all of the asset.[48] You may even have asymmetrical results depending on whether the beneficiary/trust is a buyer or seller. This is discussed in more detail in Section II.v.

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.[49]

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.[50]

[47] Treas. Reg. §1.671-3(a)(2).

[48] E.g., in PLR 9211026, three trusts had proposed a transaction between them, with two being fully grantor trusts and the third a grantor trust only as to accounting income, not corpus/capital gains. The IRS ruled that the transaction between the grantor trust and partial grantor trust would be recognized.

[49] See *Oppenheimer v. Comm'r*, 16 T.C. 515 (1951), with similar facts.

[50] 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 as filing a full Form 1041 though. See Section II.ee. of this paper.

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.[51] 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).[52] Similarly, non-grantor trusts that sell small business stock for a loss are denied the $50,000/$100,000 ordinary loss permitted individuals under IRC §1244.[53]

For example: an LLC, 50% owned by a trust, invests in $500,000 worth of 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).[54]

An individual 50% owner (whether via BDOT 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. if it were ten year property then 1/10 of $500,000, times 50% ownership, or $25,000).[55] This is a huge tax difference between the two varieties of trusts (and one hardly ever discussed at tax conferences)!

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[51] 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 usually *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 fully exploit §179 for an LLC/LP taxed as a partnership owned by a trust.

[52] See Section 13101 of the Tax Cuts and Jobs Act, modifying IRC §179(b). This also adjusts for inflation. In 2019, it will be $1,020,000. Rev. Proc. 2018-57, §3.26. In 2020, $1,040,000. Rev. Proc. 2019-44, §3.26.

[53] IRC §1244(d)(4).

[54] 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).

[55] 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

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 BDOT 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 exactly the same as 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).[56] 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).[57] 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).[58] 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.[59] 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.[60]

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deduction under section 168 or a section 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."

[56] IRC §167(d) and IRC § 642(e).

[57] 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.

[58] Rev. Rul. 74-530.

[59] IRC §642(h).

[60] See Treas. Reg. §1.179-3 for carry forwards when a taxpayer cannot use §179 deduction.

c) Advantage – Net Investment Income 3.8% Surtax, $25,000 real estate PAL

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.[61]

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 the IRS has issued a *non-acquiescence* and an extraordinarily strict TAM, and Treasury may issue future regulations to change the result.[62] 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 *as to the ongoing S Corp income*, where activity of the beneficiary will determine applicability of the NIIT. However, as noted in the section below, QSSTs are ***not*** taxed the same for any *sales* of the S

[61] IRC §1411(a)(2).

[62] 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.

corporation stock. Thus, while final regulations did not confirm this, the 3.8% 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.[63]

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.[64] 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.

$25,000 Real Estate Passive Activity Loss Limitation Exception

Similar to IRC §§ 179(d), 1244, 121 and others discussed herein, another tax loophole only afforded to individual taxpayers (and, of course, grantor trusts) is in IRC §469 dealing with passive activity loss limitations. This special provision to permit up to $25,000 of real estate losses to be deducted is only permitted to "natural persons".[65]

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[63] 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."

[64] 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 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."

[65] IRC §469(i): "$25,000 offset for rental real estate activities.
(1)In general
In the case of ***any natural person***, subsection (a) shall not apply to that portion of the passive activity loss or the deduction equivalent (within the meaning of subsection (j)(5)) of the passive activity credit for any taxable year which is attributable to all rental real estate activities with respect to which such individual actively participated in such taxable year (and if any portion of such loss or credit arose in another taxable year, in such other taxable year).
(2) Dollar limitation
The aggregate amount to which paragraph (1) applies for any taxable year shall not exceed $25,000."

d) Advantage – S Corporation Ownership, Contrasting QSSTs

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).[66] "[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."[67] 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.[68]

For many purposes, a QSST is the same as a §678 beneficiary deemed owner trust for income tax purposes. In fact, the QSST regulations specifically reference §678. A "qualified subchapter S trust" (QSST) is a trust,

> "(A) the terms of which require that (i) during the life of the current income beneficiary, there shall be only one income beneficiary of the trust; (ii) any corpus distributed during the life of the current income beneficiary may be distributed only to the beneficiary; (iii) the income interest of the current income beneficiary in the trust shall terminate on the earlier of the beneficiary's death or the termination of the trust; and (iv) upon the

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[66] 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). Treas. Reg. §1.1361-1(h) is even more explicit:

> "(1) General rule. In general, a trust is not a permitted small business corporation shareholder. However, except as provided in paragraph (h)(2) of this section, the following trusts are permitted shareholders:
>
> (i) Qualified subpart E trust. A trust all of which is treated (under subpart E, part I, subchapter J, chapter 1) as owned by an individual **(whether or not the grantor)** who is a citizen or resident of the United States (a qualified subpart E trust). This requirement applies only during the period that the trust holds S corporation stock." [**emphasis** added]

[Is a joint grantor trust deemed owned 50/50 by two spouses or a trust splitting w/d powers between two beneficiaries-deemed-owners owned by "***an*** individual"? Probably, but in a narrow reading, **no**.]

[67] 1995-2 C.B. 135 (I.R.S. July 1, 1995). See also Rev. Rul. 92-73.

[68] 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**." [***emphasis*** added - a BDOT withdrawal power is simply a presently exercisable general power of appointment]

termination of the trust during the life of the current income beneficiary, the trust shall distribute all of its assets to the beneficiary; and

(B) all of the income (within the meaning of § 643(b)) of which is distributed (or required to be distributed) currently to one individual who is a citizen or resident of the United States."[69]

QSSTs are deemed to be BDOTs for qualification as an S corporation shareholder; taxable income from the S corporation is treated like a BDOT.[70] BDOTs are not necessarily QSSTs, however, but they may make a protective QSST election.[71]

Let's compare and contrast the QSST and the BDOT:

Similarity: Both should qualify as S corporation owners and pass through ongoing K-1 income from the S corporation directly to the beneficiary rather than be trapped in trust. This should include receipt of mind-bogglingly high Section 179 expense deductions that are denied to non-grantor trusts such as ESBTs or trusts for up to 2 years after the death of a testator/grantor. That said, the rules regarding phantom income being taxed to the beneficiary are clearer in a QSST (for better and worse). Phantom income is when the S corporation's taxable income reported on its Forms K-1 exceed distributions, such as if the corporation reinvested its profits rather than paying distributions to shareholders. Withdrawal of phantom income in BDOTs is discussed elsewhere herein.

Difference: Sale of S Corporation Stock or Most of Its Assets. When the larger tax event of a sale of stock or most of the company's assets occurs, the QSST loses its advantage to pass through income to the beneficiary's tax return similar to a §678(a) trust. Whenever S

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[69] IRC §1361(d)(3).

[70] IRC §1361(d)(1): "In general In the case of a qualified subchapter S trust [QSST] with respect to which a beneficiary makes an election under paragraph (2)—

(A) such trust shall be treated as a trust described in subsection (c)(2)(A)(i), *[i.e. grantor trust or BDOT, "(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."]*

(B) for purposes of section 678(a), the beneficiary of such trust shall be treated as the owner of that portion of the trust which consists of stock in an S corporation with respect to which the election under paragraph (2) is made" *[it is treated as the owner of the trust's S corporation taxable income, like a BDOT, even though § 678(a) would ordinarily require the beneficiary to have the ability to withdraw all taxable income rather than simply accounting income, otherwise it would be only a part-grantor trust]*

[71] Treas. Reg. § 1.1361-1(j)(6)(iv): "Protective QSST election when a person is an owner under subpart E. ***if the current income beneficiary *** of a trust is treated under subpart E as owning all or a portion of the trust consisting of S corporation stock, the current income beneficiary *** may make the QSST election. See Example 8 of paragraph (k)(1) of this section." Also see Treas. Reg. §1.1361-1(k)(1), Example 2, paragraph (iii).

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"), or other deemed sales.[72] This can lead to confusion, penalties, interest and attorney and accounting fees when this is missed.[73]

Difference: Transfers of Principal to Others. Granting the trustee any spray power to distribute to others or granting a lifetime limited power of appointment permitting transfers to anyone other than the income beneficiary generally precludes a QSST election.[74] Not so with a BDOT, but if a BDOT beneficiary withdraws income and transfers it to another, this does not affect the income taxation as distributions from a non-grantor trust would – the BDOT beneficiary would still be taxed on the taxable income. Inadvertent or accidental distributions to anyone other than the QSST beneficiary or neglecting to get a beneficiary's sign off can easily terminate the S election through sloppy or incompetent administration.[75] Not so with a BDOT.

Difference: Required Distributions Leaving the Trust. QSSTs require that the fiduciary accounting income be paid.[76] There are PLRs, however, that have permitted the trustee to retain income if the beneficiary so elects.[77] BDOTs clearly do not require this. Note that even if we could rely on those PLRs, an *affirmative election* to retain income, as in the QSST PLRs cited below, is NOT the same as a *lapse* for gift, estate, GST and state debtor/creditor law! It is more akin to a release or assignment, which is more likely to be a fraudulent transfer and/or be

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[72] 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 as income to QSST beneficiary).

[73] E.g., see the saga in PLR 2017-35005 where this issue was missed and led to years of messy reimbursement issues involving state and federal taxes, interest and attorney fees with court filings and ultimately an expensive PLR on top of all that to fix it and clarify estate/gift/GST effects of the incorrect payments and reimbursements.

[74] E.g., see PLR 8952014 where a beneficiary released such a lifetime power in order to qualify as a QSST.

[75] E.g. see PLR 2014-37009, where trustee erroneously made a payment to a QSST beneficiary's children contrary to boilerplate QSST savings clause. The IRS permitted the trust to pay a fee and correct the inadvertent termination. Even if the IRS permits the correction, this can be a costly mistake.

[76] 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).

[77] IRC § 1361(d)(3), but see PLR 8508048: "(2) In any year in which a beneficiary of one of the proposed trusts elects to have the trustee retain all or any portion of the net income of the trust, such election by the beneficiary will not change the status of the trust as a "qualified subchapter S trust." Such income retained by the trustee will be includible in the gross income of the beneficiary." PLR 8836057 is similar and has almost identical language.

considered a contribution to a self-settled trust for state debtor/creditor law, and a gift and contribution for GST purposes for tax law. The PLRs did not address those issues!

Difference: Protective ESBT Election if QSST/BDOT Disqualified. A trustee may wish to make an ESBT election to protect the trust. To the extent it is a fully grantor trust or BDOT, the effect of the ESBT election is simply disregarded.[78] However, a protective ESBT election for a QSST is not permitted.[79]

QSST to ESBT (and vice versa) transitions are permitted, but have strict prohibitions against frequent toggling back and forth within 36 months.[80] By contrast, there is no such prohibition regarding grantor trust toggling.

Difference: QSST's Ability to "Stick it" to the Beneficiary via Phantom Income v. BDOT's Protection of Beneficiary's Right to Taxable Income. QSSTs have to pay out all their income annually to the beneficiary, but this refers specifically to trust accounting income (fiduciary accounting income), whereas BDOTs must grant a right to withdraw all *taxable* income.[81] These two meanings of "income" can vary considerably. An S corporation can punish (intentionally or not) any QSST beneficiary by not making distributions and forcing them to pay tax on phantom income that will pass to them on a Form K-1. QSSTs impose no duties whatsoever upon companies to make distributions to shareholders. Officers don't even owe shareholders a duty to distribute enough to cover taxes unless the operating agreement requires it – sometimes the company is cash poor or may need to retain or reinvest funds for business purposes. This can stick the QSST beneficiary with a large tax bill with no wherewithal to pay it. *Ouch*! By contrast, a BDOT beneficiary would still have the power to withdraw income that may be satisfied from other assets, including the S corporation stock itself. A QSST could also give a beneficiary a greater withdrawal power, but this is rare.[82]

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[78] 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.

[79] Treas. Reg. § 1.1361-1(m)(2)(v): "No protective election. A trust cannot make a conditional ESBT election that would be effective only in the event the trust fails to meet the requirements for an eligible trust described in section 1361(c)(2)(A)(i) through (iv). If a trust attempts to make such a conditional ESBT election and it fails to qualify as an eligible S corporation shareholder under section 1361(c)(2)(A)(i) through (iv), the S corporation election will be ineffective or will terminate because the corporation will have an ineligible shareholder."

[80] Treas. Reg. §1.1361-1(j)(12) and (m)(7).

[81] IRC §643(b), which is referenced in the QSST rules, refers to "(b) Income

> For purposes of this subpart and subparts B, C, and D, the term "income", ***means the amount of income of the estate or trust for the taxable year determined under the terms of the governing instrument and applicable local law."

[82] Treas. Reg. § 1.1361-1(k)(1), Example 8.

For example, if an S corporation's Schedule K-1 for the trust shows $100,000 of taxable income, but the S corporation makes a distribution of only $20,000, the accounting income required to be paid from a QSST to the beneficiary is only $20,000. The beneficiary receives a Form K-1 for the full $100,000, however, because the QSST election causes the portion of the trust consisting of the S corporation stock to be treated as a BDOT for income tax attribution purposes.[83] With a true BDOT, a beneficiary may withdraw the full $100,000, and the trustee would have to make other assets available if there were insufficient cash. Which of these two designs is better may depend on your perspective! With a QSST, the tax bill (including state or sometimes even local income tax) could easily be twice what was received! But imagine the opposite scenario occurs the next year – the S corporation K-1 is only $20,000 but the distribution is $100,000 (perhaps there was a large Section 179 expense). The QSST has to pay $100,000, whereas a BDOT may only grant the power to withdraw $20,000 (although the beneficiary might have a concurrent 5/5 power or the trustee may have the ability to distribute more, as discussed elsewhere herein).

This potential for phantom income and the attendant due process concerns is probably why Congress only permitted this tax treatment with an affirmative election by the beneficiary (except as noted below).

QSST income from any assets other than the S corporation is taxed based on normal non-grantor trust income tax rules, which makes any attempted transactions between a QSST and the beneficiary more problematic even if there is only a money market account temporarily holding S corp distributions prior to distribution to a beneficiary (see further discussion in section (u) of this paper, *Transactions Between Beneficiaries and their BDOTs*).

Difference: Affirmative Action by Beneficiary: QSST beneficiaries must sign the appropriate election, else risk disqualifying the S corporation (or forcing trustee to make an ESBT election). BDOTs would not have such a requirement, although conceivably a beneficiary newly vested with BDOT powers could file a qualified or non-qualified disclaimer which would negate the clause's effect for income tax purposes and force the trustee to make an ESBT election similar to if an intended QSST beneficiary refused to sign or filed a non-assent.[84]

Difference: QSST Complexities and Uncertainties Upon the Death of the Primary Beneficiary: 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

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[83] IRC §1361(d)(1)(B).

[84] IRC §678(d) "Effect of renunciation or disclaimer

> 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."

ESBT election.[85] When a QSST beneficiary dies, there is a similar two year rule,[86] but if the trust simply continues with another beneficiary stepping in, the QSST election remains in place, although the new QSST beneficiary may affirmatively refuse to consent to the election.[87] More importantly - and confusingly - if the trust is now considered a "new trust", then the beneficiary must file a new QSST election.[88] How many trusts are clear when there is a "new trust"? How many attorneys and accountants would recognize the difference?

Difference: Complexity of Multiple Trusts. QSSTs are often 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 and it would make sense to apply the power of withdrawal over all the taxable income of the trust without need to segregate S corporation stock from other assets.

Difference: Asset Protection (or lack thereof) for Beneficiary. Any remote possibility of corpus being distributed to another person during the beneficiary's lifetime, such as a cessor or forfeiture clause, or even a contingent poison pill provision common in special needs trust clauses, kills the QSST *ab initio*. [89] Such remote possibilities would not kill a BDOT. The IRS takes the position that trust payments to a grantor trust for a beneficiary do *not* meet QSST requirements.[90] By contrast, a BDOT could have any income not withdrawn lapse and/or pass to a separate trust if desired.

Imagine a debtor/beneficiary lives in a state that permits garnishment of a portion of mandatory trust distributions, such California or New York. QSST income would just keep coming out and be consistently available to creditors. The trustee and beneficiary cannot turn off the spigot. By contrast, a cessor/forfeiture clause in a BDOT could cut off the withdrawal right altogether, and as discussed above, any prior ESBT election would then become controlling or the trustee would have to make an ESBT election if none had prior been made in order to keep S corporation status.

Difference: Dangers of Broad Trust Protector or Other Clauses Permitting Mergers and Decanting. Similar to the concern noted above, the mere *possibility* that a merger, decanting or amendment clause could change the trust terms after a QSST election could easily disqualify a

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[85] IRC §1361(c)(2)(ii).

[86] Treas. Reg. § 1.1361-1(j)(7); PLRs 2014-20005, 2015-16016.

[87] Treas. Reg. § 1.1361-1(j)(9)(i).

[88] Treas. Reg. § 1.1361-1(j)(9)(ii), Example 2.

[89] See, e.g. Rev. Rul. 93-31. Even if the S corp stock is sold, see Rev. Rul. 89-55. PLR 9035048.

[90] PLR 9014008.

QSST ab initio.[91] This is why most state decanting statutes specifically limit the ability to decant QSSTs.[92] Some powers in trust instruments may go beyond what state law would permit though. Any clause that might allow a beneficiary other than the current beneficiary to be added later (other than the death of the QSST beneficiary of course) could jeopardize S corp/QSST status.[93]

Difference: Tax Reporting: BDOTs may use their deemed owner(s)' social security number(s) as their taxpayer identification numbers but may also use an EIN, and may file a Form 1041 or not.[94] However, a QSST ***must*** file Form 1041 and attach a statement of the items treated as having been received directly by its beneficiary.[95]

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[91] See AICPA article *QSST Documents Should Avoid Dangerous Provisions* in The Tax Advisor by Raymond Olczak discussing undesirable boilerplate spendthrift or no contest clauses. As for trust protector or cessor clauses that could halt mandatory income distributions and thus disqualify a marital deduction for similar reasons, see *Miller v. United States*, 267 F. Supp. 326 (M.D. Fla. 1967) and TAM 8248008, which follows *Miller*.

[92] See, e.g., the *Uniform Trust Decanting Act*, §19(b)(4) including comments. This section would still allow decanting from a QSST to a BDOT, however, since the new trust would continue to qualify as a S corporation owner.

[93] Rev. Rul. 89-45 held that "A trust which provides that during the life of the current income beneficiary a portion of its corpus may be used to fund a new trust for the benefit of a person other than the current income beneficiary, in this case, an "after-born" grandchild of the grantor, is not a "qualified subchapter S trust".

[94] Treas. Reg. § 1.671-4(b)(2)(A).

[95] Treas. Reg. § 1.671-4(b)(6).

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.[96] Notably, there is no income distribution deduction that would otherwise allow tax shifting to the beneficiaries.[97] 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.[98] 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.[99] These negatives extend to sale of S stock, even if on installment sale.[100] Often

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[96] 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.

[97] This would be allowed under ordinary non-grantor trusts under IRC §651 or §661.

[98] 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.

[99] Treas. Reg. §1.641(c)-1(e).

[100] 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).

this negative aspect of ESBT income being taxed at the highest marginal income tax bracket extends to many states that would otherwise have progressive income tax brackets.[101]

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).[102] 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.[103] 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 receive the §199A deduction 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."[104]

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

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[101] E.g. CA Rev & Tax Code § 17731.5

[102] See §13541 and §13542 of the Act. IRC §1361(b)(1)(C) (non-resident alien), IRC § 1361(c)(2)(B)(v) (ESBT exception).

[103] 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—

[104] Treas. Reg. §1.199-6(d)(3)(vi).

f) Advantage – Ensuring the §199A Deduction 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.[105]

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.[106] 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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[105] 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).

[106] Prop. Reg. §1.199A-6(d)(3)(iii), drastically amended in the final regulations, had 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."[107]

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![108] That said, despite ACTEC suggesting that Treasury provide some examples (I was on a committee that submitted comments and suggested examples), 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

[107] Treas. Reg. §1.199A-6(d)(3)(vii).

[108] Imagine an S Corp that has a healthy yield of 5% income. To save \$50,000 with such a strategy, that would mean shifting \$250,000 of business income, meaning stock worth \$5 million! How could giving away \$5 million possibly have a "principal purpose" of saving a mere \$50,000 – 1% of the amount transferred??? Incomplete gift, non-grantor trusts (INGs), however, might conceivably be in this category, because nothing is really given away.

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 the leverage of 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 LP/LLC 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 address many of the 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.[109]

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![110] Moreover, if the beneficiaries are in a lower bracket (approx.. <$500,000/$600,000, adjusted for inflation), 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.

There is probably more opportunity to take advantage of IRC §199A in the S corporation context than with any LLC/LPs taxed as partnerships, however. The issue for many closely-held partnerships where interests are gifted to family members outright or through trusts, *especially* many of those that would be specified service businesses under Section 199A(d)(2), is that in order to shift income to another related owner, the partnership must run through a complex gauntlet of three tests (in addition to typical tests such as whether a donor/owner is being paid reasonable compensation).[111]

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[109] See Rev. Rul. 81-6.

[110] IRC §641(c), Treas. Reg. §1.641(c)-1.

[111] See IRC §704(e) and for more detail, Gerald Snow, *Problem Areas Under Internal Revenue Code Section 704(e): The Family Partnership Revisited,* 3 BYU J. Pub. L. 29 (1989).

The first one is enough to stop many in their tracks: capital must be a material income producing factor of the partnership, otherwise the income will not be part of the *donee's* distributive share, but the *donor's.* Treasury regulations define this requirement as:

> Capital is a material income-producing factor if a substantial portion of the gross income of the business is attributable to the employment of capital in the business conducted by the partnership. In general, capital is not a material income-producing factor where the income of the business consists principally of fees, commissions, or other compensation for personal services performed by members or employees of the partnership. On the other hand, capital is ordinarily a material income-producing factor if the operation of the business requires substantial inventories or a substantial investment in plant, machinery, or other equipment.[112]

Many firms meeting the §199A definition of specified service businesses that are taxed as partnerships whose owners' families would benefit the most from transfers of ownership to non-grantor trusts or BDOTs may not be able to meet this test (and thus, not be able to shift the income). There are even more complexities in the second and third test in the regulations beyond the scope of this white paper, especially surrounding trusts as donees, but I would commend the reader to another article that concluded after examining these regulations that:

> Many taxpayers will want to avoid the partnership tax rules by placing business operations into an S corporation instead of a partnership, or converting to an FLP (or LLC) taxed as an S corporation…S corporations do not have the same issues that apply to partnerships under Code Sec. 704(e), in that an S corporation's ownership can be donated to another party, who will be taxed on the income reported out to the owners without having to specify [prove] that capital is material.[113]

Another option aside from S corporation status, depending on the value and ownership structure, may be to simply gift/sell **100%** of the company so that it's no longer a partnership but a disregarded entity, such as a single member LLC.

Treasury regulations are clear that these §704(e) family partnership rules trump IRC §678: "Nor are the rules as to family partnerships affected by the provisions of subpart E, even though a partnership interest is held in trust."[114] These issues go away, of course, if the BDOTs are funded at death.

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[112] Treas. Reg. 1.704-1(e)(iv).

[113] *Family Partnership Rules of Code Sec. 704(e) and New Code Sec. 199A*, by Martin M. Shenkman, Jonathan G. Blattmachr, Alan Gassman and Joy Matak, Estate Planning Review – The Journal. I commend the article as the best summary of these core issues in light of tax reform and Section 199A.

[114] Treas. Reg. § 1.671-1(c).

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 (*Understanding and Mastering the 5x5 Lapse Protection of §§2514/2041*)**

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.

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.[115] Let's explore how we keep any withdrawable but untaken funds protected from being considered a contribution by the beneficiary for estate/gift/GST and then explore how this affects the corpus of the trust for state law asset protection purposes.

5x5 power for federal transfer tax purposes.

The lapse protection under federal estate and gift tax law is fairly well known colloquially as part of a "five and five" ("5x5") 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 it does not exceed the greater of $5,000 or 5%.[116]

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[115] 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.

[116] 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."

So, if someone had 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.[117] That said, depending on the trust terms, it would often be an incomplete gift[118] or a gift in part to oneself, but if the latter, for valuation purposes the value of any retained interest is disregarded).[119]

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 rather than $5,000.[120] This may not sound important to many taxpayers who would likely spend the income and even if they didn't, do not have $11.58 million estates to worry about gift tax anyway. However, many states' creditor protection laws explicitly incorporate IRC §2514(e), so *how* the 5% is calculated is still an important concept even aside from gift/estate/GST tax.

If the power of withdrawal is not based on the entire corpus, but on the accounting income alone, the 5% would be calculated based only on the accounting income available to withdraw, *not* the entire principal.[121] Therefore there may be a tracing element to determining

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

[117] See, e.g., PLR 9804047, where a spouse as beneficiary of a trust left to her by her late husband had the power to withdraw 10% of the trust corpus annually. To the extent the spouse did not withdraw corpus, any excess above 5% permitted to lapse was considered a gift (i.e. up to 5%).

[118] Often it would be incomplete for several reasons, e.g., access by creditors, per Rev. Rul. 76-103; retained powers of appointment per Treas. Reg. §25.2511-2(c), etc.

[119] IRC §2702(a)(2)(A).

[120] 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%.

[121] 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, extraordinary dividend or distribution) 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

how the 5% is calculated and care should be taken in drafting how and from what sources the power may be satisfied. In the *Fish* case and Rev. Rul. 66-87 cited above, the source of funds withdrawable had to be traceable to accounting income. To quote the 9th Circuit in *Fish*, the beneficiary had "no power whatever to invade the corpus of the trust". When the source of the funds may be any of the principal, the 5% is calculated on the entire principal, whether the withdrawal right is over $1 or $1 million. It helps to view the Treasury Regulation example:

> "For example, if an individual has a noncumulative right to withdraw $10,000 a year from the principal of a trust fund, the failure to exercise this right of withdrawal in a particular year will not constitute a gift if the fund at the end of the year equals or exceeds $200,000. If, however, at the end of the particular year the fund should be worth only $100,000, the failure to exercise the power will be considered a gift to the extent of $5,000, the excess of $10,000 over 5 percent of a fund of $100,000. Where the failure to exercise a power, such as a right of withdrawal, occurs in more than a single year, the value of the taxable transfer will be determined separately for each year."[122]

Thus, even though the withdrawal right is only over $10,000 in Treasury's example above, the "aggregate value of the assets out of which, or the proceeds of which, the exercise of the lapsed powers could be satisfied" is $200,000, and 5% of that is $10,000.

The *Fish* rule should not apply to a BDOT wherein a beneficiary has the power to withdraw all the taxable income attributable to *principal if* the power can be satisfied out of the entire corpus/principal and proceeds of the entire principal of the trust (even though the regulations say "or", rather than "and", why not be comprehensive?). If taxable income is $10,000 and the withdrawal power is over $10,000, why is this so different than a simple withdrawal power over $10,000 if it can be satisfied out of the exact same assets and proceeds therefrom? This is closer to the code and regulations. Strangely, the 5% lapse protection usually has nothing whatsoever to do with the amount actually withdrawable, provided the amount can be satisfied from any of the corpus/principal and not limited to income as in the *Fish* case. That said, it's not 100% clear. What are the risks and how can they be mitigated or even eliminated?

First, let's explore the *worst-case scenario* and why it's not as bad as you'd think. Example: a $1 million trust has $30,000 of taxable income and the beneficiary has the power to withdraw this income or any principal of the trust up to this amount and the beneficiary takes

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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.

[122] Treas. Reg. §25.2514-3(c)(4). Treas. Reg. §20.2041-3(d)(3), the estate tax analog, has a similar example. Rev. Rul. 85-88 also has some similar examples.

$10,000 to cover taxes and lets $20,000 lapse and remain in trust. However, the IRS auditor ignores the plain language of §2514(e) and examples in Treas. Reg. §25.2514-3 under a misapplication of the *Fish* case and concludes the lapse protection is only 5% x **$30,000** = $1,500. If upheld or settled as such, this means (assuming a typical hanging power is included), that the power to withdraw $18,500 *hangs* into the following year when we had expected the amount to be $0. Not a great result, especially if we had added a zero to the above examples.

But even under this absolute worst-case scenario, what is the lapse in the *following year*? In the following year, the power to withdraw the $18,500 hanging amount is no different in the slightest from your basic *Crummey* power covered by clear examples in the treasury regulations that could not possibly be more on point. Thus, if we assume similar corpus/income/withdrawal in the following year 2 (no growth), with the worst case misinterpretation of the 5x5 lapse, the total lapse protection in year 2 would be calculated as ***the greater of*** 5% of $30,000 = $1,500 (the withdrawal right over year 2 taxable income similar to that in year 1) **or** 5% of $1 million = $50,000 (the withdrawal right over the $18,500 *hanging power*, which is most assuredly calculated based on the entire corpus because it's a pecuniary amount no longer tied to taxable income and is *exactly* the same as withdrawal powers described in Treas. Reg. §25.2514-3 and Treas. Reg. §20.2041-3 examples). Both the $20,000 of Year 2 lapsing taxable income and the $18,500 of Year 1 hanging power would safely lapse, as it is far under this $50,000 amount. The Code does ***not*** permit the two lapses to be considered separately. In fact, the beneficiary could refuse to take the $10,000 anticipated withdrawal in Year 2 and let that lapse safely as well. As will be further discussed below, the Code and Revenue Rulings clearly base the 5x5 lapse on the aggregate of *all* ***powers*** applicable in a given year, ***not*** *per power* or even *per trust*. Thus, even in the absolute worst-case scenario of the IRS inappropriately extending the *Fish* case, the positive effect of the first-year lapse protection over a full 5% of corpus would simply be delayed by a year in most cases, because future year determinations of the lapse of any hanging powers clearly have to calculate the 5% *based on the entire corpus*.

Gaffing the *Fish*. But there is an even better solution which did not occur to me in earlier versions of this paper or article. This feature of hanging powers noted above and how the 5% is calculated is so beneficial, it may be ideal to include an additional annually renewing power over a pecuniary amount much less than 5% of the corpus, in order for the 5% to always be calculated on the entire corpus even if the IRS were to successfully contort the *Fish* case to its bidding. This exploits the fact that under the Code and Regulations, even the power to withdraw a mere $1 from a $1 billion trust calculates the 5% lapse protection on $1 billion, not $1, and *all powers held by a beneficiary must be aggregated together for lapse purposes*.

For example, revisiting our example above, what if the trust also granted a second power, the right to withdraw $5,000 from the principal of the trust (it could be any amount, I just picked an amount I thought would be meaningful for a beneficiary to have)? This would more closely mimic the Treasury Regulation example above. Remember the examples in both Treasury Regulations are crystal clear – the 5% lapse is calculated on the *entire corpus and the amount withdrawable is irrelevant*, except for the aberrant *Fish* case. However, where it's simply a dollar amount, Treasury has provided explicit examples we can rely on. This should still shift all of the taxable income to the power holder beneficiary under §678(a)(1), yet ensure the lapse protection is calculated on the entire corpus.

Increasing the Lapse Protection: Multiple Powers and Coordination with other Trusts

An important nuance of 5x5 powers and how lapses are calculated is that they are **NOT** per event, per power or per trust, but *per year* and *per beneficiary*. In the half century of *Crummey* trust discussions, this is always seen as a *negative*, but this design feature may also be an *extraordinary benefit*. First, let's revisit the code/regs and rulings and how they are worded in this regard, then examine what ~~loopholes~~ planning opportunities that it opens up.

IRC §2514(e) provides:

> "The rule of the preceding sentence shall apply with respect to the lapse of **powers** [note the use of plural here] *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** [again, note the plural] **could be satisfied**."[123]

So, it's not $5,000 or 5% per event/power/trust, but per calendar year. If someone had the right to withdraw $5,000 a month that lapsed every month, only $5,000 of the $60,000 total withdrawable would be protected under IRC §2514(e)(1). The lapse protection provided under IRC §2514(e)(2) would be 5% times the largest of the amounts on the 12 lapse dates (e.g., if the corpus on the 12 lapse dates varied between $400,000-$500,000, $500,000 is used).[124]

[123] IRC §2514(e). IRC § 2041(b)(2) [the estate tax analog] is nearly identical, but uses a past tense.

[124] Rev. Rul. 85-88.

More importantly, **all powers held by a taxpayer are considered together, "aggregated", including multiple powers in the same trust or powers in other trusts**. This has traditionally been seen as a *negative,* and it can indeed be limiting, especially in regard to the $5,000 minimum floor.

Example #1, illustrating the *negative* aspects of aggregation: both dad and Aunt Jane each establish a *Crummey* trust for son/nephew Jimmy. Dad funds his trust with $15,000 and grants Jimmy a 60-day window in which to withdraw $15,000 and Aunt Jane does the same with $11,000 for her trust, after which point the power lapses. Jimmy's powers over the $26,000 donated to the two trusts lapses. Let's imagine that the value of the two trusts together when the powers lapse is still $26,000. Jimmy's **total** lapse protection for the two contributions to the two trusts is the greater of $5,000 or ($26,000 times 5% = $1,300), or only $5,000 – ***not*** $10,000. If the trust did not have hanging powers, but limited the withdrawal right to the 5x5 power, then perhaps only $2,500 of dad and Aunt Jane's annual exclusion would be used. This can be very complicated when there are multiple trusts/powers for a beneficiary. Did dad's and Aunt Jane's trusts for Jimmy take each other's trust into account (*in pari materia*)? Probably not. If there are typical hanging powers in each trust, do the two trusts have equal amounts protected from lapse ($2,500 each), or is it 15/26 (57.7%) and 11/26 (42.3%)? IRC §2514 says nothing about this, it only determines the total amount protected from being considered a gift – what amounts *hang* requires a construction of the trusts.

But let's examine the potential *upside* of this feature of §2514(e). If Jimmy's dad funds the trust with $1 million, it solves the 5% lapse limitation for ***both trusts***. The amount that is protected by §2514(e) from being considered a gift is 5% x $1 million plus 5% of $11,000, or $50,550, and the $26,000 withdrawable is well under this amount.

Example #2, illustrating the positive aspects of aggregation, multiple powers in one trust: John establishes $1 million trust for Jimmy, granting him the noncumulative power to withdraw $5,000 of corpus anytime but also grants him a second power to withdraw all taxable income at the end of the year, which is ultimately calculated at $35,000. Jimmy's total power of withdrawal is $40,000. Even if, under the worst-case scenario interpretation of the *Fish* case, the 5x5 lapse protection for Jimmy's power over taxable income is only $35,000 x 5% = $1,750, the total lapse protection must be aggregated for both of the powers, and the lapse protection for the other power is clearly based on the entire principal of the trust, or $1,000,000 x 5% = $50,000. Unlike the second part of Example 1, these amounts are not added together.

Example #3, illustrating the positive aspects of aggregation, powers in multiple trusts: John is a beneficiary of a GST exempt irrevocable trust over which he has the power to withdraw all taxable income. Let's imagine a $5 million trust in which the parties anticipate selling a block of stock for a $1 million gain. If this were John's only power, and the corpus stayed the same at the time of lapse, the 5% lapse protection would only apply to $250,000, causing $750,000 excess to "hang" (assuming such a power were included), which would in turn cause this to be included in his estate and be susceptible to his creditors under state debtor creditor law (it may be possible to cure the latter by/changing situs or adding a non-adverse party trustee consent, as discussed below, but this does not solve the estate/gift/GST issue). John would not want to simply withdraw this $750,000 because it would add to his estate, reduce asset protection and reduce the GST exempt trust. If the trust had 2.5% of taxable income in future years (and John did not take any of the income, causing it to lapse), this causes $125,000 excess to lapse each year (ignoring growth). Thus, it would take an additional six years of administration for the $750,000 "hang" to wear off, because the capital gain was such a large proportion of total principal. This would of course vary depending on the growth, income and withdrawals from the trust.

What if John's spouse (or anyone else, but a spouse is the most likely candidate) were to fund another $16 million trust, granting John a power to withdraw $5,000 from corpus? This is not an uncommon provision at all in a SLAT with Crummey powers, since practitioners often so limit spousal Crummey powers to avoid an ETIP period. In such case, the two trusts over which John has the withdrawal power must be aggregated for estate/gift/GST tax purposes under §2514(e) and §2041(b)(2). The lapse protection would be calculated based on the aggregate value of both trusts at the time of lapse, $21,000,000. The total amount withdrawable from both trusts, $1,005,000 is now well under 5% of this ($1,050,000). John's power to withdraw the $1 million and $5,000 in the two trusts can now safely lapse. *It does not matter that the trust has different settlors or that the second trust has completely different tax characteristics*.

There is substantial authority for this aggregation of separate powers not only in the plain language of the statute and regulation, but in specific revenue rulings:[125]

> "**Where the donee has noncumulative powers to withdraw property from two or more trusts, the 5 percent test is applied by aggregating the amount determined pursuant to the preceding sentence for each such trust with respect to which the withdrawal power has lapsed during the calendar year**.
>
> For example, suppose *B* has the power to withdraw $20,000 from the corpus of one trust, and the power lapses on June 1, when the trust corpus is worth $300,000. If *B* has a second noncumulative power to withdraw $20,000 from the corpus of the *same trust*, and such power lapses on December 1, when the value of the trust corpus has appreciated to $400,000, then the maximum amount of trust assets subject to *B's* withdrawal power at the time of any lapse during the calendar year would be

[125] Rev. Rul. 85-88.

$400,000, and the amount of *B's* 5-and-5 exemption for the year would be $20,000 (5% x $400,000). **On the other hand, if B's second withdrawal power in the example is exercisable only with respect to a *second, separate trust*, B's 5-and-5 exemption for the year would be $35,000 (5% x $700,000)**."

Can John or his spouse accomplish this with an incomplete gift trust, such as a DAPT or a NING – or even a revocable trust? Perhaps, but the better authority probably argues against it. First, a settlor cannot create a general power in themselves for estate/gift tax purposes.[126] Secondly, if someone has made an incomplete gift, then arguably the donee/beneficiary does not yet have a general power of appointment over which §2514/2041 would apply, unless and until the gift is made complete through either the exercise of the power or the right/power causing the donor's gift to be incomplete being otherwise removed.[127] That said, marital deduction trusts *are* completed gifts that can be structured to use no estate/gift/GST exclusion. To build on the example above, if John's spouse had gifted the $16 million into a marital deduction trust for John, she would use no estate/gift/GST exclusion amount, yet if John were granted a typical *Crummey* or 5x5 power as discussed above, he would clearly have a withdrawal right for §2514(e) purposes, and the lapse of such a power would have to be aggregated with John's powers/lapses in other trusts for §2514 purposes, *for better and for worse*. Powers of withdrawal are perfectly consistent with marital deduction trusts provided the other prerequisites are satisfied.[128]

Of course, this solution goes a considerable way towards solving one (but not all) of the key issues with BDITs (discussed in section II.jj and elsewhere herein). Imagine a BDIT is funded with $495,000 from parent at the same time as spouse funds a $10 million QTIP or SLAT, with the beneficiary having the power to withdraw all $495,000 from the BDIT and $5,000 from the QTIP or SLAT. Because the statute and Rev. Rul. 85-88 require the two trusts to be aggregated together and do not permit them to be considered separately for §2514 lapse protection calculations, the entire amount subject to withdraw is protected from lapse being a gift.

To summarize, the various solutions to the "above 5% income" issue include:

1) reducing the numerator of income by investment policies that reduce realized income to below 5% (or below the amount the beneficiary won't withdraw) - usually possible, but

[126] IRC §2514(c)(3)(A), §2041(b)(1)(C)(i).

[127] For more discussion on these issues, see section V. *Doubling or Increasing the Basis Step Up* at *First* or *Other* Deaths, specifically subsection d., of the white paper The Optimal Basis Increase Trust, available at http://ssrn.com/abstract=2436964.

[128] E.g., see Treas. Reg. §25.2523(e)-1(g)(5).

occasionally there is a forced taxable merger or sale of property over which someone has no control, or IRD from inherited annuities or retirement plans might be 100% income;

2) reducing the numerator by making withdrawals of any income above 5%, which would be extremely common, because I've heard rumors that, while shocking to many, sometimes beneficiaries getting phantom income occasionally like to receive money from trusts to spend and pay their tax bill – if the trust makes 8% income and the beneficiary takes 4%, then the amount lapsing is only 4%;

3) the use of modified hanging powers (ideally ones that do not completely lapse so as to ensure the amount upon which the lapse protection is calculated in future years would have to be the entire corpus even under worst case interpretations of *Fish* as discussed above) or;

4) increasing the denominator by increasing the total assets in *other* trusts subject to a withdrawal power over corpus, since a beneficiary's withdrawal powers, including powers in other trusts and including trusts from other grantors, must be aggregated.

5x5 power for state law and bankruptcy creditor protection purposes

State creditor protection law does not necessarily follow federal tax law. Under longstanding common law, the entire lapse would be protected and it would not be considered "self-settled", but efforts to modify this through new Restatements and by the Uniform Trust Code and Uniform Power of Appointment Act lead to much variation. In many states (most UTC states), the protected amount would be the greater of the "five and five" amount, or the annual exclusion amount ($14,000 in 2017, $15,000 in 2018-2020, potentially twice that for married couples), but a surprisingly high number still provide unlimited protection unhampered by any "five and five" rule, even many UTC states.[129]

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[129] See 50 state + D.C. 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 Uniform trust code entirely: 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 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, 2nd, 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 power 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*

If a beneficiary lives in a state with reduced asset protection or if the applicable state law changes, a beneficiary can simply withdraw any amounts above the 5/5 and/or state creditor lapse protection and if asset protection is still desired, contribute unspent amounts to an IRA/Qualified Plan, cash value life insurance, 529 plan, LLC, homestead, self-settled asset protection trust, SLAT/IGT 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. Exercising a general power to fund a trust is the same as funding it directly.[130]

Alternatively, the trust can include a modified "hanging power" similar to that commonly seen in *Crummey* trusts (i.e. if income and withdrawal power for a $1 million trust is $60,000 but the 5% protection under §2514(e) only covers $50,000, the powerholder retains the power to withdrawal $10,000 that does *not* lapse but "hangs", continuing into the next year). This hanging power would still be a general power of appointment for estate/gift/GST tax, but would often lapse in a subsequent year when income is less than 5% of corpus.

If a hanging power can only be exercised with the consent of a *non-adverse* trustee (e.g. the trustee is not a current or remainder beneficiary), it does not cause a taxable lapse, because it is still a *general* power for estate/gift tax purposes.[131] However, such a power would ***not*** be susceptible to creditors in the vast majority of states that limit protection for powers of withdrawal to 5x5, because the definition of "power of withdrawal" which the creditor access statute references in most of those states, under the UTC, specifically *excludes* such a power.[132]

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

[130] Treas. Reg. § 1.671-2(e)(6), Example 9.

[131] IRC §2514(c)(3)(B). Treas. Reg. § 25.2514-3(b)(2), Example 3 involves a non-adverse co-trustee, someone who would not be affected by any appointment, therefore it was still a *general* power. Trustees are not usually adverse, unless they happen to also be beneficiaries.

[132] 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

Bankruptcy trustees and receivers generally step into the shoes of the debtor in their ability to exercise a debtor's rights/powers, but they cannot simply exercise powers of a *third party* trustee whose consent would be needed to exercise such a power. Whether a trust is excluded from a debtor/beneficiary's bankruptcy estate is generally going to follow state law applicable to the trust.[133]

If state law is negative or uncertain as to whether a power to withdraw only with consent of a non-adverse trustee is susceptible to creditors, consider making the hanging power *testamentary* rather than *presently exercisable*. The IRS will not see this as a gift-taxable lapse, since the beneficiary powerholder still has a general power of appointment over this amount, but under state law (and bankruptcy law) it may be completely different, since the beneficiary's *testamentary* hanging power is not currently accessible and is much less likely to be susceptible to creditors (except perhaps in the rare case that someone dies while in bankruptcy holding such a power).

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not count on a court taking a literal reading of the statute in such a case, and this may not help in a bankruptcy context since the trustee may simply exercise the debtor/trustee's sole unfettered power.

[133] 11 U.S.C. §541(c)(2) provides the exclusion of spendthrift trusts valid under state law, but §548(e) might bring in fraudulent transfers to a "self-settled trust or similar device" which is still unclear.

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 mandatory minimums in marital/conduit trusts), or a trust protector provision might do so as well.[134] To keep within the §678(a) "sole" power requirement, and improve asset protection, withdrawal rights could be limited to a window in time in which they can be exercised (e.g. December 15-31), 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 a prospective cessor clause provides adequate protection and this would provide greater argument for disregarding any mid-year transactions between a beneficiary and their BDOT.

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[134] Restatement of Trusts, 3d, §57 Forfeiture for Voluntary or Involuntary Alienation provides "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".

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 can opt for an accumulation trust design if asset protection is a concern. A QSST has a similar issue, but if the trust is a grantor trust a QSST election is unnecessary – 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…".

Even the Supreme Court of California, a notoriously creditor-friendly state, has approved of a cessor clause that shifted interests to another beneficiary thwarting creditors, even the U.S. government, *Security-First Nat. Bank v. Rogers*, 51 Cal.2d 24, 330 P.2d 811 (Cal. 1958).

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 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 (which is mostly helpful), but also to trusts owning S corporation stock, including grantor trusts and ESBTs![135]

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*.[136] The Uniform Trust Code will protect mandatory

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[135] Ohio R.C. §5815.22 (B)(1):

> "(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 (QSST) 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. §678(a) and §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).]

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 XX 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 if it has not 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.

[136] 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.

income distributions from garnishment, but only insofar as the trustee makes the distributions within a reasonable time after the designated distribution date.[137]

In the event that such a cessor/forfeiture clause or trust protector action cuts off a general power of appointment (such as a current withdrawal right or hanging power), it is unlikely to be considered a taxable release/gift by the beneficiary.[138]

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[137] UTC §506(b).

[138] In the context of trustee-initiated reformations, see PLR 2019-41023, PLR 2018-45029 and article on the latter here: https://www.linkedin.com/pulse/irs-honors-retroactive-correction-crummey-powers-edwin-morrow-iii/. If the beneficiary initiates/procures the change, this could be a de facto *release*.

j) Advantage – Passing Through Capital Losses?

As discussed in prior LISI articles,[139] 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***.***[140] Certain passive losses in trust may fare even worse.[141] *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, must pass through any capital losses directly to the beneficiary, and may be used to offset a beneficiary's own capital gains (and up to $3,000 of ordinary income).*[142] A trust that converts to a BDOT may also unlock trapped capital losses, even if it is not completely "terminated".[143] Despite the Regulation cited, there is an argument that net capital losses should not pass out in some cases where there is no income, solutions for which are discussed later in this section.

Capital losses in a non-grantor trust can usually be used in a subsequent year. However, there are some underappreciated situations in which this is not the case. Most obvious are situations in which the capital loss is large and the trust and its investments just don't generate much in the way of capital gains. Maybe it mostly consists of closely-held business assets, real estate, etc.? The trust may not terminate for hundreds of years, if ever.

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[139] *The Optimal Basis Increase Trust*, LISI Estate Planning Newsletter #2080 (March 13, 2013), was updated in 2018 and is available at the following link http://ssrn.com/abstract=2436964

[140] IRC §642(h).

[141] See discussion of IRC §469(i) in section II.c. of this paper.

[142] Treas. Reg. §1.671-3(a).

[143] 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 on 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 partial 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.*

Moreover, even when there are capital gains subsequently generated inside of a trust, there are situations in which the capital gains, *but not the capital losses*, are passed out to beneficiaries. This statement probably surprises more than a few readers, who probably assume that if capital gains are distributed to a beneficiary as part of DNI that capital losses must logically be netted against such gains first. Sometimes that is the case, and sometimes not. Treatment of capital gains and losses is yet another confusing aspect about Subchapter J, Subparts A-D taxation that many practitioners are confused by (if they are even aware of the issue) and would rather avoid. IRC §643(a)(3) gives us the default rule that capital gains are usually excluded from distributable net income (DNI), except in limited cases. But practitioners love, love, love to have capital gains be able to be part of DNI for all the great reasons noted in this paper, so try to come under the three exceptions in Treas. Reg. §1.643(a)-3(b):

> (1) Allocated to income (but if income under the state statute is defined as, or consists of, a unitrust amount, a discretionary power to allocate gains to income must also be exercised consistently and the amount so allocated may not be greater than the excess of the unitrust amount over the amount of distributable net income determined without regard to this subparagraph § 1.643(a)-3(b));
>
> (2) Allocated to corpus but treated consistently by the fiduciary on the trust's books, records, and tax returns as part of a distribution to a beneficiary; or
>
> (3) Allocated to corpus but actually distributed to the beneficiary or utilized by the fiduciary in determining the amount that is distributed or required to be distributed to a beneficiary.

The details and uncertainty behind complying with these is beyond the scope of this paper, but even worse than that, the rule regarding capital losses does not completely track the one for capital gains, leaving some situations in which capital gains may pass out with DNI to beneficiaries without the benefit of net offsetting losses, and capital losses remain stranded unused inside the trust. Treas. Reg. §1.643(a)-3(d) provides further that:

> (d) Capital losses. Losses from the sale or exchange of capital assets shall first be netted at the trust level against any gains from the sale or exchange of capital assets, **except for a capital gain that is utilized under paragraph (b)(3) of this section in determining the amount that is distributed or required to be distributed to a particular beneficiary.** See § 1.642(h)-1 with respect to capital loss carryovers in the year of final termination of an estate or trust.

Thus, if the trustee is using paragraph (b)(3) to justify its passing out of capital gains as part of DNI in making distributions to beneficiaries,[144] the capital losses are **not** netted against these gains and they remain forlorn inside the trust, waiting for some future year when

[144] For an article advocating the advantages of this method, see *Including Capital Gains in Trust or Estate Distributions After ATRA*, Trusts and Estates, March 2013, by Frederick Sembler.

sufficient capital gains will be generated by the trust and yet insufficient distributions are made to beneficiaries that would reduce that gain. If the trustee uses paragraphs (b)(1) or (2) to justify including capital gains as part of DNI, then the losses must be used to offset this.

Is there 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 discussed 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 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 of ordinary income) 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.[145] 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. After all, this is how QSSTs work, which are basically §678(a) trusts for any losses in the course of an S corporation's business.[146] Regulations and examples under other grantor trust code sections are clear that grantors take the capital losses even if they may never bear any economic detriment thereby.[147] For IRC §678, it may depend on whether the beneficiary power holder truly bears

[145] 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, the beneficiary/power holder could still receive 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 and income allocable to principal, in which case the w/d right in the above scenario would be $50,000.

[146] 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."

[147] E.g., Treas. Reg. §1.677(a)-1(g), Example 2.

the burden of the loss, through the trustee accounting for this and truing 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 in trust property).

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 provided in Treas. Reg. §1.671-3(a). Capital gains and losses are always paired together throughout the code and regulations. However, if the beneficiary bears no financial detriment, no decrease in his or her later ability to access income, then it may be 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 *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.[148] 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. In one PLR wherein a capital loss occurred while the trust was a beneficiary deemed owner trust under IRC §678, even though the trust later reverted to a non-grantor trust, the IRS ruled that the deemed owners were entitled to take the capital loss.[149]

One tax court case sheds some light on this issue, but is not conclusive.[150] 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 deduct the capital losses on his personal return 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 the owner of income attributable to principal, the losses would have passed through. This is confirmed by an example in the regulations and in the *Madorin*

[148] 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.

[149] *PLR 9220012*, discussed in footnote 142.

[150] *Edgar v. Commissioner*, 56 T.C. 717 (T.C. 1971).

case, and the experience of anyone who has dealt with reporting for any non-§678 grantor trust.[151]

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.[152] 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"
>
> 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

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[151] 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.)**" This is true even though IRC §677(a) has no reference to a power over principal. Also see *Madorin v. Comm*., 84 TC 667 (1985), in which a grantor reported capital losses from a partnership on his personal tax return but when the trust converted to a non-grantor trust, gain was triggered on debt relief in excess of his basis.

[152] PLR 2016-33021.

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"[153]

This situation will thankfully not come up very often – only in years with extraordinary realized losses. While there is substantial authority that the loss equally passes though pursuant to the regulation above (and none contrary), it is safest to assume the possibility that a capital loss in excess of net income will ***not*** pass through. A conservative position would be 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, or otherwise adapt as below.

There are two methods that may ameliorate some of this uncertainty: first and (sometimes) easiest is to avoid substantial capital losses beyond capital gains inside the trust in the first place by actively managing gains and losses or 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).[154]

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

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[153] *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.

[154] 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 (i.e. $50,000 not $250,000 in the above example), 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 §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 when cost basis is higher than fair market value (i.e., loss property), causing issues whenever loss property is distributed in kind to beneficiaries of a grantor trust other than the grantor. See also the section of this paper on *Kenan* gain and differences between non-grantor trusts and BDOTs as to in kind distributions.

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 capital gain offset by the prior year's $200,000 capital loss carryforward – a wash.[155] Just like with non-grantor trust (or even individual) capital losses, of course, it may take years before a large capital loss can be used.

While it's uncertain, there is still an argument that the losses should pass out similar to the gains, despite the oddness of it. QSSTs have been around for decades, and they are essentially §678(a) trusts except when either the stock or all the assets of the S corporation are sold, as discussed elsewhere herein, and to my knowledge no tax preparer or IRS auditor has ever had any issues passing out any net capital losses from the S corporation Form K-1 to the QSST beneficiary, even though QSST beneficiaries rarely have access to the capital gains upon sale of the S corporation stock or all its assets (when the quasi-678 trust reporting no longer occurs). That said, while Treas. Reg. 1.671-3 points to net capital losses passing out to a Section 678 powerholder, do not count on it in a year when the income is negative and do not promise a beneficiary that result, and simply deal with it proactively by not realizing the loss in the first place if avoidable, by distributing the asset in kind, or by allocating for it by reducing the withdrawal right over net capital gains in future years as noted above. In the worst-case scenario, the capital losses will be treated the same as if were a non-grantor trust, so this is hardly a reason to avoid BDOTs altogether.

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[155] 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 (unless one of the exceptions noted herein apply).

k) Related Advantage? Tax Effects of Changing Status from Non-Grantor to Grantor Trust (including BDOT) – Can it *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, and it converts to a grantor trust, including through a grant of a withdrawal power over taxable income to cause BDOT status, it may be able to unlock significant trapped losses for the beneficiary.[156] Such a conversion would not ordinarily be a taxable event.[157] Unfortunately, the IRS has been contradictory and confusing at times in its guidance. In a related area, whether decantings are *distributions* to a new trust or a termination, the IRS has been studying the topic for nearly a decade now without issuing any guidance.[158]

Here's how one recent PLR discussed the income tax effects of a conversion from non-grantor trust to grantor trust status [**emphasis added**]:

> "Rev. Rul. 85-13, 1985-1 C.B. 184, holds that a grantor who acquired the corpus of a trust in exchange for an unsecured promissory note was considered to have indirectly borrowed the trust corpus resulting in grantor trust treatment. As a result, the transfer of trust assets to the grantor was **not a sale** for federal income tax purposes and the grantor did **not acquire a cost basis** in the assets of the trust. The ruling concluded that the grantor became the owner of the trust corpus which he had indirectly borrowed and thus was taxable on the trust's income and, as the deemed owner of the trust assets, could not engage in a transaction with the trust that would be respected for income tax purposes. It did not conclude that the grantor realized the amount of the indirect borrowing or any portion of that amount as income.
>
> Rev. Rul. 77-402 concludes that the lapse of grantor trust status during the grantor owner's life may have income tax consequences, but does not impose such consequences on a non-grantor trust that becomes a grantor trust. Rev. Rul. 85-13 describes the income tax effects of a non-grantor trust becoming a grantor trust, which effects **did not include the realization or recognition of any income by the grantor-**

[156] As, for example, in PLR 9220012.

[157] CCA 2009-23024, PLR 2017-30017 (citing Rev. Rul. 77-402 and Rev. Rul. 85-13)

[158] Rev. Proc. 2020-3 §5 AREAS UNDER STUDY IN WHICH RULINGS OR DETERMINATION LETTERS WILL NOT BE ISSUED UNTIL THE SERVICE RESOLVES THE ISSUE THROUGH PUBLICATION OF A REVENUE RULING, A REVENUE PROCEDURE, REGULATIONS, OR OTHERWISE, (8) Sections 661 and 662.—Deduction for Estates and Trusts Accumulating Income or Distributing Corpus; Inclusion of Amounts in Gross Income of Beneficiaries of Estates and Trusts Accumulating Income or Distributing Corpus.—Whether the distribution of property by a trustee from an irrevocable trust to another irrevocable trust (sometimes referred to as a "decanting") resulting in a change in beneficial interests is a distribution for which a deduction is allowable under § 661 or which requires an amount to be included in the gross income of any person under § 662."

> **owner by reason of the conversion**. Given the lack of authority imposing such consequences, we conclude that the conversion of Trust from a non-grantor trust to a grantor trust **will not be a transfer of property to Grantor from Trust under any income tax provision**.
>
> ***
>
> Upon the conversion of Trust from a nongrantor trust to a grantor trust, the owner of the grantor trust can claim a federal income tax charitable deduction under § 170(a) only if property has been transferred to the grantor trust from the nongrantor trust.
>
> Because the conversion of Trust from a nongrantor trust to a grantor trust is not a transfer of property held by Trust for income tax purposes, Grantor is unable to take an income tax charitable deduction under § 170(a).
>
> Based on the information submitted and the representations made, **we conclude that: (1) the conversion of Trust from a nongrantor trust to a grantor trust is not a transfer of property held by Trust to Grantor as settlor of Trust for income tax purposes**;"[159]

While the IRS got the ultimate rulings correct in this PLR, some of their reasoning and interim conclusions to get there are incorrect, overbroad or misleading. This PLR concerned a non-grantor CLT converting to a grantor-CLT and the taxpayer was attempting to get a charitable income tax deduction at the time of conversion similar to someone funding a grantor CLAT *ab initio*. The PLR is correct to cite Rev. Rul. 85-13 and conclude that the conversion was not a sale or exchange or taxable event, but it goes too far when it says that there "will not be a transfer of property to Grantor from Trust under ***any*** income tax provision" or that it is "not a transfer of property held by Trust to Grantor as settlor of Trust for income tax purposes." Of course they are transfers, and who else would they be to if not to the grantor? What the IRS should have concluded instead is that conversion is indeed a transfer, just not a sale or disposition under IRC §1001 that would be a *taxable* transfer. The reason the settlor should have been denied a new charitable income tax deduction is that the transfer to a grantor CLT has to come *from* an individual (or trust deemed owned by an individual) to receive the tax deduction under §170, and this transfer to the grantor CLT came *from a non-grantor* trust. A non-grantor trust can only receive a charitable deduction under §642(c), and cannot receive one under §170 (with exception for S corp/ESBTs after TCJA).[160] The settlor/taxpayer was a *transferee* upon conversion, not a *transferor* as the IRS mistakenly refuted. The IRS implies that

[159] PLR 2017-30017.

[160] IRC §642(c)(1).

if conversion were deemed a transfer from the non-grantor trust the settlor/taxpayer would receive a deduction under §170, but this is incorrect.

Despite all the very favorable authority and guidance on conversions, there are still unanswered questions about how certain tax characteristics would flow through to the newly deemed owner on conversion. The threshold questions, whether a non-grantor trust converts to a standard grantor trust or a BDOT, are whether there is 1) a *distribution* to the deemed owner for income tax purposes and, trickier, 2) whether the non-grantor trust is considered "*terminated*" under Subchapter J.[161] In most cases, but not all, it would be advantageous to be considered *terminated*. A mere distribution will carry out current year DNI, but it would take a *termination of the trust* to carry out capital gains if they are not otherwise made part of DNI, or to carry out net operating losses (NOLs), capital loss carryforwards and excess deductions under IRC §642(h).

Suspended passive loss carryforwards should add to basis on termination or even a mere distribution of the interest.[162] Note that there is a parallel in that gifting such assets to a non-grantor trust (or presumably gifting to a grantor trust and then converting to a non-grantor trust) also adds such suspended losses to basis,[163] but there are special rules when the basis exceeds the fair market value at the time of the gift.[164]

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[161] 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."

[162] 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."

[163] IRC §469(j)(6).

[164] IRC §1015(a).

Some tax items, however, such as losses suspended due to at risk rules[165] and certain tax credits or other tax carryovers,[166] may *not* pass out on termination.[167] If there were substantial amounts in these categories, taxpayers may prefer that a conversion to grantor trust status *not* be considered a termination of the trust as a separate taxpayer, so that it may convert back to non-grantor trust status at some point to later soak up such tax preferences.

One influential treatise concludes that:

> "a [non-grantor] 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."[168]

PLR 9220012, discussed previously herein, which permitted beneficiaries to use capital loss carryforwards on conversion from non-grantor trust to BDOT status, is perfectly consistent with this conclusion. However, PLRs are not citable authority.

Some distinguished experts, however, question whether the conversion from a non-grantor trust to a grantor trust is a *termination*, and question whether carryovers such as passive losses, capital losses, disallowed investment interest and net operating losses would merely be *suspended* (and perhaps even expire in the case of NOLs) after changing from non-grantor to grantor trust status.[169] It's certainly an open question.

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[165] See IRC §465.

[166] See, e.g., IRC §27 (foreign tax credit), IRC §53 (alternative tax credit), IRC §611 (depletion carryover), IRC §163(d) (investment interest carryover). Many business credits turn into deductions in final year when a taxpayer "dies or ceases to exist", IRC § 196. Does a trust *cease to exist* on becoming a grantor trust?

[167] Losses in pass through entities that are suspended may also be trapped and not pass out to beneficiaries on termination, see Treas. Reg. § 1.1366-2(a)(6) for S corporations and *Sennett v. Commissioner*, 80 T.C. 825, 831 (1983), aff'd 752 F2d 428 (9th Cir. 1985) for partnerships, which may be cause for delaying any outright distribution (or, potentially delaying full conversion to BDOT status).

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

[169] 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.

The IRS and courts may ultimately adopt a middle ground between the above two interpretations. Is the trust *terminated* 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, the property is now considered the grantor's (or beneficiary deemed owner's) for income tax purposes. But it is not clear, and the regulations are extremely awkward to interpret in the context of grantor trusts. The most recent IRS pronouncement did not address this issue.[170] 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 with income taxed to powerholder) and no one has ever argued that this is not a *de facto* termination of the trust for IRC §642(h) purposes.[171]

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.[172]

The regulation discussing trust "termination" is not under the §642(h) regulations as we might expect, but under §641(b) regulations, and does not speak to situations in which the tax status changes.[173] If, as hinted at by this regulation, vesting in the beneficiary is important, converting to a BDOT arguably fits into this definition better than converting to a garden variety IGT, since most grantors have no property interest in an IGT whatsoever and it's hard to argue

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[170] CCA 2009-23024.

[171] 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).

[172] IRC §641(c)(4).

[173] 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 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. ***."

that property has been distributed to them (unless, of course, we ignore the trust as a taxpayer and consider the distribution to be to the deemed owner). 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 easily 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). Perhaps the parties could waive any rights in the trust that expand upon powers/rights already granted under state law that could be used to amend the trust to cause the trust to revert back to non-grantor trust status. This is analogous to not considering the ability of all interested parties including the settlor to amend irrevocable intervivos trusts under state law as an IRC §2036/2038 trigger causing inclusion in the settlor's estate.[174]

This is an uncertain area. If a conversion from non-grantor trust status is anticipated and the passive losses, NOLs or capital loss carryforwards are large enough, consider soaking them up by triggering gains prior to conversion, which might also soak up other deductible expenses that may be lost. That may or may not be possible. If the goal is to consider the trust terminated for income tax purposes, the trustee should file a final Form 1041 return as a non-grantor trust checking the "final year return" box F, as well as the "Final K-1" box on the top of the beneficiary's Form K-1 to start the statute of limitations running on that particular issue.

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[174] See 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"

In some cases, it may be desirable to keep an old non-grantor trust with favorable tax characteristics open and bifurcate into two trusts – one non-grantor trust that can keep any valuable credits or other tax characteristics, and one that continues as a clean grantor trust/BDOT.

l) Advantage – Avoidance of *Kenan* Gain Disasters

Arguably the most ubiquitous, overlooked and *dangerously* underappreciated clauses in trusts are division or distribution clauses based on pecuniary amounts rather than fractional divisions. Most 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 (not to mention irrevocable grantor trusts).[175]

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.[176] For example, if a trustee gives $50,000 of stock with a basis of $40,000 and $10,000 of cash to pay towards a $60,000 obligation (e.g. annuity), the trust incurs $10,000 gain and the beneficiary has a new basis of $50,000 in the received stock.[177] This is true even for distributions to charities, though in many cases a charitable deduction up to the gain may be permitted.[178] By contrast, a trustee cannot take a "Kenan loss" – if, similar to our example above, a trustee distributed $50,000 of stock with a *$60,000 basis*, the $10,000 *loss* would be denied.[179]

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

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[175] There are many thousands of these out there – the IRS is notorious for its lack of Fiduciary Income Tax audits and simply fails to catch the issue. For grantor trusts, see PLR 2009-20031 (it's not a problem when the amount comes back to the grantor of a GRAT, but when it's payable to another, it is).

[176] *Kenan v. Comm.*, 114 F. 2d 217 (2d Cir. 1940), in which a trust directed the trustees to pay a beneficiary $5 million 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. 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).

[177] Rev. Rul. 68-392.

[178] 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 was entitled to a §642(c) charitable deduction equal to the amount of gain recognized upon the distribution. Can we extrapolate from this to also permit a 642(c) deduction upon funding a pecuniary bequest to charity with IRD that is triggered? IRS Chief Counsel Memo 200644020, discussed further below, did not discuss or mention Rev. Rul. 83-75.

[179] IRC §267(b)(6). The beneficiary may be able to use some of the basis on later sale, §267(d). There is a special exception for taking a loss for an *estate* that satisfies a pecuniary bequest in kind - §267(b)(13).

distributed, the result would be *exactly the same*. The distribution would trigger gain even though the trust did not as obviously reference a pecuniary amount.[180]

More dangerously, because of the much larger dollar amounts, if the trust instrument split into A/B trusts based on a pecuniary formula, or GST exempt or non-exempt trusts based on a pecuniary 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

[180] 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*."

tax free, $3 million of ordinary income[181] and $10,000 of capital gain would be triggered.[182] This may hold true even though logic would lead us to think that it's a *de facto* residuary clause when the assets of the estate/trust are nowhere near sufficient to fund the bequest.[183]

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[181] See IRC §691(a)(2) and Treas. Reg. §1.691(a)-4 for the general rule that transfers of income in respect of a decedent for consideration trigger tax to the transferor. Is the satisfaction of the pecuniary obligation consideration? Potentially, yes. After all, if the trustee, using our example above, satisfies $50,000 of their obligation to the beneficiary by transferring a traditional IRA in kind worth that amount, they receive a benefit (in contractual lingo, consideration) of having $50,000 of their debt to the beneficiary reduced. This is implied but not specifically stated in (b)(2) which states that "If a right to income in respect of a decedent is transferred by an estate to a specific or residuary legatee, only the specific or residuary legatee must include such income in gross income when received." Presumably by omission, transfers to a non-specific or residuary legatee (i.e., a beneficiary of a pecuniary bequest) would not come under this rule or Treasury would have not have used the special modifiers. The latest IRS salvo on this has not been followed up on by the IRS. In Chief Counsel Memorandum (CCM) 2006-44020, the IRS ruled that the *Kenan* gain principal applied to using IRA/401(k) income in respect of a decedent to satisfy a pecuniary bequest. This is contested by many smart attorneys on the theory that IRC §691(c) ("income in respect of a decedent") rules trump this. It's not so clear to this author – if the IRS ever clues in to audit any of the thousands of cases this applies to every year it probably has a strong case. It's certainly recommended in planning mode to avoid the fight and potential risk. The strongest argument to make that *Kenan* principles do not apply is the language in IRC §691(a)(2) that excludes "a transfer to a person pursuant to the right of such person to receive such amount by reason of the death of the decedent or by bequest, devise, or inheritance from the decedent." In CCM 200644020, the IRS did not adequately analyze and explain why this sentence in 691(a)(2) should not apply. It would clearly apply if the IRA (or other IRD) were specifically assigned in the document to a particular beneficiary or subtrust. The key question would be – is the beneficiary of the trust (or the subtrust) funded with the pecuniary bequest receiving it "from the decedent" or from the master revocable living (or testamentary) trust, which is a different taxpayer? It's clearly coming from the decedent, but through the trustee as intermediary. Do they have a "right" to that IRD property? Arguably not, they only have a right to a pecuniary amount. But what if using IRD were the only way to satisfy that obligation? Then, arguably they do have a right to it, at least to the extent that other assets could not be used to satisfy it (e.g., if the pecuniary amount were $5 million and the IRA was $3 million and non-IRA assets $3 million, then there is arguably a *right* to at least $2 million of the IRA). Should the interposition of the trust or estate as an intermediary between the decedent and the ultimate beneficiaries matter? Difficult issues – try to avoid them altogether! By the IRS not bothering to raise this issue in the last 15 years when it's had tens of thousands of opportunities to do so, we might surmise that they don't know how to view this either and are less than confident in their stated position.

[182] For appreciated assets being used to satisfy a pecuniary marital deduction trust triggering gain, see Rev. Rul. 56-207. See also PLR 2008-48009, where the IRS concluded that a probate court-approved amendment to change from pecuniary funding of a GST exempt share to fractional funding was **ineffective** to change the *Kenan* income tax effect and therefore gain must still be recognized on the appreciation upon funding, despite the valid amendment. The IRS may have misapplied *Bosch* because it is unclear whether the highest state court would not have also approved the same reformation under applicable state law (was the probate court order a disingenuous construction of what the trust actually said, in which case I might agree with the IRS since the language was pecuniary and the highest state court would not have approved, or was the order a reformation fully compliant with state law, in which

If the trust has a staggered distribution, for example, 1/3 at age 35, whether this rule applies will 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 is a distribution of a pecuniary amount that is simply initially (and deceptively) defined by use of a fraction, not dissimilar to how Treasury considers the distribution of net income to be a pecuniary amount, as noted above. It does not matter for tax law that the pecuniary amount is not known at the time of death. In fact, such a staggered distribution is strikingly similar to the original *Kenan* case. Many attorneys disagree with me on these points (and yes, many have clients who have passed through audit without the IRS catching it), but the authority is quite strong. For example, the IRS has ruled that "one-half of his adjusted gross estate as finally determined for Federal estate tax purposes" is a pecuniary bequest triggering *Kenan* gain, not fractional.[184] These conclusions would likely surprise many readers. Although one could argue these distributions should treated similar to any residuary distribution, don't bet on it. Just because most tax preparers, professionals (and, truth be told, even IRS personnel) ignore this issue does not mean that an IRS agent will not wake up one day and discover it.

The beneficiary who received such a distribution *might* actually *prefer* this *Kenan* gain result, because triggering gain in the trust means they receive the assets with a step up in basis

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case *Bosch* would have been misapplied?). There is substantial authority for honoring the *prospective* tax effect of amendments if completed *before the taxable event occurs*. That said, that doesn't mean the strategy would have worked had it been a *bona fide* reformation and the IRS analyzed it correctly. Whenever taxpayers agree to reform a trust where the parties subsequently hold substantially and materially different legal entitlements as a result, the *reformation itself* may be considered an income taxable event, with potentially devastating consequences which might even be worse than the *Kenan* gain effect. See *Ed Morrow on Potential Income Tax Disasters for Early Trust Terminations,* LISI Estate Planning Newsletter #2753 (October 9, 2019). Under the Supreme Court case of *Cottage Savings* and IRC §1001, would the taxpayers in the PLR have had materially different legal interests before and after? They may have, because a significant amount of time had passed so the difference between a pecuniary and fractional share funding could have been quite substantial.

[183] See Rev. Rul. 66-207, 1966-2 C.B. 243, in which the Service ruled that specific bequests that were underfunded retain their character as specific bequests, and thus do not carry out income, even in the final year of the estate, under IRC §661. "The fact that the fair market value of the property remaining in the estate is not equal in amount to the bequest of the specific sum of money does not transform that bequest into a bequest of the residue of the estate.*** Accordingly, a final distribution by the executor of an estate of appreciated property, in order to satisfy a pecuniary legacy, will result in a gain to the estate, although such distribution is of an insufficient amount to completely satisfy such bequest." There is ample reason to disagree with the IRS position on this point. If I purport to leave $1 trillion of my trust/estate to my beneficiary but only have a $400,000 estate, is that really a pecuniary bequest? It seems like an absurd conclusion, but you would have an uphill battle against the IRS with that Revenue Ruling against you.

[184] *Rev. Rul. 60-87*, citing and clarifying Rev. Rul. 56-270.

due to the triggered sale. Or they may be livid about their own large tax bill on the Form K-1! Whether a distribution of a pecuniary amount would carry out *Kenan* gain to the beneficiary or trap the income in trust would depend on whether: 1) the capital gain becomes part of DNI (despite the default rule that it usually does not);[185] and 2) whether the distribution of the pecuniary amount to the beneficiary is excluded from being considered a distribution that carries out DNI as a specific bequest in three installments or less under IRC §663(a)(1). For example, an instruction to distribute $1 million or Blackacre when the beneficiary reaches age 40 and another $1 million at age 50 would be excluded as a distribution that carries out DNI, but an instruction to distribute 1/3 of the trust value on date X would *not* be excluded because the amount or asset is not ascertainable at death or funding of the trust.[186]

By contrast, if the value of the 1/3 varied based on the value of the portfolio of assets at the time of distribution, e.g., if the beneficiary's rights increased or decreased between the measuring date and the distribution date accordingly, such as 1/3 of each asset, it may be no different from a distribution to any residuary beneficiary (i.e., no gain unless a §643(e) election is made). Most staggered age clauses are probably *not* in this category.

Estate equalization clauses can also inadvertently trigger *Kenan* gain. For example, if someone gifted family company stock to one child, then added language to their will/trust to equalize the trust/estate between their two children at their death taking into account the prior gifts made to one child only.[187]

However, if this right of withdrawal/distribution comes from a fully beneficiary deemed owner trust (BDOT), no gain should be triggered at all under Rev. Rul. 85-13 and Rev. Rul. 55-294. The basis in any assets withdrawn in kind remains the same.[188]

The power to *withdraw 1/3 or 1/2 of the corpus* at age X might be a different analysis if the beneficiary did not have a power over all of the trust income. The trust would only be

[185] IRC §643(a)(3) generally excludes capital gains from DNI. There are three exceptions to this general rule outlined in Treas. Reg. §1.643(a)-3(b) that may also be considered. The IRS can be stingy about this and in similar situations without specific language in the trust has found it does not apply. See Rev. Rul. 68-392 cited earlier.

[186] IRC §663(a)(1) and Treas. Reg. §1.663(a)-1(b).

[187] Rev. Rul. 82-4, 1982-1 C.B. 99, which addressed those facts and found the equalization amount to be pecuniary and thus any satisfaction of said amount with appreciated assets would trigger gain.

[188] Rev. Rul. 55-293: "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]."

partially deemed owned by the beneficiary (in the above example, of 1/3 or 1/2, similar to a 5x5 power). Would such a withdrawal also be a non-event, i.e., would it be deemed to be taking from the deemed owner portion only? Perhaps, but we cannot have the same level of confidence because we do not have as much guidance on ***part***-grantor trusts. If I sell to a 50% grantor trust is ***half*** my sale ignored? The conclusion that is most consistent with the principles of the Treasury Regulations under 671 would be that, assuming the 1/3 or ½ does not apply to specific assets, that a portion of any withdrawal (whether in cash or in kind) would be disregarded as a transaction between the trust and its deemed owner, and a portion would be deemed as a distribution from a non-grantor trust, potentially triggering Kenan gain if involving the distribution of appreciated assets in kind, and carrying out DNI like any other distribution.

m) Estate Inclusion Risk (and Advantages): Mitigating and Exploiting It

Amounts of income (or principal) subject to withdrawal at death are included in a beneficiary's estate under IRC §2041.[189] E.g., if on July 1 date of death a trust had $50,000 of income and the beneficiary had withdrawn $30,000 before death, leaving $20,000 withdrawable at death, $20,000 would be includable. 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.[190]

For non-taxable estates, taxpayers would prefer to trigger estate inclusion over all appreciated assets up to their available exclusion amount, not just current taxable income. Thus, a beneficiary deemed owner trust may 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.[191]

For taxable estates, however, this is a problem, similar to that of "stub income" provisions. This power would cause the taxable income that is still withdrawable at the powerholder's death to be taxed at 40% estate tax rate, unless it is appointed to charity/spouse or trust therefore. This can be mitigated if the withdrawal right is not vested and not exercisable until the end of the year (unless the beneficiary dies on the last day of the year during the time window, of course). A beneficiary would be unlikely to die with any includible right and the risk of inclusion would be minimal.

If the beneficiary engages in transactions with their BDOT, however, it would be prudent to have the withdrawal right apply all year round continuously, to avoid any argument that the trust only becomes a BDOT at the end of the year when the withdrawal right is exercisable.

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[189] Treas. Reg. § 20.2041-3(d)(3); *Estate of Dietz v. Commissioner*, T.C. Memo. 1996-471. "FMV" refers to "fair market value", see Rev. Rul. 59-60.

[190] I cheated and stole this calculation from an actual case with identical facts, see *Prokopov. v. Commissioner*, TC Memo 1997-229.

[191] 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.

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, yet have ordinary distribution provisions for all other assets.

Grantor trusts are permitted this exclusion provided the other occupancy requirements are met.[192] 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.[193] However, section §678 trusts (such as BDOTs) are specifically included in the regulations (as are disregarded entities such as SMLLCs).[194] *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.[195] Of course, the goal with this type of provision would be to grant the withdrawal right over the capital gain

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[192] 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).

[193] 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.

[194] 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).

[195] 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.

from 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*![196] 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.[197] 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.[198] 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.[199]

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[196] Census Bureau Statistics show that widowers are more likely to remarry much sooner after a death of a spouse than widows.

[197] 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).*****

[198] Uniform Prudent Investor Act (Restatement of Trusts, 3rd), §181.

[199] 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*.[200] 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.[201]

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).

For further discussion of the use of BDOTs to own residences, not only for IRC 121 purposes, but for deductibility of mortgage interest, impact on ad valorem taxes, homestead and asset protection under Florida law, see the recent Florida Bar Journal article that even includes some sample clauses, *Creating a Florida Irrevocable Homestead Trust for Ad Valorem, Income, and Transfer Tax Purposes*.[202]

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[200] *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).

[201] Treas. Reg. §1.163-1(b) (equitable ownership sufficient)

[202] *Creating a Florida Irrevocable Homestead Trust for Ad Valorem, Income, and Transfer Tax Purposes*, by Thomas O. Wells and Jennifer E. Okcular, Florida Bar Journal Vol. 94, No. 5, September/October 2020.

o) Advantage – Section 170 v. 642(c): 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, Ability to Donate Trust Assets to CRT and Grantor CLTs

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 – it's the same as taking a withdrawal and cutting a check to the charity.[203] Increased income to the beneficiary enables a greater percentage of any charitable deduction to be taken due to the increase in the taxpayer's 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 in Section 642(c) 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.[204] There is no problem with phantom income if the charity gets funds directly from a trust, whereas §642(c) deductions can be denied if the charity does not actually receive income.[205] There is no need to have a specific charitable instruction in the governing instrument, and most importantly, any unused deduction can carry forward up to five succeeding years (fifteen for qualified conservation easements).[206]

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[203] *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)."

[204] 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 tracing 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 Congress got rid of tracing for the most part in enacting Subchapter J – it's a huge mess.

[205] *Sid W. Richardson Foundation v. United States*, 306 F. Supp. 755 (N.D. Tex. 1969).

[206] IRC §170(d).

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.[207]

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.[208] 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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[207] 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.

[208] 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.[209] 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* (as of 2018, line 22 of Form 1041).

Donating Long-Term Gain Appreciated BDOT Assets to CRTs

Non-grantor trusts can't just defer gains on sale of appreciated assets by donating assets to a CRT, even if the document allows it, because neither an IRC §170 nor an IRC §642(c) deduction would be available to a non-grantor trust funding a CRT and a valid CRT requires "a deduction…allowable under section 170, 2055, 2106, or 2522."[210] Some argue that a donor could establish and gift to a CRUT themselves to make the CRUT valid, and then have the trust add to it later, on the theory that the first contribution which allows a deduction to the settlor/donor under Section 170 makes the CRUT valid and thus cleanses any future contributions from the trust that would otherwise be ineligible for a deduction.

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[209] 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 BDOT. For example, if a taxpayer/beneficiary of a BDOT 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. 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.

[210] Treas. Reg. §1.664-1(a)(1)(iii)(a).

Presumably a "peppercorn" of funding would not work, so how much would be required? This may or may not "work" – there is no authority either way. Does the requirement that a deduction be allowable mean "allowable to any settlor/donor" or "allowable to each settlor/donor"? Even if an individual signs a CRUT, the non-grantor trust would be considered a settlor/donor as well. Proponents of this strategy gloss over this requirement, but it's far from clear that the regulation means "allowable to any settlorfcarry".

In some cases (such as an ING), a non-grantor trust funding a CRT might involve a completed gift that would receive a charitable gift tax deduction under §2522, but this may not always be the case.

A distribution to charity from a fully grantor trust should be deemed to be a transfer from the deemed owner.[211]

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[211] *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 but only as to the accounting income, and a charitable deduction would have been allowed if it had come from a taxpayer's grantor trust portion, but the court ultimately denied the deduction since the contribution was not traced to the ordinary income but to principal). Treas. Reg. §1.671-2(c) provides "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)."

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.[212] 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**.[213] 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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[212] 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.

[213] 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.[214] 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![215]

By contrast, a beneficiary can sell a life insurance policy insuring themselves to a BDOT without triggering the transfer for value rule.[216] 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.[217]

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).[218] 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.[219]

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[214] IRC §2035, §2036.

[215] IRC §101(a)(2).

[216] 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. See also PLR 2012-35006.

[217] 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).

[218] Treas. Reg. §1.671-2(e)(5), using a GPOA to appoint in trust makes the powerholder the grantor for income tax purposes.

[219] 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.[220] One reason that trustees tend to avoid them is that non-grantor trusts it's unclear whether all trusts receive the same income tax deferral that an individual would receive, although the most recent PLR on this discussed below is quite favorable to non-grantor trusts as well as grantor trusts.[221] 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).[222]

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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[220] 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).

[221] 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.

[222] 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. The most recent PLR discussed below did not touch on §72(s)(4).

The IRS recently confirmed the distinction between grantor trusts and non-grantor trusts in the annuity realm in PLR 2020-31008, in which the IRS summarized the difference in the context of ownership of non-qualified annuities:

> "Accordingly, the Grantor is the "taxpayer" with respect to the Contract, and references to the "taxpayer" in sections 72(q)(2)(A), (C), and (D) are references to the Grantor.***
>
> The Grantor is treated as the owner of the entire Grantor Trust, and as a consequence, the Grantor is also treated as the owner of the Contract for federal income tax purposes. See Rev. Rul. 85–13. The Grantor Trust is holding the Contract for the Contract's tax owner, the Grantor, who is a natural person. Accordingly, the holding of the Contract by the Grantor Trust is not taken into account for purposes of section 72(u)(1). ***
>
> The Non-Grantor Trust, however, cannot attain age 59½, become disabled, or have a life expectancy, as contemplated by sections 72(q)(2)(A), (C), and (D), respectively. Thus, the exceptions provided by these provisions are not applicable to distributions under the Contract in the Non-Grantor Trust Scenario.***
>
> **RULINGS**
>
> **We rule that in the Grantor Trust Scenario –**
>
> (1) For purposes of section 72(q)(2), (i) the Grantor is the "taxpayer," so the exceptions in sections 72(q)(2)(A), (C), and (D) will apply based on the age, disability, and life or life expectancy, respectively, of the Grantor and (ii) the Grantor Trust is the "holder" of the Contract, so that the exception in section 72(q)(2)(B) will apply based upon the death of the primary annuitant (as defined in section 72(s)(6)(B)), who is the individual Grantor Trust Beneficiary.
>
> (2) For purposes of section 72(u)(1) and pursuant to the flush language of that section, the Contract is held by the Grantor Trust for the Grantor, so that section 72(u)(1) will not apply even though one of the Grantor Trust Beneficiaries is a charitable organization.
>
> **We rule that in the Non-Grantor Trust Scenario –**
>
> (1) For purposes of section 72(q)(2), (i) the Non-Grantor Trust is the "taxpayer," so that the exceptions in sections 72(q)(2)(A), (C), and (D) will not apply to any distribution from the Contract because the Non-Grantor Trust cannot attain age 59½, become disabled, or have a life or life expectancy within the meaning of such sections and (ii) the Non-Grantor Trust is the "holder" of the Contract, so that the exception in section 72(q)(2)(B) will apply based upon the death of the primary annuitant (as defined in section 72(s)(6)(B)), who is the Non-Grantor Trust Beneficiary.
>
> (2) For purposes of section 72(u)(1) and pursuant to the flush language of that section, the Contract is held by the Non-Grantor Trust for the Non-Grantor Trust Beneficiary, so that section 72(u)(1) will not apply."

s) *Advantage – Avoiding 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.[223] This is especially true for trusts holding S corporation stock making an electing small business trust election (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.[224]

Sometimes we can avoid taxation in *any* state through using professional trustees in favorable trust jurisdictions. These may include not only states without an income tax (e.g. Florida, Texas, Washington), but also many other states such as Ohio or Delaware that would not tax a trust just because the trustee and administration are in that state. Trapping income in trust is often strategically intended for those beneficiaries in the highest income tax bracket who live in a high-tax state.[225] 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

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[223] 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.

[224] 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.

[225] See, *INGs: Not Just for State Income Tax Avoidance*, by this author, available at www.ultimateestateplanner.com and 50 state plus D.C. trust taxation chart available from the state survey section of ACTEC's website: https://www.actec.org/assets/1/6/Morrow_State_Residency_and_Source_Income_Factors_for_Taxation_of_Irrevocable_Non-Grantor_Trusts.pdf.

or where its assets, beneficiaries or trustee is located (a.k.a. "founder states").[226] Other jurisdictions are similar with regard to *testamentary* 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.[227]

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?[228] 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 (despite the argument that many of the residency of the settlor is irrelevant, as found in the *Fielding* case, or that the residency of the beneficiary is mostly irrelevant, as found in the *Kaestner* case).

States may not always grant a full credit for taxes paid to sister states either. When a trust as taxpayer has sufficient nexus with different states, each may tax the income.[229] While

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

[227] Because of continuing jurisdiction asserted 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*!

[228] 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.

[229] *Curry v. McCanless*, 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."

many states allow trusts some form of credit for taxes paid to other states, it may be limited to source income only or it may not even be required.

Sometimes state income tax will not be an issue because all of the income is being distributed (if capital gains allocated to income, and if the trust is not an ESBT).

Under some state income tax statutes, it may be possible to avoid the reach of the statute by simply changing the trustee and administration to a favorable jurisdiction. Changing the residency of grantors, testators and beneficiaries, however, is not so easy. Some may be able to tolerate the prospect of fighting years of battles with state tax departments to have broad statutes that use residency of the settlor and/or beneficiaries as a factor declared unconstitutional (at least as applied to them). However, not everyone loves litigation or has the resources of the Pritzker family to fight such battles. *Grantor trust status avoids this mess altogether*.[230] Mostly.[231]

Thus, BDOT provisions can be especially helpful for "founder state" trusts, where the beneficiary lives in a state with a lower state income tax rate, because the income tax can be shifted to the state of the beneficiary deemed owner without having to take the assets out of the protective wrapper of the trust (which may be GST exempt and outside of the beneficiary's state, and is much better protected from an asset protection/divorce standpoint).

For more discussion of state income tax planning using trusts as beneficiaries of other trusts, see Part II.mm Entities, Other Trusts, UTMA Custodians as Deemed Owners.

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[230] 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 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."; CA Rev & Tax Code § 17731 expressly provides that: "a) Subchapter J of Chapter 1 of Subtitle A of the Internal Revenue Code, relating to estates, trusts, beneficiaries, and decedents, ***shall apply, except as otherwise provided***."

[231] Pennsylvania is an exception and to my knowledge the only state that taxes grantor trusts separately. See discussion and cites in footnote 319 below. Also, some states may impose filing requirements on a trustee even if all the income is reported under grantor trust rules to a non-resident, which may include withholding requirements if there is any source income. See, e.g. Massachusetts Department of Revenue Directive 89-4: Grantor Trust with Non-Resident Grantor.

BDOTs may also be used to remove source income from a trust where the state may see such income as a factor in determining whether a trust is a "resident trust" over which it can tax the entire income of the trust, not just the source income, such as in NY, NYC, NJ, ND.[232]

[232] See discussion in *Ed Morrow, Jonathan Blattmachr and Marty Shenkman on Using Decanting and BDOT Provisions to Avoid a Peppercorn of Income Potentially Triggering State Income Tax on a Trust's Entire Income*, LISI Income Tax Planning Newsletter #204 (September 15, 2020).

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.[233] 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.

Explaining the income taxation of a QTIP/BDOTs to spouses would be *infinitely* easier. Whether it fits a particular client's situation will largely depend on their level of desire to preserve the 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,

[233] 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."

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

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 had 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.

Imagine H, with a $22.8 million estate in 2019 (no gift/estate/GST exemption previously used), dies leaving his estate to W. H leaves all of his estate in a QTIP trust, and the executor/trustee makes a QTIP election over all of the trust, but makes a *reverse* QTIP election such that the trust is bifurcated and half is allocated his GST exemption (zero inclusion ratio), and half is not (thus, in W's estate for both estate and GST purposes). This is not a particularly uncommon scenario for an estate of this size. Imagine that W also has her own $11.4+ million estate aside from the QTIPs. Under a standard estate planning design, the GST exemption is gradually wasted (i.e., not fully exploited) by the drain on the GST exempt trust, because it is paying out, at a minimum, all net income annually. With a BDOT structure, however, W would simply take any of her current need for distributions from the GST *non-exempt* QTIP trust, permitting **the GST exempt QTIP trust to *grow tax-free***. See further discussion in section II.hh on GST planning with BDOTs.

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

When a grantor or beneficiary is deemed to be the owner of all the income under §671-679 for income tax purposes, there is no authority or rationale 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, both IRC §678(a)(1) and the regulations are clear that a §678 beneficiary "**shall be treated as the owner**" for income tax purposes of "any portion of a trust with respect to which such person has a power exercisable solely by himself to vest the corpus **or the income therefrom** in himself." It does **not** say "shall be treated as the owner for everything but sales and exchanges."

Regulations are similar: "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**."[234] Throughout the grantor trust/portion regulations, you will see the rules applying equally to a "grantor *or* other person" or "grantor *or* another person". This interpretation of treating a §678 deemed owner similar to a §673-677 deemed owner for purposes of disregarding transactions under rationale of Rev. Rul. 85-13 is confirmed in a recent private letter ruling.[235]

Many readers are undoubtedly wondering – since BDOT techniques can create what is considered a grantor trust as to the beneficiary as to all trust taxable income so that they are deemed the owner for income tax purposes, 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?[236] Put another way, can a taxpayer engage in a transaction with a BDOT that would even be respected for income tax purposes? There is nothing in IRC §678(a)(1) that would justify treating someone who can withdraw the corpus differently from someone who

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[234] Treas. Reg. §1.678-1(a).

[235] PLR 2020-22002, in which one trust sold a partnership interest to another trust. The same taxpayer was deemed to own one trust under traditional grantor trust rules §671-677, and deemed to own the other trust under §678 due to a withdrawal right. The IRS cited Rev. Rul. 85-13 (and its underlying authority) and ruled that the transaction was not recognized for income tax purposes because the "same person is treated as owning the purported consideration both before and after the transaction."

[236] One recent ACTEC Journal article answered this question in its title: *A Sale to a BIDIT Should Work as Well as a Sale to an IDIT*, by Michael D. Mulligan, ACTEC Law Journal Volume 46, #3, Summer 2021. That said, the article did not discuss any potential nuances between rights to corpus or income therefrom.

can withdraw all the income derived from it (hence the word "or"). There are, however, still a few areas of uncertainty, discussed further below.

The issues are identical to an installment sale or swap with an 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 a much larger seed gift (rather than a mere $5,000) to justify a much larger transaction, and with less attendant substance over form risk accordingly.[237]

Outside of the 2nd 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.[238] There is an argument under the code that *Rothstein* is correct and that transactions between trusts and their deemed owners should *not* be ignored for income tax purposes. However, the IRS has specifically refused to follow *Rothstein* (in Rev. Rul. 85-13), no case since has followed it, and in the 35 years since that case the IRS has issued many 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 – there is no indication or justification for treating IRC §678 differently from other grantor trust code sections (and because of the alternative way in which §678(a)(1) is worded, there is no indication or justification for treating a power over corpus differently than a power over income). Here is a short summary of recent cases and rulings:

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.[239] It stated that

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[237] 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). Similar, Rev. Proc. 2020-3, §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).

[238] *Rothstein v. United States*, 735 F.2d 704, 709 (2d Cir. 1984). Several *dissenting* opinions also made this argument in *Estate of O'Connor v. Comm*. 69 T.C. 165 (1977), but the majority opinion in that case was basically a precursor to Rev. Rul. 85-13, holding that a Section 678 trust was completely disregarded as a separate taxpayer from its deemed owner.

[239] Rev. Rul. 85-13, 1985-1 C.B. 184.

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."[240]

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.[241]

Rev. Rul. 92-84 (rendered obsolete in 1995 by S corp regulations):[242] 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 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 revenue ruling.[243] 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

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[240] *Madorin v. Commissioner*, 84 T.C. 667, 675 (T.C. Apr. 11, 1985).

[241] Rev. Rul. 88-103 (I.R.S. July 1, 1988).

[242] Rev. Rul. 92-84, 1995-2 C.B. 135 (I.R.S. July 1, 1995).

[243] Treas. Reg. §1.1361-1(j)(8).

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.*** *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."[244]

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 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."**[245]**

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.[246]

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

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[244] IRS Notice 97-24 available at https://www.irs.gov/pub/irs-irbs/irb97-16.pdf.

[245] Rev. Rul. 2004-86.

[246] Rev. Rul. 2007-13, 2007-1 C.B. 684.

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.

> **"We believe that Rev. Rul. 85-13 should be read broadly, requiring that a grantor trust not be recognized as a separate taxable entity for federal income tax purposes if someone has such dominion and control over it as to create a single identity of interest between the trust and the owner."**
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> "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 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, it cannot be recognized for federal tax purposes (at least under current interpretation).

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.[247] In his extensive 1278 pages of material (which increases prodigiously every quarter) on corporate and estate tax 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.3791 A sale to an irrevocable grantor trust is a powerful estate planning technique.3792 Clients sometimes balk at selling assets to a

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[247] 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. I highly recommend doing so. It is more comprehensive and useful than most 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). As discussed in section II.d. of this paper, QSSTs are deemed to be BDOTs taxable under IRC §678(a) for most purposes.

> 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.3793
> [note: he is referring to a QSST above rather than a BDOT discussed in this article]
> ***
> 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.
> ***
> 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).3796
> 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,3797 but does not discuss the consequences of the trust buying S corporation stock.

Thus, Mr. 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.[248] While this may seem illogical at first, 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 under Treas. Reg. 1.671-3(a) 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 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 only disregarded for ongoing S corp income and considered a separate taxpayer under non-grantor trust rules when it sells S corporation stock or as to non-S Corp income. 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.

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[248] 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).

Perhaps the IRS should revisit Rev. Rul. 85-13 and its progeny above, as it carries the grantor trust rules beyond what Congress may have originally intended. Congress never said to completely disregard grantor trusts - the code and regulations just say to report the income, deductions, credits, gains/losses to the grantor or other deemed owner. Congress made the grantor trust rules extremely broad in order to combat bracket abuse when trust/estate tax brackets were less compressed and there was an income tax advantage to creating separate taxpayers. It is theoretically possible within this structure to recognize income.[249] If I were head of the IRS, I would consider rescinding Rev. Rul. 85-13 altogether or asking Congress to close the loophole. However, until the IRS rescinds or modifies its position, we have plenty of authority and precedent to rely on.[250]

There is no authority to treat IRC §678 differently from other Subpart E code sections and no intellectually honest way to parse them differently, *with one exception noted below*. After all, the *Estate of O'Connor* case cited above and cited in Rev. Rul. 85-13 was a beneficiary deemed owner trust under IRC §678(a). There is much more tax "abuse" in disregarding transactions between a grantor and an irrevocable grantor trust in which a grantor has no beneficial equitable interest whatsoever (e.g., an IGT, SLAT) than one in which the deemed owner has a substantial *bona fide* beneficial equitable ownership as a beneficiary, as in the case with a BDOT. The only reason practitioners do not see those as abusive is that 35 years of planning with them has normalized the practice.

Some argue that a BDOT provision only applies to income, not to corpus and so it's somehow different. But that's true for other grantor code sections. IRC §677 doesn't even mention corpus, yet no one has ever claimed that Rev. Rul. 85-13 doesn't apply to SLATs that are only grantor trusts by virtue of access to only "income" under §677. When a trustee can distribute income including capital gains to a grantor's spouse, even if there is no access to principal beyond that, it's still a grantor trust over which the grantor is deemed the owner for income tax purposes even if there is no power whatsoever imputed to the grantor over the original *corpus* of the trust. The only purpose of the grantor trust rules is to determine who the

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[249] 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 realization event. Of course, this is contrary to the above Revenue Rulings (except as noted below in the CLT context).

[250] See Treas. Reg. § 601.601(d)(2)(v)(c): "Where Revenue Rulings revoke or modify rulings previously published in the Bulletin the authority of I.R.C. § 7805(b) of the Code ordinarily is invoked to provide that the new rulings will not be applied retroactively to the extent that the new rulings have adverse tax consequences to taxpayers."; § 601.601(d)(2)(v)(e): "Taxpayers generally may rely upon Revenue Rulings published in the Bulletin in determining the tax treatment of their own transactions."; *Rauenhorst v. Comm.*, 119 T.C. 157, 170, 172 (2002), finding that a revenue ruling is a concession by the IRS that the agency must either withdraw or modify before it can take a contrary position.

owner of the items of income, deductions, credits etc. is for income tax purposes. Who the legal or equitable owners are of the trust corpus is irrelevant. Congress expressly gave the two powers **equal** weight when it added “corpus **or** the income therefrom” in §678(a) deeming a beneficiary/powerholder as the owner for income tax purposes.

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.[251] However, this can be differentiated from the above authority because the payments are going to fulfill an obligation to *another taxpayer (the 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*.

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 and $100,000 cash. 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. That said, I am not aware of any other article, treatise or CLE outline warning about this, so perhaps I am alone in my concern.

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[251] 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.

Potential asymmetric exception to disregarded treatment for sales between BDOTs and their deemed owner-beneficiaries and how to avoid the issue

As mentioned above in the discussion of QSSTs and elsewhere in the discussion of the §1.671 portion regulations, it is very possible to have an "asymmetry" of tax treatment depending on whether a trust is a buyer or a seller. For example, if a beneficiary sells S corp stock to their QSST (assuming that it has no other asset) over which they are the deemed owner, as Steve Gorin notes, might be disregarded, but the opposite may not hold true. This is similar to when a beneficiary sells assets to a BDOT, which would be the most common direction of any transaction.

But let's reverse the most logical transaction and examine an incongruity that must be addressed. If a BDOT trustee sells an asset for what would be a capital gain, the beneficiary has a withdrawal right over the capital gain and must be taxed on it, similar to the *Campbell* case and likely the old *Mallinckrodt* case as well. But what if a BDOT sells an asset *to the beneficiary themselves*? We would then have a circular logic applying, because the BDOT is only disregarded because of the beneficiary's ability to withdraw income, but to the extent it is transacting with the beneficiary themselves, it *does not have any* taxable income. Arguably the withdrawal right is illusory to the extent of any gains that are attributable to the BDOT selling assets back to the beneficiary. Would that matter? Perhaps not, since all the other income would still be withdrawable and taxable to the beneficiary deemed owner – it's a non-event.

For example, a BDOT has $40,000 of ordinary interest/dividends and $40,000 of realized capital gains over the year, which the beneficiary may withdraw. This is easy to evaluate so far, this $80,000 is taxable to the beneficiary and reported accordingly. But imagine that in addition to these transactions, the trustee also swaps or "sells" $50,000 of stock with a basis of $30,000 *to the beneficiary*. With "ordinary" grantor trusts under IRC §673-677, this does not create any additional concern, provided the IRS sticks with its position in Rev. Rul. 85-13. Disregarded sales/swaps are done all the time, whether there is a formal §675(4)(C) power or not. Here, however, there is something unique about §678(a)(1)'s scope. The beneficiary would ordinarily be able to withdraw an additional $20,000 if the sale were to a third party. But here, the beneficiary cannot withdraw the $20,000 because there is no taxable income due to their very right of withdrawal over the taxable income! In some ways, this is similar to the asymmetry involved when an otherwise non-grantor trust loans funds to a grantor (sells on installment), causing the transaction to be disregarded grantor trust, as in Rev. Rul. 85-13.

The IRS could argue that the withdrawal right as to that $20,000 in our example ($20,000 out of the $100,000 total) is illusory, unless the scope of the withdrawal right is specifically crafted to include income that would be taxable income but for the application of Rev. Rul. 85-13 and other authority cited above. Of course, if that portion of the trust (the

$50,000 of stock and any income therefrom) becomes a non-grantor trust, then this triggers the $20,000 of capital gains on sale, which the beneficiary/powerholder then has a right to withdraw, which then deems them to be the owner of said gains under §678(a) of the income again. Head spinning?

If a beneficiary could easily get out of §678(a) disregarded trust treatment by purchasing assets of a trust that is otherwise a BDOT (and the withdrawal power is not modified as noted above), it would allow beneficiaries to buy trust assets generating $13,000 or so worth of gains every year to allow the trust to soak up trust income tax brackets, IRC § 67(e) deductions, SALT deductions and the like and pay tax at their rates on the rest. There is no clear authority for this other than *Rothstein*. If a disregarded transaction is desired, however, the best practice would be to modify the withdrawal right as noted above accordingly, or simply avoid it.

In short, my suggestions to attorneys when they ask about this strange asymmetry if a BDOT sells assets to a beneficiary is… "*Just avoid the issue*." There are dozens of advantages and uses of BDOTs discussed in this paper that have substantial authority and relative certainty. This type of transaction would not be in that category and there is no compelling reason to do it. Don't let some obscure transaction that no one will ever think of actually doing prevent using the technique for many other purposes. If it's still compelling, modify the withdrawal right accordingly so that the withdrawal right also covers income that would be taxable but for Rev. Rul. 85-13. That should make the power non-illusory, but this area is untested. The IRS is unlikely to issue a private letter ruling in this area – it's too outside the box and they don't want to give the public any more ideas by blessing more creative planning opportunities even if there is substantial authority, since they probably regret issuing Rev. Rul. 85-13 enough as it is.

Potential Impact of the Proposed "For the 99.5% Act" and IRC §2901 on any Swaps or Sales between Deemed Owners and Irrevocable Grantor Trusts and BDOTs

Senator Bernie Sanders has proposed a sweeping estate tax reform bill, the "For the 99.5% Act".[252] It would kill future installment sales to new irrevocable grantor trusts, including BDITs/BDOTs. It would curb the use of irrevocable grantor trusts in general considerably. Interestingly, it would grandfather in sales to pre-existing irrevocable grantor trusts as long as there is no new funding after enactment, but it carves out a special rule for installment sales to BDOTs so as to penalize those even if the trust was in existence prior to the passage of the bill. So, while ordinary BDOTs in general would not be touched by the bill, and would remain advantageous for many purposes even if this bill were passed, *any future installment sale to a BDOT* (or BDIT), even if in existence prior to enactment, would effectively be curtailed. It's almost as if someone in Treasury or at JCT had read this white paper and concluded that

[252] For links to the bill, summary and JCT revenue scoring, see: https://www.sanders.senate.gov/press-releases/sanders-and-colleagues-introduce-legislation-to-end-rigged-tax-code-as-inequality-increases/

without further legislation the technique was legitimate and could not be attacked without legislation, so any proposed legislation should be clear to combat both installment sales to "ordinary" irrevocable grantor trusts as well as installment sales to BDOTs, even if allowing pre-existing IGTs that are probably commonly used by wealthy Senators and their families. Here is the proposed IRC §2901 (**emphasis** added):

SEC. 2901. APPLICATION OF TRANSFER TAXES.

(a) IN GENERAL. —In the case of any portion of a trust to which this section applies—
(1) the value of the gross estate of the deceased deemed owner of such portion shall include all assets attributable to that portion at the time of the death of such owner,
(2) any distribution from such portion to one or more beneficiaries during the life of the deemed owner of such portion shall be treated as a transfer by gift for purposes of chapter 12, and
(3) if at any time during the life of the deemed owner of such portion, such owner ceases to be treated as the owner of such portion under subpart E of part 1 of subchapter J of chapter 1, all assets attributable to such portion at such time shall be treated for purposes of chapter 12 as a transfer by gift made by the deemed owner.
(b) PORTION OF TRUST TO WHICH SECTION APPLIES. —This section shall apply to—
(1) the portion of a trust with respect to which the grantor is the deemed owner, and
(2) the portion of the trust to which a person who is not the grantor is a deemed owner by reason of the rules of subpart E of part 1 of subchapter J of chapter 1, and such deemed owner engages in a sale, exchange, or comparable transaction with the trust that is disregarded for purposes of subtitle A. [i.e. a BDOT – IRC §678 is the only code section that applies to someone who is not a grantor]
For purposes of paragraph (2), the portion of the trust described with respect to a transaction is the portion of the trust attributable to the property received by the trust in such transaction, including all retained income therefrom, appreciation thereon, and reinvestments thereof, net of the amount of consideration received by the deemed owner in such transaction.
(c) EXCEPTIONS. —This section shall not apply to any trust that is includible in the gross estate of the deemed owner (without regard to subsection (a)(1)).
(d) DEEMED OWNER DEFINED. —For purposes of this section, the term 'deemed owner' means any person who is treated as the owner of a portion of a trust under subpart E of part 1 of subchapter J of chapter 1.
(e) REDUCTION FOR TAXABLE GIFTS TO TRUST MADE BY OWNER. —The amount to which subsection (a) applies shall be reduced by the value of any transfer by gift by the deemed owner to the trust previously taken into account by the deemed owner under chapter 12.
(f) LIABILITY FOR PAYMENT OF TAX. —Any tax imposed pursuant to subsection (a) shall be a liability of the trust.''.
(b) CLERICAL AMENDMENT. —The table of chapters for subtitle B of such Code is amended by adding at the end the following new item:
''CHAPTER 16. SPECIAL RULES FOR GRANTOR TRUSTS''.
(c) EFFECTIVE DATE. —The amendments made by this section shall apply—
(1) to trusts created on or after the date of the enactment of this Act,
(2) to any portion of a trust established before the date of the enactment of this Act which is attributable to a contribution made on or after such date,
and

(3) **to any portion of a trust established before the date of the enactment of this Act to which section 2901(a) of the Internal Revenue Code of 1986 (as added by subsection (a)) applies by reason of a transaction described in section 2901(b)(2) of such Code on or after such date**.

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 tax as well.[253] For example, in one recent PLR, two married taxpayers both had grantor trusts and had proposed transactions with the other spouse's grantor trust and the IRS ruled that it was not a taxable transaction based on IRC 1041 and Rev. Rul. 85-13.[254]

However, interest income on intra-spousal (or intra-spousal grantor trusts) promissory 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 interest-payor spouse.[255] 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.[256]

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[253] IRC §1041 (disregarding sales between spouses for income tax purposes).

[254] PLR 2019-27003.

[255] *Gibbs v. Commissioner*, T.C. Memo 1997-196.

[256] 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".[257] 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.[258] 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.[259]

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 withdrawn is a small

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[257] IRC §678(a).

[258] IRC §2514/2041.

[259] 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*PLR 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.

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.[260] 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% 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,[261] 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.[262] 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.[263] 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. There is also an open question as to whether a change in status "terminates" the non-grantor trust for purposes of IRC §642(h), as discussed in Section II.k.

Another exception: the new Qualified Opportunity Zone tax scheme provides that a conversion from a grantor trust to a non-grantor trust or vice versa may be treated as an "inclusion event" that subjects previously deferred capital gains to immediate tax.[264]

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[260] For a discussion of these issues with multiple case citations, see *The Optimal Basis Increase and Income Tax Efficiency Trust*, Part VII, originally published in 2013, available for download at www.ssrn.com.

[261] E.g., the seminal Rev. Rul. 85-13 which changed from non-grantor to grantor trust tax-free.

[262] 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.

[263] See, e.g., *Malone v. U.S.*, 326 F. Supp. 106 (D.C. Miss. 1971), aff'd, 455 F.2d 502 (5th Cir. 1972).

[264] Treas. Reg. §1.1400Z2(b)-1(c)(5)(ii): "*Changes in grantor trust status*. In general, a change in the income tax status of an existing trust owning a qualifying investment in a QOF, whether the termination of grantor trust status or the creation of grantor trust status, is an inclusion event. Notwithstanding the previous sentence, the termination of grantor trust status as the result of the death of the owner of a qualifying investment is not an inclusion event***"

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.[265] Bypass trusts generally would not, unless the beneficiary decedent held a general power of appointment or exercised a limited testamentary power of appointment in such a way as to trigger the Delaware Tax Trap. 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.[266] Other practitioners have transitioned to overusing QTIPs, despite the many other drawbacks to this design.

Here is an overlooked potential drawback of such trusts that could be quite significant.[267] 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 understanding

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[265] 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).

[266] 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.

[267] 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 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.

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. [268] 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

[268] 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.

does not change at death that this is potentially an issue.[269] The examples in the regulation do not address such a scenario.[270]

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.”[271] 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.[272]

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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[269] 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 *Ed Morrow & The Upstream Optimal Basis Increase Trust*, LISI Estate Planning Newsletter #2635 (April 17, 2018). Whether trusts become 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 non-grantor trust just because a beneficiary dies. Even if a new EIN is obtained, this would not be determinative. Arguably when a beneficiary dies, the fundamental relationship has changed. This is also an issue with QSSTs as to when the death of a beneficiary triggers a need for a new consent filing.

[270] 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.”

[271] Treas. Reg. § 1.1014-6(a)(1).

[272] 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.[273] 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

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[273] 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 compelling 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. A full lapse of such a power (not partial) would clearly not implicate §678(a)(2), e.g., see PLR 7943153.

So why doubt all the above highly distinguished authors (and others) 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)) strongly imply an *affirmative action* is required on the part of the deemed owner and there is no mention of lapses. A release requires an affirmative action. A lapse does not. Different words have different meanings, even if overlapping, 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"). Anecdotally, BDITs have passed through audit without ill effect. That said, I am still skeptical that this is correct and consider a lapse being deemed the same as a release for Section 678 to be uncertain at best, despite the many favorable PLRs cited above (which can only be relied on by the taxpayer issued the ruling).

states and situations protected under lapse rules, so as a practical matter, provided these measures are added, the entire $2 million plus any income is going to be protected.[274]

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 be a great

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[274] 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.

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= 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 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.[275] 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.[276] 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).[277]

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.[278] A non-judicial settlement agreement might be such an action, since it would require

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[275] *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."

[276] 11 U.S.C. §541(c)(2).

[277] 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.

[278] 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

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.[279] 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, power to add charitable beneficiaries, swap power etc.), 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.[280]

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.[281]

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), and in such

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many accomplished authors and commentators in this field are comfortable concluding that lapse=release for §678(a)(2) purposes. See the various articles cited in footnote 3.

[279] Treas. Reg. 1.671-2(e)(6), Example 9.

[280] 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.

[281] *Restatement 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."

event the trustee should timely file an electing small business trust (ESBT) election to enable the S corporation status to continue.[282]

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.[283]

[282] 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. When grantor trust status ceases for other reasons, such as a GRAT annuity period expiring or a grantor releasing triggering powers, the shorter 2 ½ month period applies. PLRs 2014-45001, 2014-23013, 2015-16001.

[283] See Treas. Reg. §1.1001-2(c), Example 5; Rev. Rul. 77-402, 1977-2 CB 222 (partnership).

aa) Application of Designated Beneficiary Qualified Plan/IRA See Through Trust Rules to BDOTs[284]

Much of middle-class taxpayers' wealth is tied up in a home and retirement plans.[285] The passage of the SECURE Act gives additional rationale to using BDOT clauses.[286] The SECURE Act changes the post-death RMD (Required Minimum Distribution) rules for defined contribution plans (IRA, 401k, 403b, 457) to generally require that all distributions after death be made by the end of the 10th calendar year following the year of death, if there is a designated beneficiary. Exceptions are made for those who are both "designated beneficiaries" (under old rules) and also qualify under one of the five new categories of "eligible designated beneficiaries" (EDBs): someone is either a surviving spouse, chronically ill, disabled, not more than 10 years younger than the decedent, or is the owner's child who has not reached the age of majority.

The ten-year rule applicable to most trusts that will receive retirement benefits now after passage of the SECURE Act presents a dilemma for non-Roth accounts. In planning for the 99% of taxpayers whose income level does not rise to the top income tax bracket, leaving such assets in trust increases the income tax rate substantially. It may be 2-3 times as high under the compressed trust income tax brackets.

Distributing the income out of a trust can save income tax, but this destroys the asset protection benefits of the trust. Advisors (not to mention beneficiary-trustees) will invariably recommend trust distributions to carry out distributable net income (DNI) in order to save income taxes. Thus, even if the trust is an 'accumulation trust,' it will function for all practical purposes as a conduit trust, limiting the estate tax sheltering and asset protection for those assets to only 10 years as well.

If only we could find an effective way to shift the income tax to those beneficiaries who are usually in a much lower tax brackets, without destroying the estate/gift/GST and asset protection benefits of the trust! A beneficiary deemed owner trust (BDOT) can do just that.

Flaws of Existing See Through Trusts After Passage of the Secure Act

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[284] This section was updated in February 2020 and includes portions of the article: *Using BDOTs for Optimal Asset Protection and Income Tax Minimization After Passage of the Secure Act,* LISI Income Tax Planning Newsletter #192 (February 18, 2020).

[285] According to www.ICI.org, $30.1 trillion dollars are in retirement plans as of end of Q3 2019.

[286] Setting Every Community Up for Retirement Enhancement Act of 2019 ("SECURE Act"), included as part of the Further Consolidated Appropriations Act, 2020.

"See through trusts," those designed to qualify as designated beneficiaries for purposes of determining distribution periods after the death of the owner, come in two basic varieties: conduit trusts and accumulation trusts.[287]

Both of these should be re-examined in light of whether the owner/settlor's goals lean towards asset protection or income tax avoidance. This section will largely omit discussion of "eligible" designated beneficiaries who may still come under the old rules ("EDBs" include surviving spouses, disabled, chronically ill, minor children of the owner until age of majority or beneficiaries not more than 10 years younger).[288] Note that in planning for surviving spouses, particularly common in blended family situations, the Secure 2.0 Act sweetens the deal for using conduit trusts for surviving spouse by enabling inherited IRAs for the benefit of a surviving spouse, including conduit trusts where the spouse is considered the "sole beneficiary", to receive a delayed required beginning date and use the same uniform life table that most individuals use, starting in 2024.[289]

The popular wisdom is that conduit trusts will always be a disaster after the passage of the Secure Act. This is not necessarily true, though some may be. Some accumulation trusts might *also* now be a disaster. It depends on the clients' goals and situation, and how flexible the trusts are.

Conduit trusts and trusteed IRAs drafted so as to ONLY pay RMDs (and no more) could be an income tax disaster. If the owner dies before their required beginning date, all the funds would come out in the 10th year into the trust and then out to the beneficiary, allowing no use of the beneficiaries' lower tax brackets by distributing funds more gradually before then. Unless the beneficiary is in the 1% of taxpayers in top tax bracket, this is a disaster for any larger amounts, since the lower tax brackets were not efficiently used. The lack of distributions in years 1-9 may also be very problematic for non-tax reasons.

Most conduit trusts and trusteed IRAs, however, are drafted with much more flexibility (e.g. pay RMDs, plus more at the trustee's discretion). Moreover, this tax issue may disappear once an owner passes their required beginning date, since treasury guidance is likely to allow the trust to use the "at least as rapidly" rule (a.k.a. "ghost" life expectancy of the decedent), and even if they do not, it's extremely easy to disqualify a trust from being considered a designated beneficiary.

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[287] Treas. Reg. §1.401(a)(9)-5, Q&A7(c)(3) contains two relatively sparse examples.

[288] See IRC §401(a)(9)(E)(ii) and §401(a)(9)(H)(ii).

[289] See *Ed Morrow: SECURE 2.0 Offers Longer Stretch for Conduit Trusts, but Contains Traps for Surviving Spouses*, LISI Estate Planning Newsletter #3010 (January 24, 2023).

Thus, conduit trusts and trusteed IRAs are rarely going to be an income tax disaster (in fact, they may often be the opposite, since they ensure that no income is trapped in trust). The problem with conduit trusts is usually not the income tax ramifications, but that all the funds are leaving the trust over ten years (or potentially slightly longer, under a ghost life expectancy as discussed above), which completely eviscerates the estate/gift/GST and other asset protection benefits of the trust. Is it worth even bothering with a trust for only ten years of protection? Many taxpayers would be tempted to simply leave the funds outright if that were the only alternative.

Current accumulation trusts may be an income tax disaster as well if they have conservative distribution standards, and/or lack any lifetime limited powers of appointment or spray powers. Retirement plan distributions in many cases may be trapped in trust at the highest trust compressed tax bracket (currently 37%, but Congress may always increase this again). With increasing inflation, the bracket differences will only be exacerbated in the future.

Rate	**For Single Individuals, Taxable Income Over**	**For Married Individuals Filing Jointly, Taxable Income Over**	**For Heads of Households, Taxable Income Over**	**For Trusts and Estates, Taxable Income Over**
10%	$0	$0	$0	$0
12%	$9,875	$19,750	$14,100	
22%	$40,125	$80,250	$53,700	
24%	$85,525	$171,050	$85,500	$2,600
32%	$163,300	$326,600	$163,300	
35%	$207,350	$414,700	$207,350	$9,450
37%	**$518,400**	**$622,050**	**$518,400**	**$12,950**
Source: Rev. Proc. 2019-44, Year 2020 Tax Rates				

For example, if the trust instrument provides that distributions be made for "health, education and support", but nothing further, does this permit the trustee to pay out the entire IRA at this newly accelerated level? Distribution standards are real restrictions, even if the beneficiary is trustee or co-trustee, despite what some think. If a $2 million IRA would have paid $60,000 annual RMDs under the old rules and the trustee would have been justified in paying that much to beneficiaries, is the trustee now *equally* justified to distribute $200,000+/yr over only ten years, even when this distribution schedule leaves no principal from those accounts for the remaindermen? Is the higher distribution within the current distribution standards which were designed by the settlor under quite a different income tax environment?

Some trust instruments instruct a trustee to be conservative with distributions of principal – or even forbid it. Retirement plan distributions over ten years are often likely to be 100% principal (or maybe 90% in the final year).[290] Are such distributions to beneficiaries *justified* under the trust instrument?

This issue does not exist in every trust of course. Some trusts have an independent trustee with absolute discretion or liberal distribution standards that would justify higher payouts that are now encouraged from an income tax standpoint under the compressed 10-year stretch.

What is the settlor's wish? *To minimize income tax or protect corpus and/or preserve principal for remaindermen?* Should practitioners consider discussing the addition of some version of the instructive paragraph below with clients?

> "I understand that under recently passed law my retirement benefits will be paid to this trust within ten years or perhaps a slightly longer period in some cases should I pass away after my required beginning date. I direct my trustee to consider the overall tax impact to the trust and beneficiaries in making distributions and favor a level of distributions that reduce the overall income tax to the trust/beneficiaries."

This brings us back full circle, however, to the central tension between conduit and accumulation trusts noted at the outset of this article. If a trustee of an accumulation trust distributes most or all of its taxable income received from retirement funds in order to be more income tax efficient, it is effectively no different than a conduit trust as a practical matter!

The ideal scenario for many is to enable the shifting of income tax to exploit the lower marginal tax brackets applicable to most beneficiaries without destroying the asset protection benefits of the trust. *Families often want their beneficiaries to have the protections of a trust,*

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[290] See *Uniform Principal and Income Act*, §409. The general rule that RMDs are 90% principal and 10% accounting income and non-RMDs are 100% principal has been changed by the Uniform Fiduciary Income and Principal Act, but this has thus far only been passed in one state. See www.uniformlaws.org for updates in this area.

but not if the cost of this is to increase the tax on millions of dollars of taxable income from 12%/22%/24% → 37%!

Beneficiaries Whose Income Would Be Taxed in the Top Tax Brackets

For wealthy beneficiaries who will be in the top tax bracket already, or perhaps even those who are in the top two or even three brackets but who might be able to escape a high state income tax, there may be no such tension. Trapping income tax in trust at the exact same tax rate has no negative federal income tax impact. In some scenarios, it may be advantageous from a *state* income tax perspective, even for beneficiaries living in states subject to a throwback tax.[291] In other scenarios, trapping income in trust may be much *worse* from a state income tax perspective. This depends on several factors and permutations, such as whether the settlor lived in a "founder" state and where the beneficiary and trustees reside, discussion of which is beyond the scope of this newsletter.[292]

Roth IRAs and Other Roth Accounts; Net Unrealized Appreciation (NUA)

Obviously Roth IRAs and other Roth accounts do not have this issue – in most cases trustees will want to wait until the last year possible to withdraw such funds. Net unrealized appreciation (NUA) from employer securities held in a qualified retirement plan, if the trustee thinks to make a lump sum distribution of such assets prior to moving such plans to inherited IRAs, offers an unlimited "stretch".[293] These circumstances are not discussed in this newsletter either.

Using BDOTs to Achieve the Best of Both Conduit and Accumulation Trusts

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[291] CA. Rev. & Tax Code § 17745(b) and N.Y. Tax Law § 612(b)(40), for example, contain throwback provisions, but exclude income incurred prior to a beneficiary reaching age 21, which is built into the old federal throwback rules in IRC §665(b). Paying attention to this rule for any family willing to set aside benefits for someone under age 21 can save considerable tax: 13.3% (CA), 8.82% (NY state), 3.876% (NYC) – whether accumulating income that would otherwise be subject to throwback but then converting to a BDOT structure for those CA/NY residents over age 21 can avoid the throwback tax will have to await discussion in another article. As discussed, trapping income in trust would only be advisable for those beneficiaries in the top tax brackets even in the best of circumstances.

[292] For a 50 state comparison chart outlining the different factors that states use to tax non-grantor trusts, with hyperlinks to statutes, regulations, administrative rulings, case law and articles, email the author for the latest update or see https://www.actec.org/assets/1/6/Morrow_State_Residency_and_Source_Income_Factors_for_Taxation_of_Irrevocable_Non-Grantor_Trusts.pdf

[293] IRC § 402(e)(4). Recall, however, that the NUA tax break was once up for the chopping block in the Greenbook along with killing the stretch IRA, like it or *lump it*.

Here is an example of how a BDOT provision may operate when it receives significant retirement plan assets that, after the SECURE Act, will be subject to the 10-year rule:

John, age 71, has a $6 million estate, $2 million of which is a traditional IRA. He splits his trust between his son and daughter into two accumulation trusts with $3 million each, $1 million of which is comprised of an inherited IRA payable to the trust. The 10-year rule applies. They are in 22%/24% tax brackets.

In years 1-10 (for simplicity, we'll ignore that the ten-year rule is really eleven tax years when considering the partial first year of the trust), the trustee takes $100,000 (not an RMD, just a distribution) for 10 taxable years from IRA (again, let's ignore growth to more simply highlight the issue), and the trust makes 3% taxable interest and dividends on the other $2 million every year - $60,000 (again, ignoring growth).

Each year, the trust grants each child the right to withdraw the taxable income, which is $100,000 (IRA) + $60,000 (interest/dividends) = $160,000. The child is taxed on all $160,000 of income regardless of how much they actually take. Let's assume for this example that the child withdraws 30% of this to pay taxes and spend ($48,000) and allows the $112,000 to lapse and remain in trust. Had a conduit or accumulation trust with liberal distribution standards been used, $160,000 would be leaving this trust over 10 years instead of only $48,000. Over ten years of distributions, this is a huge difference: $112,000 x 10 years = $1.12 million more that is protected in trust, with the exact same income tax minimization benefits. Considering growth over ten years, this difference could easily be twice as much.

Wealthier beneficiaries who have the wherewithal to pay the income tax burden, just like those who voluntarily establish irrevocable grantor trusts, may leave even more in trust to let it effectively grow tax-free for their descendants like any other grantor trust, which means in our example that half a million more dollars would be in a protected GST exempt trust outside of the beneficiary's estate.

Needier beneficiaries may withdraw more, of course, but at least there is the option of keeping these retirement funds protected in trust that would not be there under other trust designs without trapping the income in trust at more confiscatory brackets.

Like a *Crummey* power, to the extent that such a power is not exercised and is allowed to lapse, only the greater of $5,000 or 5% is protected from being considered a taxable release/transfer and any amounts allowed to lapse above this threshold will be considered an additional contribution for estate/gift/GST purposes.[294] In many states, this protection of lapses

[294] IRC 2514(e). Treas. Reg. §26.2652-1(a)(5).

up to 5% rule holds true for state debtor/creditor purposes as well, but a surprising number of states follow the common law rule that does not regard any lapse, even greater than 5%, as creating a self-settled trust (see attached chart).

If the power of withdrawal is only over accounting income, the 5% lapse protection will only be calculated on that accounting income rather than the entire corpus, but if the power is over all the income attributable to the entire corpus and may be satisfied from those assets, the 5% should be calculated on that larger amount.[295] That said, there is no clear case or ruling on this point, and some may wish to draft a withdrawal power which extends to the greater of the trust taxable income or 5% of the trust corpus, which might also extend more flexibility in down years.

In our simple example above, the $160,000 of taxable income was slightly over 5% of the trust corpus ($3,000,000 times 5% = $150,000), but the amounts allowed to lapse ($112,000) was well under this amount. What if the beneficiary had allowed it all to lapse? $10,000 of the $160,000 total allowed to lapse would be over the 5% ($150,000) and would be considered a contribution to the trust, which would cause a fraction to be considered self-settled under some state debtor/creditor laws, and a fraction to potentially be included in the power holder's estate.

To avoid this, the beneficiary can simply withdraw $10,000 and only allow $150,000 or less to lapse. That could go into any number of estate and asset protection vehicles. Beneficiaries are also known to, on rare occasions, spend money. The trust could also borrow from the "hanging power" concept so often used in *Crummey* trusts, and account for this separately and provide that this amount "hang" and be withdrawable (and likely lapse) in future years. If the amount is only withdrawable with the consent of a non-adverse trustee, in many states it would still be protected from creditors, yet would not cause a taxable release for estate/gift/GST purposes since it would still be a general power of appointment under IRC § 2514(c). In short, the 5% limitation is rarely going to be a major problem, especially when other assets are included to comprise a portion of the trust (and may be invested to produce more growth and less taxable income if desired).

Separate but equal is not good enough! End IRA/Trust Segregation!

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[295] 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, extraordinary dividend or distribution) 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. Also Treas. Reg. §25.2514-3(c)(4).

Before the SECURE Act, some practitioners argued that separate or standalone trusts should be strongly considered for retirement plans/IRAs.[296] This was more important when trusts had to more careful to exclude older beneficiaries or potential appointees from shortening the "stretch" deferral because they would also be considered "designated beneficiaries" (this concern will only be relevant in some rare cases now). There may still be some advantages in segregating trusts where charities might be desired beneficiaries of other trust assets, which would still botch "designated beneficiary" status (though this would now only cut the stretch in half from ten to five years if the owner dies before their required beginning date). There may still be some rationale in being able to more selectively shift different types of income more efficiently with multiple trusts. It's unclear to what extent that separate IRA trusts with the same grantor/beneficiary could now be consolidated together pursuant to the new Treas. Reg. § 1.643(f)-1(a), "if a principal purpose...is avoidance of federal income tax".

More importantly, however, the BDOT strategy will often work much better when the assets are consolidated into one trust, rather than segregated. Because there are other assets to comprise the corpus over which the 5% is calculated, assets which typically produce less than 5% of taxable income (and which can be manipulated to produce less through investment decisions), more can be soaked up with the IRC §2514(e) lapse protection and be allowed to remain protected in trust. This issue might be overcome, however, if the other non-IRA trust with other assets also has a power of withdrawal (see Section II.h. of this paper). By contrast, if standalone IRA trusts are used and comprise the entire corpus of a trust and there is no withdrawal right over other assets in the other trust, the taxable income would at some point over ten years inevitably exceed 5%, since even if distributions were prorated over eleven taxable years the taxable income as a proportion of the total corpus would rise to over 9%.

Why a BDOT Should Still Be Drafted to Comply with Accumulation Trust Rules

Does a BDOT qualify as a "see through trust" in which the beneficiary is considered the sole "designated beneficiary"? Perhaps, but don't count on it. If such qualification matters, it's best to ensure that it qualifies as an accumulation trust.

Arguably, if all income from a trust must be taxed to the beneficiary under IRC §678(a), there is not even a need to consult the "see through trust" rules. Rev. Rul. 85-13 already orders us to ignore a grantor trust as a separate taxpayer! There is, unfortunately, no ruling to clarify

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[296] *Using Standalone or Separate Trusts Solely to Receive Retirement Benefits, Morrow, Edwin P., Nov./Dec 2007 issue of Journal of Retirement Planning*

this invisibility in the see-through trust area, so defensive planning dictates not to rely on this yet (even if the trust allows the beneficiary to withdraw the entire corpus).

Some argue that a BDOT is a *de facto* equivalent of a conduit trust. After all, in the marital trust context (both GPOA marital and QTIP varieties), the ability to withdraw income is considered the same as the mandatory distribution of it.[297] While the logic of this analogy is indisputable, we cannot count on this interpretation either. Under a strict reading of the conduit trust example in the regulations, it requires actual distribution, not merely the right to withdraw the distribution.[298] In fact, a strict reading of the example even requires tracing!

More uncertain still, a BDOT design may have the flexibility to prospectively eliminate, add back or customize the withdrawal right year by year through a cessor/forfeiture clause or trustee or trust protector power. This may also preclude qualification as a conduit trust, which under a literal reading of the regulation would not permit any “hold back” or other clauses that could cut off future distributions, even under extreme situations.

Remember Natalie Choate’s acronym “O/R-2-NLP”: outright to named living persons.[299] Ensuring that some individual who is living at the time of the settlor’s death ultimately receives any accumulations at some point outright is the easiest way to ensure that the trust still qualifies as a designated beneficiary. If the owner reaches their required beginning date but is still relatively young and the “at least as rapidly”, “ghost life expectancy” rule would give 10-15 years of deferral regardless of “designated beneficiary” status, then perhaps any special clauses to ensure designated beneficiary status may comfortably be jettisoned.[300]

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[297] Treas. Reg. §20.2056(b)-5(f)(8).

[298] The “conduit trust” is in Treas. Reg. 1.401(a)(9)-5, Q&A7(c)(3), Example 2:

> (i) The facts are the same as Example 1 except that the testamentary trust instrument provides that all amounts distributed from A's account in Plan X to the trustee while B is alive **will be paid directly to B upon receipt** by the trustee of Trust P.
>
> (ii) In this case, B is the sole designated beneficiary of A's account in Plan X for purposes of determining the designated beneficiary under section 401(a)(9)(B)(iii) and (iv). **No amounts distributed from A's account in Plan X to Trust P are accumulated in Trust P during B's lifetime for the benefit of any other beneficiary.** Therefore, the residuary beneficiaries of Trust P are mere potential successors to B's interest in Plan X. ***

[299] See Natalie Choate’s discussion of accumulation trust rules in her chapters on trusts in her various editions of *Life and Death Planning for Retirement Benefits*.

[300] This may not necessarily be true, however, if the owner has substantial qualified plans. Beneficiaries of such plans who are not *designated* beneficiaries cannot utilize IRC §402(c)(11) which allows only *designated* beneficiaries to rollover from an inherited qualified plan to an inherited IRA.

Alternative Solutions Will Frequently be Discussed, but Rarely be Used – CRT, Charitable Annuity, Roth Conversions, Life Insurance

Roth IRA calculators invariably assume someone has the cash and the intestinal fortitude to pay the additional tax due on conversion and they and their children will not be in lower tax brackets, which is often not the case. Conversions make less financial sense if a taxpayer must incur capital gains to raise the cash, or worse, use traditional IRA funds. Congress pulled out the rug on the Roth segregation conversion strategy, which exploited the prior ability to cherry pick and "undo" (recharacterize) some Roth IRA conversions but not others. Taxpayers are not idiots to ask the question: "if Congress can suddenly pull the rug out from under "stretch IRAs" that we've relied on in planning for decades, what's to stop them from doing the same to Roth accounts?" The simple answer to this is "nothing." There is no Constitutional prohibition to changing the tax law. The Secure Act was an astonishingly bipartisan bill. Unlike insurance companies, drug companies, real estate developers etc., there is no strong lobbying constituency to protect such broad tax breaks.

If a Roth conversion did not make sense when the beneficiaries could get 50-80 years of tax-free growth, it won't make much more sense when it's only ten years. Despite the above concerns, partial or even full Roth conversions can still make sense, but the variables to consider are often much more complicated than financial writers make them out to be. We are stuck with planning for traditional accounts for the foreseeable future.

Leaving traditional IRA funds to charitable remainder trusts and charitable annuities is only going to be palatable to taxpayers with strong charitable intent, who have little regard to the asset protection or sheltering of funds from estate tax for their beneficiaries. For those with taxable estates, the §691(c) deduction would likely go completely wasted by using a CRT![301] In short, extremely few people will ever strongly consider these more complicated estate planning structures over other options, such as simply carving out a charity as a direct beneficiary of a portion of an IRA without tethering them together with individual beneficiaries for life.

Conclusions – When Will a BDOT Fit? Building Flexibility

In conclusion, a BDOT will not fit every situation with large retirement benefits– no one trust design ever does. Granting a withdrawal power to substance-abusing or special needs beneficiaries doesn't make any sense.

That said, it will fit many situations. Doesn't it make sense to grant a trustee the power to prospectively add these withdrawal rights, or eliminate them, as the circumstances require?

[301] See PLR 1999-01023, Treas. Reg. §1.664-1(d)(2).

The old paradigm where settlors rigidly distribute accounting income only, so that principal grows for the next generations on end is a relatively rare request these days. It's much more common that clients want to minimize "dead hand control" but still provide the most protection they can for creditor and divorce situations, and the ability to shelter from potential estate tax increases. A BDOT design fits this desire and can largely solve the inherent tension between asset protection and income tax minimization in light of compressed tax brackets and distribution schedules that the SECURE Act now foists upon unsuspecting taxpayers.

bb) Adapting to Special Needs Trusts, Medicaid qualification

A §678(a) power would ***not*** work well 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.[302] 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 triggering events (and/or with preconditions at inception), causing the trust to be excluded as a countable resource.

[302] 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. 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 Trust

Most of this article has concentrated on trust designs *after* the settlor's death, but 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, or section below on upstream BDOTs). With an intervivos BDIT or BDOT, a settlor must be careful to avoid all of the various rights and powers that cause grantor trust status to a settlor under §671-677, which would trump §678(a).[303] Some of the BDIT private letter rulings contain provisions that I would argue trigger grantor trust status as to the settlor rather than the beneficiary and thus were incorrect.[304] For example, a power of substitution (a.k.a. swap power), even if held by the powerholder instead of the settlor, might inadvertently cause grantor trust status as to the settlor under IRC §675(4), even though the power holder would not be "re"-acquiring any assets.

Another potential grantor code section to be wary of is IRC §674, which provides that:

> "(a) General rule
>
> The grantor shall be treated as the owner of any portion of a trust in respect of which the beneficial enjoyment of the corpus or the income therefrom is subject to a power of disposition, exercisable by the grantor or a nonadverse party, or both, without the approval or consent of any adverse party."[305]

A power of withdrawal is basically a presently exercisable general power of appointment. While it would not be a power over the entire corpus, it would still be considered a power of *disposition* over the income, which is all that IRC 674(a) requires. But is the powerholder an "adverse party"? If so, §674(a) does not apply. This is not simple. "Adverse party" is defined for Subchapter J, subpart E purposes (i.e., §674) in IRC §672(a) as:

> "(a) Adverse party
>
> For purposes of this subpart, the term "adverse party" means any person having a *substantial beneficial interest* in the trust which would be *adversely affected by the exercise or nonexercise* of the power which he possesses respecting the trust. A person having a general power of appointment over the trust property shall be deemed to have a beneficial interest in the trust."[306]

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[303] IRC §678(b), Treas. Reg. §1.678(b)-1.

[304] PLR 2012-16034.

[305] IRC §674(a). Treas. Reg. § 1.674(a)-1(a) is similar, but clarifies that the power could be "a fiduciary power, a power of appointment, or any other power".

[306] IRC §672(a). See also Treas. Reg. § 1.672(a)-1.

A power holder of a §678 withdrawal right is not *automatically* an "adverse party", but in many cases would be. The power holder would first have to have a *substantial beneficial interest* in the trust. This is not hard to meet, but this interest must also be *adversely affected* by the exercise or non-exercise of the power. Most, but not all, situations would meet both criteria, but we don't have clear guidance as to what amount is "substantial".

For example, if a settlor were to establish a trust that was otherwise a non-grantor trust, but grant various remote or contingent beneficiaries a withdrawal right (what some call "dummy *Crummeys*", or after another court case, "*Cristofani* beneficiaries"),[307] they may **not** all be considered "adverse parties". They may have an interest in the trust, even a "present interest", but it may not rise to the level of a ***substantial*** beneficial interest in the trust that is "adversely affected by" their decision to exercise their withdrawal power or not. In many cases, settlors establish a trust for children, but name spouses, grandchildren, parents, siblings, nieces and nephews, etc. who are unlikely to ever receive a dime from the trust, in order to utilize annual exclusion gifts.[308] The more remote beneficiaries may have a present interest for annual exclusion purposes under IRC §2503 case law, but they may not have a "substantial beneficial interest" for §672(a)/§674(a) purposes. Is a BDIT withdrawal power over $5,000 a "substantial beneficial interest"? Regulations define "*substantial*" in terms of whether its "value in relation to the total value of the property subject to the power is not insignificant."[309] So for a $5,000 trust, a power over $5,000 is significant. What level is "significant"? 1%? 2%? One PLR ruled that a 5% remainder interest was sufficient.[310] In several cases where beneficiaries were very unlikely to ever receive anything, the courts ruled that the parties were non-adverse.[311] Might this practical long-term view doom powers that are intended to lapse forever without any benefit to the powerholder from being "substantial"?

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[307] *Estate of Cristofani v. Comm.*, 97 T.C. 74, 97 T.C. No. 5 (T.C. July 29, 1991).

[308] E.g., see *Ed Morrow and Alan Gassman on Mikel v. Commissioner: Tax Court Approves the Mother of All Crummey Trusts with 60 Beneficiaries*, LISI Estate Planning Newsletter #2309 (May 14, 2015). Neither the IRS nor the tax court even batted an eye at the 60 beneficiaries being counted for annual exclusion purposes in the *Mikel* case, many of whom would have fit in this category. The case dealt with completely different issues.

[309] Treas. Reg. § 1.672(a)-1(a).

[310] PLR 2016-36031 included several beneficiaries who would receive 5% upon the death of the settlor, but the ruling did not discuss the issue of what amount is considered "substantial".

[311] *Water Resource Control v. Comm.*, T.C. Memo. 1991-104, aff'd *Whitehouse v. Comm'r*, 972 F.2d 1328 (2d Cir. 1992) (There is some alarming language in the decision: "However, where the trustees have no obligation to make any payments to a beneficiary, the beneficiary does not have a substantial interest, and thus is not an adverse party. *Fulham v. Comm'r* [40-1 USTC ¶ 9378], 110 F.2d 916 (CA-1 1940), affg. [Dec. 10,743] 40 B.T.A. 48 (1939)", however, this case concerned a gimmicky "Pure Common Law Trust Organization" so its application may be more limited); *Holt v. U.S.*, 669 F. Supp. 751 (1987) (parents of

In most intervivos BDIT or BDOT trust designs, a beneficiary is going to not only have a withdrawal right, but also be a spray or HEMS or discretionary beneficiary after lapse (and in a BDOT they would keep a power of withdrawal over income as well), often coupled with limited testamentary powers of appointment, so his or her exercise of the withdrawal power adversely affects their remaining beneficial interest in the trust that will not lapse, which should be substantial.

What sounds bizarre and counterintuitive in this context is that a beneficiary's *general* power can also benefit themselves as well as others. Someone's power of withdraw is not adverse to their own *interests*, aside from spendthrift/substance abusing situations, it's perfectly *consistent* with it. But that is not the test to determine whether someone is an "adverse party"– the test is whether a power's exercise would *adversely affect* (i.e., reduce in value) a *substantial beneficial interest in the trust held by the powerholder*. Under the code and regulation's definition of adverse party, a beneficiary of a withdrawal power still qualifies as adverse even if his power of disposition could benefit himself as well as others. This sounds strange, but it is no different from the dozens of ING PLRs, wherein power holders in the various distribution committees could appoint to themselves yet are still considered "adverse parties" under IRC § 672(a) so as to prevent grantor trust status. All the dozens of BDIT PLRs, while not discussing this issue, would have to be consistent with this interpretation as well.

While strange-sounding, this interpretation makes sense in the scheme of Subchapter J and the prior case law such as *Mallinckrodt* and other cases discussed herein, otherwise §674(a) would completely swallow any application whatsoever of §678 to intervivos trusts, which Congress could have done in much simpler manner if it had so intended, e.g., "Any power under §678(a) is imputed to the grantor while the grantor is living". The IRS has ruled in such cases, without any discussion of the above, that general powerholders of unfettered withdrawal rights in intervivos trusts trigger IRC §678, but not §674, or at least do not trigger it by sole virtue of the withdrawal right.[312]

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settlor would only receive anything from trust if their grandchildren predeceased, a highly unlikely event, thus they were non-adverse); *Barker v. Comm*., 25 T.C. 1230 (1956) (parents of settlor would only receive anything if their young son died before the age of 35 without a surviving spouse or issue, and odds were 96-97% likely he'd live to age 35, were thus considered non-adverse); *Chase National Bank v. Comm.*, 225 F.2d 621, 627 (8th Cir. 1955), aff'g *D.G. McDonald Trust*, 19 T.C. 672 (the beneficiary would not receive anything unless both a 29-year old and an 18-year old died before reaching age 35 without issue and the court found such an interest too remote to create a substantial adverse interest). Both *Barker* and *Chase* interpreted a similar predecessor statute to IRC § 672(a) and §677 under the prior grantor trust rules that included the phrase "substantial adverse interest".

[312] E.g., PLR 2009-49012. There are several other PLRs involving intervivos trusts that imply that if other explicit grantor trust powers such as a power to add charitable beneficiaries or power of substitution would not have been present to override §678(a) via §678(b), that a power of withdrawal would have

Annual Exclusion. If an intervivos BDOT only grants the beneficiary a power over the income later to accrue, this may not qualify for the gift tax annual exclusion. By contrast, BDITs usually grant an immediate power over the entire $5,000 corpus which qualifies 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 unless the future income or use of the property were assured or a *Crummey* provision were added.[313] However, all of the taxable income would be taxable to the beneficiary power holder under §678(a)(1).

Large seed gift possible compared to BDIT. As noted above, BDOTs permit 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 in our $1 million example above, this would mean the beneficiary could sell $9 million of assets to the trust. Further comparison to BDITs is in Section II.jj of this paper.

Comparing to installment sale to IGT/SLAT. From the beneficiary's standpoint, provided they have a parent or other donor who might gift or leave them assets in trust that is deemed to be owned by them for income tax purposes, this is far superior to a sale to a typical IGT/SLAT, 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/SLAT.

More security/access than DAPT/hybrid DAPT. 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

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caused beneficiary deemed owner tax status to powerholders under §678, e.g., PLR 2007-320101, PLRs 2007-29005 through 200729016. If all powers of withdrawal were always 674(a) powers, none of the dozens of PLRs re BDITs, intervivos QSSTs, etc. over the last decades should have been issued.

[313] 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)."

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.

rule on this issue when asked to in private letter rulings.[314] 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 that later benefit the settlor after the donee spouse’s death, assuming the settlor-spouse survives the donee-spouse. 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/forfeiture or floating spouse clause can apply to them during the spouse’s lifetime, making them more susceptible to creditors due to the income leakage that cannot be cut off. Decanting and ability to amend must be very limited. There is an opportunity cost in using them because they are included in the donee spouse’s estate, whereas other trusts can leverage the gift tax exclusion or save state income/estate tax or provide better asset protection before death. Any credit shelter trust can get the main benefit of the “super-charged credit shelter trust” (shifting income tax burden to the surviving spouse) by simply adding a BDOT provision, which would have the added benefits of being able to later cut off the income and change to non-grantor trust status if desired.

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.[315] This could also be an advantage, as intentional 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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[314] 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 until the facts and circumstances are known, see PLR 9837007 and PLR 2009-44002.

[315] 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). Of course, loans are also how the trust became a grantor trust in Rev. Rul. 85-13.

ee) Advantage - Beneficiary Deemed Owner Trust (BDOT) Tax Reporting

Grantor trusts can often get by with using the deemed owner's social security number without having to obtain a separate EIN.[316] 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.[317]

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.[318]

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.[319] Many states do not

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[316] Treas. Reg. §1.671-4(b). See also Treas. Reg. §301.6109-1 regarding EINs for trusts.

[317] IRC §6501(a), (c)(3), *Paschall v. Comm'r*, 137 T.C. 8 (T.C. 2011).

[318] See Treas. Reg. §301.6109-1(a)(3).

[319] See blog article *Tennessee Now Recognizes Grantor Trusts,* by attorney Brian Howard dated August 19, 2013 at: https://www.tennesseeestateplanninglaw.com/2013/08/articles/irrevocable-

want a state Form 1041 equivalent filed for a grantor trust.[320] Some do.[321] Others are fine with attaching a copy of the federal 1041 information.[322] 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.[323]

A few simply follow the federal rules on reporting, so that if the trust files using the Form 1099 method or reports using the deemed owner's social security number the trust need not file a state equivalent of a Form 1041 but if a federal Form 1041 "grantor trust" return is filed, a parallel state return must also be filed.[324] Others diverge quite a bit.[325] Just because a federal Form 1041 is not required for a grantor (or beneficiary deemed owner) trust does not mean 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, one should consult state law for grantor trust filing requirements.

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trusts/tennessee-now-recognizes-grantor-trusts. Since Tennessee's income tax is phasing out, this may be short-lived.

[320] 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. Illinois Tax Department's pronouncement that: "Note: "Grantor" trusts are not required to file Form IL-1041.", https://www2.illinois.gov/rev/research/taxinformation/income/Pages/fiduciary.aspx

[321] E.g., see Minnesota's directions: http://www.revenue.state.mn.us/businesses/fiduciary/Pages/I_need_more_information_about_grantor_trusts.aspx.

[322] E.g., see Indiana's FAQs re grantor trusts at https://www.in.gov/dor/files/fiduciary-faq.pdf.

[323] 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." 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.

[324] See, e.g., page 6 of New York's Instructions for Form IT-205 Fiduciary Income Tax Return

[325] 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/pitguide_chapter_14.pdf. This 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).

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 (iftestamentary), 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 (though I would not advise this usually). Appointing to a trust with a "five and five" power could 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.[326]

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 an independent trustee's exercise of its fiduciary power to be subject to gift/estate tax. Decanting by trustees who are also beneficiaries, however, should be scrutinized to make sure there is no shifting of wealth away from the beneficiary/trustee, else this exercise of discretion to make a distribution could be considered a taxable gift by the bene/trustee.[327]

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[326] See discussion in the white paper "Optimal Basis Increase and Income Tax Efficiency Trust", Part III.i-Part III.o., downloadable for free from www.ssrn.com.

[327] Treas. Reg. § 25.2511-1(g)(2).

gg) Easier Tax Elections for BDOT Property Exchange/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)[328] and other elections.[329]

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."[330]

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."[331]

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[328] See IRS Form 4562 for the Section 179 election.

[329] 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."

[330] Rev. Rul. 88-103, which supplemented and amplified Rev. Rul. 70-376 above.

[331] Rev. Rul. 2004-86.

hh) Leveraging GST Exempt Trusts at the Expense of Non-Exempt Trusts (and/or Beneficiaries) so GST-Exempt Grows Tax-Free

Imagine a single taxpayer with a $21.4 million estate (no DSUE) who dies in 2019. Their likely estate plan is to leave $11.4 million (or remaining applicable exclusion amount) in a GST-exempt trust for kids/grandkids and leave the remaining amount (approx. $6 million after estate tax) in a similar GST *non-exempt* trust, which often has the exact same beneficiaries (children, then their issue at death). This GST non-exempt trust would either pay a GST tax when a child dies and their share passes to the next generation, or more often, it would grant the children a general power of appointment to force an estate tax rather than a GST tax (or even better, it may grant a formula power to adapt to the best of the two or have various clauses to enable a trust protector to modify this clause prior to death).

How can the taxpayer exploit IRC §678 in the same way we've always exploited grantor trusts, but for *GST advantages*? *Solution: Settlor adds a clause to the GST exempt trust that the trustee of the non-exempt trust has the unfettered right to withdraw all the taxable income of the exempt trust. This is similar in many ways to PLR 2016-33021 (see prior discussion and footnotes 32-35). Voila! We have a freeze of the GST non-exempt trust and tax-free growth accreting to the GST exempt trust.* Let's examine how that would work in year one, assume 4% taxable income, 4% unrealized growth net of fees and distributions of $500,000/yr., ignoring compounding for simplicity:

GST exempt trust grows 8% ($912,000) to $12,312,000. Of this growth, $456,000 is taxable income that the GST non-exempt trust may withdraw. Assuming it is not withdrawn, this trust is growing at the full 8%, income tax free.

Meanwhile, the GST non-exempt trust grows 8% ($480,000) to $6,480,000. By contrast, its taxable income is $240,000 *plus* the $456,000 taxable income attributed to it by IRC §678 from the GST exempt trust ($696,000 total). If the trust makes $400,000 of distributions (assuming the DNI is at least this much), and ignoring expenses, the trust would have $396,000 of net taxable income and pay about $120,000 of income tax, depending on the mix of ordinary income v. capital gain/qualified dividend, making the net growth after distributions/taxes slightly negative ($480,000-$520,000). Over time, this difference will be quite significant.

This concept could be extended to grant beneficiaries a withdrawal right *directly* over taxable income in the GST-exempt trust, enabling the same tax-free growth as indicated above, but with less complexity. However, those readers with experience in trust administration know that, despite asset protection gurus telling them to keep assets in trust, sometimes beneficiaries actually want some of the money!

Attorneys could accomplish a similar strategy to the above by granting withdrawal rights over income from both the GST-exempt trust and the GST non-exempt trust, but this would only work as well only if the beneficiaries limit their withdrawals to the income from the GST non-exempt trust. In some cases this would be less efficient than shifting taxation to the GST non-exempt trust (state income tax could make a difference as well). In our example above, the taxable income of the GST non-exempt trust was only $240,000 and the beneficiaries needed $400,000 (they would need much more if they were taxed on $796,000 rather than $400,000 that they would be taxed on in our prior example), thus they would be dipping into the GST exempt trust for another $160,000 (plus about $100,000 or so more to cover the additional tax burden due to BDOT status). Thus, the GST-exempt trust would be depleted more in cases where beneficiaries need distributions that exceed the income of the non-exempt trust if both are deemed owned by the beneficiary for income tax purposes. By contrast, if the GST non-exempt trust were much larger, $60 million for example, rather than $6 million in our example above, this alternative strategy would be more viable because the beneficiaries would *much* less likely need to tap into the GST-exempt trust's income.

In either variation of the above, care should be taken to avoid a deemed contribution to the GST-exempt trust, which could occur if any powerholder permits their withdrawal power to lapse in excess of the IRC §2514(e) "five and five" power, as discussed elsewhere herein. Such lapses would make the powerholder a transferor.[332] This may not be a disaster, as the power holder would usually be a generation below the original grantor anyway, but it would complicate accounting and potentially create a fractional exclusion ratio if GST is not allocated. Thus, the power holder should probably just withdraw any excess or retain a state-law protected hanging power that does not create a lapse for estate/gift/GST purposes, as previously discussed herein. If not, the trust should account for that amount left hanging and consider segregating.

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[332] See Treas. Reg. §26.2652-1(a)(5), which actually has an example of a withdrawal power lapsing in excess of the five and five lapse protection:

> "Example 5. Effect of lapse of withdrawal right on identity of transferor, T transfers $10,000 to a new trust providing that the trust income is to be paid to T's child, C, for C's life and, on the death of C, the trust principal is to be paid to T's grandchild, GC. The trustee has discretion to distribute principal for GC's benefit during C's lifetime. C has a right to withdraw $10,000 from the trust for a 60-day period following the transfer. Thereafter, the power lapses. C does not exercise the withdrawal right. The transfer by T is subject to Federal gift tax because a gift tax is imposed under section 2501(a) (without regard to exemptions, exclusions, deductions, and credits) and, thus, T is treated as having transferred the entire $10,000 to the trust. On the lapse of the withdrawal right, **C becomes a transferor to the extent C is treated as having made a completed transfer for purposes of chapter 12. Therefore, except to the extent that the amount with respect to which the power of withdrawal lapses exceeds the greater of $5,000 or 5% of the value of the trust property, T remains the transferor of the trust property for purposes of chapter 13.**"

Bailouts of Terminating or GST-Non-Exempt Non-Grantor Trusts?

The situations discussed above assume we're in drafting stage and able to modify the GST exempt and non-exempt distribution powers however we want. Can BDOTs be used to bail out existing irrevocable non-grantor GST exempt (including grandfathered) trusts that are terminating early due to the rule against perpetuities or other mandated distributions? How can they be used to exploit the capital in existing non-grantor GST non-exempt trusts?

Amending such "old and cold" irrevocable trusts from a state law perspective has never been easier. Every year, more and more states pass extensive decanting and non-judicial settlement agreement statutes and increasing avenues to amend such trusts with or without beneficiary consent through a court proceeding. In all my years of practice, I have yet to hear of a single state amending their statutes to make it *more difficult (or attorneys drafting trusts to do so)*. If a trust is not yet governed by a state that has such a statute, it can change situs to one that does. Most decanting statutes permit granting a limited power of withdrawal over taxable income to a current beneficiary, and if they don't, a court can.

But before jumping on that train, consider the tax implications. Not the tax implications of such an amendment moving forward, which are very likely to have the desired tax effect provided they are pursuant to the instrument and state law.[333] I refer to the potential income and transfer tax implications of the *amendment itself*. How many articles have you read or conferences have you been to that advocate decanting, amending and even terminating trusts without bringing up the potential for adverse income tax effects? It is possible that any changes that materially change the beneficial interests of the beneficiaries could be a gift or income taxable exchange. [334] This paper will not go into those issues in depth.

It is tempting to also establish new trusts that grant these old non-exempt trusts a withdrawal right to permit shifting of the income tax burden from a new GST-exempt trust to an old non-exempt trust. That may work in limited circumstances, but not all. E.g., if G1 dies, funding non-GST exempt Trust 1 for G2 and G3, and then G2 or G3 (or a spouse of G2 or G3) try to establish Trust 2 granting Trust 1 a withdrawal right, the beneficiaries of Trust 1 would indirectly be the beneficiaries of Trust 2, causing Trust 2 to be a grantor trust under §677(a). However, if G3 were the only beneficiaries of Trust 1, G2 could establish Trust 2, granting Trust 1 a §678(a) withdrawal right, and provided other grantor trust triggers are avoided, all taxable income would become the burden of Trust 1.

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[333] See Rev. Rul. 79-142 and discussion thereof in Part VII.b. of *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*. Available at SSRN: https://ssrn.com/abstract=2436964

[334] For a recent article focusing on recent adverse PLRs in this area, see *Ed Morrow on Potential Income Tax Disasters for Early Trust Terminations,* LISI Estate Planning Newsletter #2753 (October 9, 2019).

ii) Upstream Planning to Shift Income Tax Burden to Wealthier Parent

For most of this outline, we have discussed using BDOT provisions to shift income from a trust to its beneficiaries, or in the last section, among trusts with different transfer tax characteristics (shifting income tax burden to GST non-exempt trusts). However, there are many situations when it makes sense to shift the income tax burden *upstream*.

We know that one of the most powerful estate planning strategies (arguably much more powerful in the long-term and with much less risk than discount entity planning) is the use of the irrevocable grantor trust so that the wealthier generation can move assets *downstream.* This is still great planning, but what do we do when the next generation (who may be in their 60s or even older) has a taxable estate as well? The usual answer is that we repeat this process by establishing GRATs, SLATs, IGTs, etc. for them to pass on wealth further downstream. But this may be inefficient.

Imagine a widow aged 85 who has an estate of $50 million. She has two children with their own wealth, $30 million each, who are considering establishing IGTs for their own children and their families. *Consider an **upstream BDOT** alternative*. The two children establish irrevocable trusts for their spouse/descendants and – in contrast to conventional practice - *avoid* any grantor trust triggering provisions (including *Crummey* powers other than for their mother, at least during their mother's lifetime).[335] Therefore a spouse could only receive distributions with the consent of an adverse party (e.g., children). These trusts also name their 85-year old mother as a beneficiary, granting her a withdrawal right over the taxable income. This would shift the burden of paying the income tax *upstream*. Mom doesn't need the money, of course, and is unlikely to withdraw anything. If each of the children funded *Upstream BDOTs* that deemed their mother as the owner for income tax purposes with $20 million that generated 5% income ($1 million), at a 40% combined federal, NIIT and state tax rate, that's $400,000 x 2 = $800,000 of income tax that the mother will have to pay instead of the children or grandchildren, that will be shifted downstream without any estate/gift/GST tax, every year (saving approximately 40% of this amount, $320,000, annually).

Upon the mother's death, the trust can become a grantor trust as to the settlor in several different ways, but it cannot just convert to a garden variety SLAT without consent of an adverse party, because that would allow income to have been accumulated from the outset without consent of an adverse party for potential future distribution to a spouse, which would cause the trust to have been a grantor trust from the outset.[336]

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[335] For discussion of how to convert SLATs into non-grantor trusts (SLANTs), see *Ed Morrow & Using Spousal Lifetime Access Non-Grantor Trusts (SLANTs) After the 2017 Tax Reform,* LISI Income Tax Planning Newsletter #139 (April 23, 2018).

[336] IRC §677(a)(2).

For example, a trust protector could amend the trust (with consent of an adverse party) to add a swap power or ability to get income to the spouse without adverse party consent or any other grantor trust triggering provision, or the mother could exercise a testamentary limited power of appointment (with consent of an adverse party) to make such changes.[337] The advantage to the latter is that it can be effective immediately upon the mother's death, which may avoid any potential issues discussed elsewhere herein when trusts convert from non-grantor to grantor trusts (i.e. while it is usually not a taxable event, it is possible that tax characteristics such as NOL, capital losses etc. may not carry out from the nongrantor trust to the grantor trust). Granting the mother a narrow testamentary limited power of appointment would also permit changes to the trust without having to burden a trust protector.

Remember that any withdrawal power granted to someone with an otherwise taxable estate does have some risk of including any currently withdrawable income at the time of the power holder's death in the powerholder's estate, but this can mitigated in a number of ways, as discussed in sections II.h, II.i and II.m., and the huge amount of annual tax-free transfers would likely be worth it.

As enticing as $800,000 of tax-free transfers might be, it's very possible that the result could be even better. Recall the discussion

[337] The mother's exercise of a testamentary limited power of appointment would not affect the identity of the grantor for income tax purposes (it would remain the child/grantor), see Treas. Reg. §1.671-2(e)(5).

jj) Contrasting Installment Sales to BDITs

I added this section to the outline as a quick primer of the BDIT strategy and offer some comparisons with a BDOT after getting several questions and requests to compare the two after CLE programs. See footnote 3 for additional articles on BDITs.

A BDIT (a Beneficiary Defective Inheritor's Trust, sometimes referred to as Beneficiary Defective Irrevocable Trust) is an irrevocable trust with the following characteristics:

1) It is **created by a parent or other third party who contributes $5,000** in cash to the trust; no other gifts are made to the trust by anyone, especially the beneficiary.
2) The settlor/grantor typically **allocates $5,000 GST exemption**
3) **The grantor retains no powers or rights that would make the trust a grantor trust** as to him or her under IRC §§671-677 or §679, so the grantor is a settlor for creditor rights and transfer tax purposes, and is considered the grantor for income tax purposes but is not deemed to own the income (either ordinary/accounting income or income attributed to corpus such as capital gains).
4) The beneficiary is given a **"Crummey" type power to withdraw** the original gift (and any income, though it might simply be parked in a no interest checking account for a time), which right **lapses**.[338]
5) The beneficiary **continues to have withdrawal rights, but limited to that necessary for health, education and support**.
6) The beneficiary may receive additional distributions at the **discretion** of an independent trustee.
7) The beneficiary has a **testamentary limited power of appointment** (there may be a carve out as to any life insurance on the beneficiary to avoid incidents of ownership under IRC §2042).

Through this design, the trust should have the following legal/tax effects:

1) The only amounts in the trust included in the beneficiary's estate would be the $5,000 withdrawal right if he/she dies while it is still ongoing. After lapse, IRC §2514/2041 "five and five" lapse protection should protect the trust from inclusion.

[338] It's long been settled that a trust can have more restrictions on access after a *Crummey* power type lapse, even before the 1968 *Crummey* case: see *A.I. Herr v. Comm*. 35 T.C. 732 (1961), aff'd, 303 F.2d 780 (3d Cir. 1962) Revenue Ruling 74-43.

2) while the power of withdrawal is outstanding, the beneficiary is treated as the owner of the trust for income tax purposes under § 678(a)(1).
3) After the power lapses, if this is deemed to "partially release" the power as many PLRs have concluded, the beneficiary is treated as the owner of the trust under § 678(a)(2).
4) Any sales/transactions at fair market value between the beneficiary and the BDIT are ignored pursuant to Rev. Rul. 85-13, similar to transactions between a grantor and an irrevocable grantor trust. Where this raises concern is when the transaction is so much larger (often in the millions of dollars) compared to the size of the initial corpus. In contrast to BDOTs, taxpayers would not bother to establish BDITs without a large subsequent sale, since there is not much point in spending multiple times more in attorney fees than the size of the trust otherwise! To justify lending to an entity with such nominal funding, personal guarantees are obtained from credit-worthy parties, which may include another irrevocable trust.
5) If it is finally determined that a sale to the trust by the beneficiary is partially a gift, the gift would be incomplete (because of his or her limited lifetime and testamentary powers of appointment).

The IRS is concerned with BDITs, but *not* necessarily with the fundamental principles and conclusions above, but with a nominal seed gift justifying a *much* larger transaction. It has not issued anything definitive and there is no case attacking BDIT transactions, but the IRS has indicated that it will not issue PLRs in this area:

> "(43) Section 678.—Person Other than Grantor Treated as Substantial Owner.—Whether a person will be treated as the owner of any portion of a trust over which that person has a power to withdraw the trust property (or had such power prior to a release or modification, but retains other powers which would cause that person to be the owner of the trust under § 671 if the person were the grantor), other than a power which would constitute a general power of appointment within the meaning of § 2041, **if the trust purchases the property from that person 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**."[339]

How might the IRS attack a BDIT? My personal conclusion is that the weakest link in the chain is that a lapse should probably not be considered a "partial release" under IRC §678(a)(2), as previously discussed. I may be a minority of one. The IRS does not seem to be concerned and apparently does not see any issue with that aspect of BDITs, since several PLRs have assumed that lapses are the equivalent of releases for IRC §678(a) and their "no ruling"

[339] Rev. Proc. 2019-3, §4.01(43). Similar, Rev. Proc. 2020-3, §4.01(43).

statement does not mention this issue. Their main concern noted in the section bolded in the Rev. Proc. above deals with the relative size of the typical transaction in comparison to the small size of the trust corpus.

Some have expressed concern about how the “portion” of the trust that is a BDIT deemed owned by the beneficiary is calculated in *future* years. For example, if the trust is initially funded with a $5,000 Crummey power over the entire corpus, the “portion” of the trust initially subject to IRC §678(a) is clearly 100%. Let’s imagine that this power lapses (and assume that a partial lapse is a partial release) and in the following year, after large installment sales have been made to it etc., the corpus is now valued at a net $50,000. Is the “portion” of the trust deemed to be owned by the beneficiary *always* 100%, or could it be considered to only be 10% now, because the portion that the beneficiary could have withdrawn and let be “partially released”, $5,000, is now only 10% of the corpus? I believe that the more logical reading requires that the calculation of the “portion” should be set in time based on when the power lapses or, in §678 parlance, is “partially released or otherwise modified” (i.e., always 100% in the example above, unless someone were to make later contributions to the trust). This issue, similar to the “lapse v. release” issue, simply does not arise in a BDOT, because the power to withdraw income never lapses.

a. **Does the guarantee fee have substance if it dwarfs the size of the trust?**

There is considerable pressure on the BDIT technique because of the need to pay the guarantee fee to third parties (which may be children or an irrevocable trust). Generally, using guarantees in irrevocable grantor trust transactions is a more conservative practice rather than something suspicious.[340] The IRS may question the substance of any sale with a large guarantee fee because of the size of the guarantee fee in comparison to the beginning corpus of the BDIT. E.g., if the corpus of the BDIT is $5,000 and the guarantee fee to be paid is $50,000 a year, the annual guarantee fee is ten times the beginning corpus of the $5,000 trust (and this may be a relatively small ratio from anecdotal data on the size of these transactions). It is commercially reasonable to obtain guarantees – commercial lenders certainly do, and to pay guarantee fees, but taken as a whole, when looking at multi-million BDIT transactions, the BDIT looks like an afterthought with no skin in the game.

b. Who is the real transferor?

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[340] For a good article on the use of guarantees generally in intra-family installment sale and grantor trust transactions, see *Role of Guarantees and Seed Gifts in Family Installment Sales*, by Martin Shenkman, Estate Planning, Vol. 37, No. 11 (Nov 2010). See also Jerry Hesch, Dick Oshins & Jim Magner: *Note Sales, Economic Substance and "The 10% Myth"*, LISI Estate Planning Newsletter #2412 (May 9, 2016).

The beneficiary does not become the grantor for income tax purposes in the case of a sale at fair market value. But remember that a transfer of property to a trust "can be considered a gratuitous transfer [for income tax purposes] without regard to whether it is treated as a gift for gift tax purposes."[341] Thus, if a beneficiary loans funds at the applicable federal rate of say 2% and the going rate for such a loan would be 3.75%, the difference might be considered a gratuitous transfer for income tax purposes even if it is not for gift/estate/GST purposes. That may not be a problem for grantor trust status, since to the extent the beneficiary is a grantor for income tax purposes merely makes it more likely they would be taxed on the income under a regular grantor trust code section such as IRC 677(a).

Transfer tax analysis may be different. To quote one old court case, where "such analysis shows that another than the formal settlor is in reality the transferor, his estate may be taxed accordingly."[342] Is the beneficiary the settlor "in reality", e.g. *in substance if not in form*?

Sections 2036 and 2038 requires not only that the transfer be for "full consideration," but that it is also "a bona fide sale". In the family partnership context, courts have held that the "full consideration" and "bona fide sale" requirements are two separate tests. Are BDIT sales "bona fide sales"? Probably, but this is an area where the IRS may decide to attack.

c. Nutshell differences between BDIT and BDOTs vis a vis installment sales

First, the BDOT structure has many, many uses outside of the installment sale context, as discussed throughout this paper. However, if we are only comparing beneficiary-deemed owner installment sales to a BDIT versus beneficiary-deemed owner installment sales to a BDOT, here are the main pros and cons of each:

1) Pros of BDITs/Cons of BDOTs:

a) Some feel that transactions with BDITs are more certain to come under Rev. Rul. 85-13 when at one point the beneficiary-deemed owner had the power to withdraw the entire corpus. In fact, there was a recent PLR that involved a transaction between a beneficiary and a BDIT, although in that case the power was current and had not lapsed and there was no extreme leverage involved. While there is no authority for any difference in treatment for someone with the power over all income v. the power over all corpus in §678(a), there may still be some uncertainty for BDOTs, especially for unique cases such as whether the document adequately addresses rights to any phantom income, or cases where income might be different for state and federal tax purposes, etc. BDOTs

[341] Treas. Reg. §1.671-2(e)(2).

[342] *Newberry's Estate v. Comm'r*, 201 F.2d 874, 876 (3d Cir. 1953).

involved in any disregarded sales should be careful to err on the side of clear access to income, whether for state or federal purposes, phantom income, later discovered/reported income, etc.

b) The beneficiary's ongoing interest/rights after the lapse might be wholly discretionary in a BDIT, so there is no need for any cessor/forfeiture clauses to cut off income rights in the event of creditor attack, and no risk that such an attack would jeopardize BDIT status as such. By contrast, if a BDOT is attacked and the cessor/forfeiture clause kicks in (depending on how it's drafted) or the trust protector removes the beneficiary's power to withdraw the income, the trust would cease to be a BDOT and simply become a non-grantor trust. This may in turn make any remaining installment payments on a sale taxable income. Thus, any installment sale to a BDOT should have an exit strategy to cover this, such as delaying any cutoff until the following year if there is any outstanding installment sale between the trust and the beneficiary deemed owner, even if such a situation would be extremely unlikely.

c) BDIT clauses are relatively simple to draft – an unfettered right to withdraw the entire corpus that lapses, much like a Crummey power that has been around for over 50 years. By contrast, BDOT clauses require much more finesse to cover different situations, especially if disregarded installment sales are anticipated – clarifying treatment of income attributed to principal/capital gains, addressing the potential for lapses beyond the 5x5 lapse protection of §2514(e) and crafting hanging powers, state v. federal income definitions, addressing when and how the power lapses and how to address late-discovered or phantom income from K-1s, etc., crafting cessor/forfeiture and trust protector powers to enable modifying/removing the right in future years without impeding the §678 unfettered power to withdraw all the income in a given year or enabling the easy exit from an installment sale before the BDOT status is turned off.

2) Cons of BDITs/Pros of BDOTs:

a) Only $5,000 seed gift for a BDIT really begs the substance over form argument for very large sales, even when there is a guarantee involved. By contrast, BDOTs might be funded with *millions* of dollars and avoid this issue altogether.

b) BDITs rely on the legal conclusion that a lapse is the same as a release for IRC §678(a)(2), and further, that a lapse wherein the beneficiary retains some other powers such as a power limited to health, education, maintenance and support, is a "partial release" (is even that 100% certain, when it is clearly no longer a general power?). By contrast, BDOTs rely on a very plain, non-controversial reading of the statute, backed by many decades of case law.

c) Uncertainty that the "portion" of a BDIT that is deemed owned by the beneficiary could have to be recalculated every year even without new contributions and the portion could change with the dramatically increased corpus. Personally, I don't agree that this is much of a risk, but other attorneys have speculated about it.
d) BDOTs can adapt to the next generation, e.g., when primary beneficiary dies, it might become a BDOT (or BDOTs if it is split into subtrusts) as to the next generation.
e) BDOTs can very easily turn off BDOT status when it may be advantageous later, perhaps to avoid state income taxes on a sale, or to shift income, or make more advantageous charitable donations. By contrast, it is uncertain how you easily "undo" or get out of a BDIT tax status. It would be too late to disclaim in most cases. Might a BDIT beneficiary have to completely release/renounce their interest? This may be a gift, or worse, a taxable exchange under IRC §1001. There is not a simple exit strategy out of §678(a)(2), other than death.

3) BDIT/BDOT Hybrid? Is it possible to blend the two for a more secure transaction?

a) Consider: If a practitioner likes the fact that BDITs have been around longer, and thinks that the Rev. Rul. 85-13 disregarded transaction paradigm may be more certain if based on the power to withdraw corpus, yet is still uncertain about the whole "lapse=release" conclusion/interpretation of §678(a)(2), a BDIT might be funded with $5,000, and upon lapse, the beneficiary *retains the power to withdraw all the taxable income* in addition to any HEMS powers. That way, even if the IRS changes their mind on the "lapse=release", the trust should remain a BDOT. A second grantor trust established by a spouse or BDOT with a much larger corpus could be funded that would be a guarantor of the first hybrid BDIT/BDOT, which might ameliorate the small seed gift issue endemic to BDITs, and avoid issues with guarantee fees since the trustee would simply be pledging assets to benefit a beneficiary.
b) Even better, remember – a BDIT or BDIT/BDOT hybrid might be funded with much more than $5,000 and still be under lapse protection if there are other trusts with larger corpus amounts that also include withdrawal rights, which would mitigate against the other perceived flaw of the BDIT structure, which is starting with such a small corpus. See extensive discussion of this in Section II.h *Advantage – Protecting Unneeded Distributions of Income and Modifying the Withdrawal Right to Keep More Funds in Trust Protected After Lapse,* especially pages 49-52.

kk) Can Conversion to BDOTs Avoid CA/NY's "Throwback Tax" System?

California and New York have unique trust income tax systems in two respects: they have the two highest state income tax rates in the country, if you count New York City (CA has a top rate of 13.3%, NY state rate is 8.82%, NYC rate is an additional 3.876%). They are also the only jurisdictions with a throwback tax.[343] Especially as regards to trusts with large amounts of taxable income, planning ahead may yield significant savings, particularly if beneficiaries are likely to be relatively high income.

Example: Client, a NYC or CA resident, plans to leave $2 million in IRA funds to NYC or CA beneficiaries in their 50s outright. In most cases this must be withdrawn within 10-11 years under the SECURE Act (discussed in section II.aa above). Imagine the trust doubles in these ten years to $4 million. For simplicity, I'll blend the state/local income tax for these jurisdictions at 13%. That's about $520,000 lost in state/local income taxes (remember under the TJCA SALT caps, only $10,000 of this a year is deductible now for federal purposes, and even that's often wasted due to higher standard deductions).

By contrast, what if the Client instead leaves these funds in a standalone IRA trust and the trust pays the income tax on the IRA distributions in the last year (often it would be best to spread out, but let's ignore that for this first example to illustrate an important point). The trust is a NY Exempt Resident Trust or California non-resident trust administered outside of the state, in FL/NV/SD/DE/OH, any state that will not tax the trust. It pays no 13% tax initially, but $1.48 million (37% of $4 million, ignoring growth, bracket run up, deductions, etc.) of federal tax. The next year, the remaining $2.52 million is paid out to the resident beneficiaries and the beneficiary pays a NY/CA throwback tax on said amount. The NY/CA throwback income tax is calculated on $2.52 million, not on $4 million, and has no penalties/interest component. The savings by using a trust intermediary is roughly 13% of $1.48 million = $192,400, ignoring brackets etc. Basically, using the trust structure is enabling the beneficiaries to indirectly obtain a NY/NYC/CA tax deduction for the federal tax paid – paying the throwback tax on the *net* after federal tax rather than gross income. The closer beneficiaries are to being in the highest income tax bracket the more this savings would accrue. Obviously, if beneficiaries could take this out over time taxed under 12/22/24% brackets, the state income tax savings would not make up for the additional federal income tax paid by trapping income in trust. Trapping income in trust for state income tax purposes should only be considered for relatively wealthy families where beneficiaries are likely to be in the top two federal tax brackets.

But could converting to a BDOT make this savings even greater?

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[343] Pennsylvania also assesses a throwback tax on accumulation distributions to resident beneficiaries from nonresident trusts at 61 Pa. Code § 105.5(c). However, this provision omits discussion or application to "resident trusts", ironically creating a loophole for resident trusts unavailable to nonresident trusts. Because many Pennsylvania resident trusts will avoid state income taxation under *McNeil v. Commonwealth*, 67 A3d 185 (Pa. Commw. Ct. 2013), this may allow some resident trusts to avoid the Pennsylvania throwback tax.

Reimagine our above scenario but instead postulate that the trust continues and subsequently converts to a BDOT, granting the beneficiary in NYC/CA a right to withdraw all net taxable income. It now has $2.52 million of high basis assets. There is $4 million of prior income on the books subject to NY/CA throwback – while it is a non-grantor trust. Moving forward, however, it will be a grantor trust (BDOT). How does NY/NYC/CA ever get to tax the remaining $4 million under their current system, or can the entire $520,000 that would have been paid had the $4 million of back income been distributed to those beneficiaries be saved (other than by, of course, moving out of state)?

Does a trustee of a grantor trust even file a trust tax return in CA or NY? It depends on the federal method used by the trustee in reporting the income, as discussed in II.ee above:

> California's instructions state:
> "Optional Filing Methods for Certain Grantor Trusts. The FTB will accept the optional reporting requirements stated in federal Treasury Regulation Section 1.671-4(b)(2)."[344]

> New York's instructions state:
> "**Grantor type trusts using optional filing methods 1, 2, or 3 for federal purposes**
> If the trust did not have to file federal Form 1041 because it chose an optional filing method, do not file Form IT-205. Follow the optional filing method instructions for federal purposes."[345]

Thus, if the trustee follows the federal guidelines for reporting grantor trust income that permit reporting without a Form 1041 filing, the trustee files no state Form 1041 equivalent (i.e. CA Form 541, NY Form IT-205). If a trustee files federal Form 1041, checking the box as a "grantor trust", the trustee should file the appropriate state forms as well. Both the NY and CA fiduciary income tax return forms have a box on their Form 1041 equivalent to check for "grantor trust". NY instructions state:

> **"Grantor type trusts not using an optional filing method for federal purposes**
> The following instructions apply only to grantor type trusts that are not using an optional federal filing method.
> If the entire trust is a grantor trust, complete the entity information at the top of Form IT-205 and Item G on page 3 of Form IT-205.
> If only part of the trust is treated as a grantor trust, report on Form IT-205 only the part of the income, deductions, etc., that is taxable to the trust. Submit with Form IT-205 a copy of the

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[344] California 2018 Instructions for Form 541 Fiduciary Income 541 Tax Booklet. If you are curious what Options 1, 2 and 3 are, see pages 13-14 of the federal Form 1041 Instructions. At a recent ACTEC Fiduciary Income Tax Committee meeting, an informal survey by attorney Greg Gadarian of approximately 100 tax attorney attendees indicated that no one had ever used or known any accountants/trustee who used the optional methods 2 or 3 involving issuing Forms 1099.

[345] Page 6 of New York Instructions for Form IT-205 Fiduciary Income Tax Return

attachment to federal Form 1041 that shows the amounts that are taxable directly to the grantor.
The income taxable to the grantor or another person, and the deductions and credits that apply to that income, must be reported by that person on his or her own income tax return.
File Form IT-205 for the grantor trust and the grantor's own income tax return separately. Do not submit a copy of Form IT-205 with the grantor's income tax return."

In short, CA/NY trust income tax return instructions do not contemplate conversions to grantor trusts and have no provision whereby additional distributions from a grantor trust are taxable. Quite simply, throwback rules don't apply to grantor trusts.

State tax authorities are thus more likely to argue that the non-grantor trust should file a "final year" Form 1041 return for the prior year, reporting the entire value of the trust as a *distribution to the beneficiary deemed owner*. Recall Section II.k. of this paper and the discussion of whether, when or if a conversion from a non-grantor trust to a grantor trust is a distribution of all the assets to the grantor/deemed owner and thus a "termination" for federal income tax purposes. To sum up those four pages, the law is *unclear*. There is a good argument that such a conversion is not a *termination* of the trust at all. It certainly is not a termination for state trust law purposes. The additional question is whether, by converting, the trust is making a *distribution* of all of its assets to the beneficiary now deemed owner and terminating as a separate trust for Subchapter J, particularly IRC §§ 641/642/662 and regulations thereunder discussed in more detail in the above section.

Here is an excerpt from ACTEC's memo to Treasury on whether decanting (which this would be similar to) should be considered a "distribution":[346]

"Should a distribution from one trust to another be subject to Code sections 661 and 662?
A. Although the Code does not specifically include a trust that can receive distributions from another trust within its definition of "beneficiary,"[347][35] case law suggests that one trust can be a beneficiary of another trust for purposes of Code sections 661 and 662 (in contrast, for example, to sections 674 and 677 discussed above).[36][348] If a Distributing Trust distributes less than all of its assets to a Receiving Trust, it seems most

[346] ACTEC Comments on Transfers by a Trustee from an Irrevocable Trust to Another Irrevocable Trust (Sometimes called "Decanting")(Notice 2011-101) Released December 21, 2011.

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

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

appropriate that the distribution be treated as a distribution to a beneficiary for purposes of Code sections 661 and 662.

If, however, a Distributing Trust distributes all of its assets to a Receiving Trust, a better approach would be to treat the distribution as a mere recasting of the Distributing Trust and to treat the Receiving Trust as a continuation of the Distributing Trust. This seems to be the position the Internal Revenue Service took in PLR 2006-07015.[37]"[349]

Even if the conversion is a suspension of status (not a defined term) rather than a termination, it is probably still a "distribution" to the beneficiary under IRC §662 and Treas. Reg. §1.662(a)-3 (even if it is all of a trust's assets, despite my ACTEC colleagues' memo above that hedges on that point). After all, Rev. Rul. 85-13 and its progeny discussed in Part II.u. of this paper generally ignore a grantor trust so that it is treated for all federal income tax purposes as an ignored alter ego of its deemed owner. Thus, there is a very persuasive argument that any decanting or other reformation that causes all of a trust's income to thereafter be taxed to the beneficiary (or grantor) is a *distribution* of those assets to the deemed owner for all income tax purposes, including §662. For federal tax purposes, this often has no meaningful tax effect (positive or negative). For state income tax throwback purposes, however, this means that the throwback rule may apply. This is a double-edged sword – a nasty surprise if the beneficiary is otherwise subject to throwback and is not expecting the state income tax hit, but it may be ideal in many cases if it is adequately planned for. For example, the beneficiary could reside out of state for that year or the beneficiary may have been under age 21 when the income was accumulated or may have resided out of state.

Let's continue with the example above but assume in year 12 of our counterfactual the trustee/trust protector grants the power of withdrawal over taxable income to the primary beneficiary's *children* who are under age 21 or who now live out of state. Even if this conversion to a BDOT would be considered a distribution to them for §662 purposes, carrying out any current federal income tax and potentially throwing back prior year income for state income tax purposes, the state throwback tax for prior year income would not apply to the non-grantor trust's deemed distribution to them because they live out of state (or if they were under age 21 and living in NY when the income was accumulated, since NY throwback taxes do not apply to income accumulated for a beneficiary before that age).[350] The primary beneficiary could receive

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[349] The memo cites PLR 2006-07015 (November 4, 2005) and also PLR 2007-36002 (May 22, 2007).

[350] The age 21 anomaly is actually in IRC §665(b), incorporated by reference, rather than directly included as a loophole in the respective CA/NY state income tax statutes: "For purposes of section 667 (other than subsection (c) thereof, relating to multiple trusts), the amounts specified in paragraph (2) of section 661(a) *shall not include amounts properly paid, credited, or required to be distributed to a beneficiary from a trust (other than a foreign trust) as income accumulated before the birth of such beneficiary or before such beneficiary attains the age of 21*. If the amounts properly paid, credited, or required to be distributed by the trust for the taxable year do not exceed the income of the trust for such year, there shall be no accumulation distribution for such year." New York's Instructions to Form IT-205-J *New York State Accumulation Distribution for Exempt Resident Trusts* provides: "A resident

distributions of principal in later years even if the trust continues as a BDOT as to the other beneficiaries or the trust might even convert back to a non-grantor trust.

If this ever became widespread, which is very unlikely since so few attorneys and accountants have even the vaguest comprehension of §678 much less complex throwback rules, CA/NY/NYC may not sit back idly and accept such results. But states can't just extend their jurisdiction to tax out of state beneficiaries on a whim, or ignore their own statutory limitations, or ignore the federal income tax import of Subchapter J to the extent they already follow it.[351] State legislatures can certainly change their laws or override their default reliance on federal trust tax law, however, as NY/NYC did with their anti-ING statute, provided there are minimum contacts for due process and subject matter jurisdiction. A beneficiary's moving back and forth out of state over short periods of time would also be highly scrutinized, but that does not mean that a state may ignore the relevant due process considerations.[352] It is probably possible for NY/NYC/CA to patch these throwback statutes in order to tax in-state beneficiaries

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beneficiary receiving an accumulation distribution from an exempt resident trust (other than an incomplete gift non-grantor trust) must include the accumulation distribution in their New York adjusted gross income, unless: *** • the accumulation distribution is thrown back to a tax year prior to when the beneficiary first became a New York State resident, or a tax year before the beneficiary was born or reached age 21, or". By contrast, however, California's law in this regard is not as clear. Its *Instructions for Schedule J (541), Trust Allocation of an Accumulation Distribution,* provide that "R&TC Section 17779 specifically excludes from conformity IRC Section 665. Therefore, *California law does not conform to federal law to exempt from taxation those accumulations occurring prior to a beneficiary turning age 21*." In fact, that statute does provide that: "Sections 665 to 668, inclusive, of the Internal Revenue Code shall not apply to distributions described in subdivision (b) of Section 17745."

That said, the Instructions for Form FTB 5870A Tax on Accumulation Distribution of Trusts mandate that preparers subtract this amount! "Line 2 – Enter the amount on line 1 that represents UNI of a trust considered to have been accumulated before you were born or reached age 21." The form is below:

"1 Amount of current distribution that is considered distributed in earlier taxable years from Schedule J (541), line 30, column (a) . . . .

2 Distributions of income accumulated before you were born or reached age 21 . . . .

3 Subtract line 2 from line 1 . . . ."

I will defer to California attorneys as to whether the state's explicit tax form and instructions would preclude the state from arguing against its own instructions, but appellate courts in other states generally hold that states are estopped from arguing against their own clear instructions and must issue corrective guidance/instructions first. See *Residuary Trust A u/w Kassner v. Director, Division of Taxation,* 2015 N.J. Tax LEXIS 11, 2015 WL 2458024 (N.J. Sup'r Ct. App. Div. May 28, 2015), aff'g 27 N.J. Tax 68 (N.J. Tax Ct. Jan. 3, 2013).

[351] E.g., CA Rev & Tax Code § 17731 expressly provides that: "a) Subchapter J of Chapter 1 of Subtitle A of the Internal Revenue Code, relating to estates, trusts, beneficiaries, and decedents, ***shall apply, except as otherwise provided***." Subchapter J includes all of the trust income tax rules discussed herein.

[352] E.g. CA Rev & Tax Code § 17745(e): "(e) In the event that a person is a resident beneficiary during the period of accumulation, and leaves this state within 12 months prior to the date of distribution of accumulated income and returns to the state within 12 months after distribution, it shall be presumed that the beneficiary continued to be a resident of this state throughout the time of distribution."

(even minors) who receive distributions, but it is much more difficult to do so for receipts of prior year accumulated income by out-of-state beneficiaries, especially after the Supreme Court's decision in *Kaestner*.

ll) Battling Powers of Appointment – When Powers to Distribute/Withdraw Overlap

I have been asked at tax conferences to opine on what happens when the primary beneficiary has a power to withdraw income, but also has a lifetime *limited* power of appointment over principal, or what happens when the trustee also has a spray power over any principal other than the current income subject to the beneficiary's withdrawal right (a trustee spray power may be considered a fiduciary limited lifetime power of appointment). What would be the income and transfer tax effects of the "dueling distribution powers"?

Income tax - if a BDOT powerholder not only has the power to withdraw income, but also has a lifetime limited power of appointment over principal (whether limited to an ascertainable standard or not), the powerholder's exercise of the limited power in favor of others should not be able to shift the income tax burden of the income over which they have the power to withdraw. In some situations, this may be a drawback to a BDOT over a non-grantor trust, since a non-grantor trust would allow the tax burden to be shifted to beneficiaries who receive distributions, up to DNI (even if it may be a taxable gift), whereas a BDOT provision prevents this. From a transfer tax standpoint, of course, it's often preferred that the older generation bear the tax burden for a younger generation receiving the benefits of the income. A BDOT beneficiary can always pay the income tax burden on the income, then withdraw what they wish to donate to a child or other beneficiary, such that the beneficiary receives the gift income tax free.[353]

If such a limited power (spray power) were held by a trustee, it should make no difference, as long as the BDOT beneficiary's withdrawal power over current accrued income is not impaired in any way.

Drafting to cover the precise mechanics of that, however, might be tricky, since it is important to carve out and prevent such powers from impairing the BDOT beneficiary's withdrawal power over the currently accessible income for the year (which is easy to calculate for publicly traded companies or bonds paying simple dividends and interest, but which might be difficult to discern if partnerships/S corporations are involved). For example, if the trust corpus is $1 million and the current income is $25,000 as of July 1, should this limited spray power enable payment of $975,000, or the full $1 million of corpus? It may not matter in our first example of the BDOT power holder having such a concurrent limited power, since their appointment of the trust corpus could simply be treated as an exercise of a limited power over $975,000 and an exercise of their general power over $25,000. However, this is trickier for the trustee spray power example, if the goal is to ensure that the power holder has the sole unfettered power over the income at all times until lapse. The trustee should be limited in its ability to spray principal above the currently withdrawable amount to anyone other than the BDOT power holder, including any capital gains or other current year income that might be added to principal, and should also be limited in its ability to spray (make distributions) to such

[353] IRC §102.

an extent that it would impair any hanging power. A simple sentence restricting the trustee's ability to distribute any funds currently withdrawable by the beneficiary to anyone other than that beneficiary should suffice.

***Transfer* tax effects of overlapping powers**

When a holder of a general power (such as a BDOT power of withdrawal) also has a *limited* power that is exercised in favor of others, the regulations actually have a specific example of how to calculate what happens:

> Furthermore, if a person holds both a presently exercisable general power of appointment and a presently exercisable nongeneral power of appointment over the same property, the exercise of the nongeneral power is considered the exercise of the general power only to the extent that immediately after the exercise of the nongeneral power the amount of money or property subject to being transferred by the exercise of the general power is decreased. For example, assume A has a noncumulative annual power to withdraw the greater of $5,000 or 5 percent of the value of a trust having a value of $300,000 and a lifetime nongeneral power to appoint all or a portion of the trust corpus to A's child or grandchildren. If A exercises the nongeneral power by appointing $150,000 to A's child, the exercise of the nongeneral power is treated as the exercise of the general power to the extent of $7,500 (maximum exercise of general power before the exercise of the nongeneral power, 5% of $300,000 or $15,000, less maximum exercise of the general power after the exercise of the nongeneral power, 5% of $150,000 or $7,500).[354]

Let's extrapolate from the above example onto a BDOT provision with a trust corpus of $1 million and $25,000 of current year income (and no hanging power) at the time of exercise, similar to our prior example. If the BDOT power holder exercises their non-general limited power to appoint $200,000 to their children, then this is not treated as an exercise of their general power if their power to withdraw the current year income is not impaired in any way and continues.

If the presently exercised general power is reduced, however, this would be deemed to be an exercise and gift by the amount the general power is reduced (in this case, $25,000). This, of course, would not necessarily be a bad thing in many cases, since it reduces the amount that could possibly later lapse over the 5x5 lapse protection, and the taxable gift would often come within the annual exclusion amounts anyway. The drafting of the trust terms could probably dictate either result – does the trust specify what happens to the powerholder's PEG power over income if he exercises a limited power? Is it deemed to be exercising the general power first? This might be best practice, with trustee/protector ability to modify otherwise.

[354] Treas. Reg. §20.2514-1.

II.mm. Entities, Trusts, UTMA Custodians as Beneficiary Deemed Owners of Trusts

IRC §678(a) provides that any "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". Pursuant to IRC §7701(a)(1), "The term "person" shall be construed to mean and include an individual, a trust, estate, partnership, association, company or corporation." Therefore, if one of these entities has the power to withdraw income from a trust (and, no other traditional 673-677 grantor trust provision applies), then such entity would be deemed the owner of the trust for all income tax purposes. Most of this white paper has concerned trusts granting such powers directly to individuals. This section will explore trusts granting such a power to other trusts, estates, partnerships or corporations – including cases where such entities may be the settlor of such trusts.

Non-Grantor Trusts: We have discussed shifting income away from GST exempt trusts to GST non-exempt trusts and enabling other techniques involving trusts throughout this paper. Recall, in PLR 2016-33021 discussed earlier, a non-grantor trust (trust #1) established by a decedent had established another trust (trust #2), reserving a §678 solely exercisable withdrawal power over the net income, and the IRS ruled that Trust #1 was deemed to be the owner of Trust #2 for income tax purposes.

With so many trusts now including *de facto* decanting powers, and so many state laws now expressly building such powers into statute, there is often ample opportunity for trustees to distribute assets into a new trust over which the old trust retains the power to withdraw the income.

A common question and concern that arises in considering such powers, whether granted to trustees or other entities, is "wait, doesn't the trustee (LP/LLC/Corp) have a fiduciary obligation to maximize its assets and hence withdraw the most that it can? Is it therefore not a breach not to withdraw? Don't beneficiaries have obligations to seek restitution for the breach else it be considered a gift to the trust? These are all valid questions, but contain some erroneous assumptions we should unpack.

Trustees do not owe duties to "the trust". Though it is often blurred in analysis (such as federal income tax law considering a non-grantor trust to be a separate taxpayer), a trust is not even an entity (with possible exception of certain business trusts created by state statutes, not discussed herein). Under common law, a trust is a fiduciary relationship with respect to property, subjecting the legal owner (trustee) to duties to the beneficiaries (the equitable owners).[355] This is not a meaningless distinction. It's an extremely important point in many

[355] See, generally, Restatement, Third, Trusts, §2 Definition of Trust.

areas of law, such as the gaping loopholes wide enough to steer an oil tanker through that allow the wealthy to avoid their resident state's income tax on their trust's income.

So, if trust #1 has a power to withdraw income from trust #2, it is not a breach *per se* for the trustee of trust #1 to fail to withdraw trust #2's income. One must instead ask whether the trustee of trust#1 ("trustee#1") is harming the beneficiaries of trust #1 in some way by failing to do so. It may be very prudent *not* to withdraw income in the majority of cases. If Trust#1 is for A, secondarily for B and C and Trust#2 is for B, secondarily for C and D, then of course A might have an action against trustee#1 for failure to withdraw any income – if A could otherwise benefit. This would depend on the trust terms and circumstances. What if A is only entitled to distributions for health, education and support taking into account other resources available, but A is independently wealthy and hence not entitled to a dime from Trust#1? What if A is only entitled to an annuity that would remain unchanged? It may be imprudent for Trustee#1 to withdraw unneeded funds if the other beneficiaries to whom it owes a duty are better off keeping funds in Trust #2. As discussed elsewhere herein, there may be state income tax law or GST reasons to have the income tax burden shifted from one trust to another.

This concept is important in understanding how to analyze other permutations of withdrawal powers between trusts and other entities as well.

Caution: Distributions from Disregarded Trusts Deemed Owned by Another Trust – Disregarding a trust deemed to be owned by another trust probably means disregarding it for more than just income attribution. I have been consulted on situations in which the attorneys/trustee for Trust#1 (non-grantor trust) established Trust#2, retaining a power to withdraw income (such that Trust#1 remains the deemed owner of Trust#2's assets for income tax purposes under IRC §678, similar to PLR 2016-33021), and then made undeclared distributions from Trust#2 to the primary beneficiary. This was done for state income tax avoidance reasons because Trust#1 is a resident of a state that would not subject the trust income to state income tax. The primary beneficiary receiving distributions, however, is in the top tax bracket and lives in a state with a relatively high state income tax, and the goal of the structure was to allow the primary beneficiary to receive funds without having the distributions carry out DNI to them and therefore be subject to state income tax that would not occur if it remained taxable to Trust#1. Does this work?

Probably NOT. If Trust#2 is disregarded as a separate entity, then its income, deductions and expenses are attributed to Trust#1 under the 678 and 671 regulations cited throughout this paper. While there does not appear to be anything in the Code or Regulations explicitly stating that distributions would also be attributed to a deemed owner, this conclusion logically follows from Rev. Rul. 85-13 and the express language of §678. The codal language of §678 is that the powerholder "shall be treated as the owner" – it does not say "shall be treated as the owner only for income and deductions and not for distributions". IRC § 661 and §662 basically hold that non-grantor trusts *may* take a deduction for distributions up to DNI made to beneficiaries and that beneficiaries *must* take such distributions into income up to DNI. In Chief Counsel Advice 201016073, the IRS concluded that the beneficiary must report in income the amount provided in §662 even if the trust forgoes the corresponding deduction under § 661. While CCAs are not authority and sometimes do get points of law wrong, they're probably right more often than not, and should be followed in this case. While there may be an argument that distributions from Trust #2 should not be considered as distributions from Trust#1 (PLR 2016-33021 did not discuss this either), this argument would likely ultimately fail if tested in court. IRC §678 clearly calls for any distributions to also be deemed to the powerholder to the extent that the powerholder is considered the owner. Otherwise, trustees could easily thwart the plain express language of IRC §662 that requires inclusion of income up to DNI to the extent of a beneficiary's distributions. Similarly, failing to deem distributions to a §678 powerholder would enable C/S corps to establish trusts to get around the various deemed dividend/distribution rules that apply when funds are distributed to shareholders. This structure may successfully hide a transaction and taxable distribution, but if state or federal authorities ever questioned it, it is doubtful to pass muster.

They would have more success avoiding state income tax in the above scenario if they used an S Corp/ESBT structure, which expressly prohibits trust distribution deductions from any S corp income – even if the S corp income is from passive investments in garden variety stocks and bonds rather than from an active business. Congress clearly designed the ESBT rules to function this way and trap income to be taxed in the trust despite distributions being made. Thus, this would be a much more certain way to accomplish the trapping of income in trust despite distributions.

Estate: It's certainly a strange idea to consider an estate to be a deemed owner of a trust. Sometimes they are even aggregated together, such as when the executor elects under IRC §645 to consider a revocable living trust with an estate. When might this occur and how would this work? When would you want to shift the tax bill from a trust to an estate?

Answer: When the trust is GST exempt and the estate is not. For example, Eileen, married, uses her gift and GST tax exemption during her lifetime to fund an irrevocable GST-exempt SLAT, which grants her husband a discretionary interest, and upon her husband's death, her estate (which may be his revocable living trust combined with the probate estate under IRC §645) retains the power to withdraw income for a period of two years. This is not as crazy as it sounds, since it is not so different from many irrevocable trusts (e.g., ILITs, IGTs) that have provisions to permit lending to and purchase of assets from an estate to facilitate Graegin loans, settling the estate and paying debts, estate taxes and the like.

That said, I do not advocate naming an estate as a beneficiary for a few reasons and I only include this category to spur thinking outside the box a bit (a *gedankenexperiment*). What if husband's estate were insolvent? What if husband has a taxable estate? How would the value of a temporary income withdrawal interest be valued for estate tax purposes? You can imagine how confused a probate judge or magistrate would be upon learning that the estate is a beneficiary of a trust. How would you value it for inventory?

Probate estates are by nature designed to be short-term affairs.[356] Trusts are the appropriate vehicles for long-term administration. Such powers granted to a probate estate would therefore probably complicate matters more than it would ever assist. Since the probate estate of most people are combined with for tax purposes and will likely pour over into a living trust (distributing all its income to it on Final K-1), it would be preferable to add such a clause to that.

Revocable Living Trust Serving as *De Facto* Will Substitute, Becoming Long-Term Trust

The above concerns about estates do not necessarily hold true for a longer-term trust, such as a revocable living trust that is a *de facto* will substitute that establishes one or more separate irrevocable trusts at death. However, it is helpful to distinguish the different stages in the administration of such trusts prior to analyzing when and how granting a power of withdrawal to it from another trust may be helpful.

In the overwhelming majority of states, the assets of a revocable living trust are susceptible to the creditors of the estate of the settlor.[357] This is likely true even if the assets funding the trust would otherwise have been protected under state or federal law, such as homestead, annuity, life insurance, qualified retirement plans or IRAs. This is one reason why some practitioners advocate paying such funds to a separate irrevocable trust at death rather than pay them to a revocable living trust as beneficiary.

Let's go back to our hypothetical above where Eileen had funded a dynastic GST exempt trust for her husband and children and passes away. Should her dynastic trust grant her revocable living trust a right to withdraw income? No – this might make the income susceptible to creditors of the estate, as previously discussed. However, any *subtrusts* created under the revocable living trust that are funded after administration or directly from another source are

[356] *Jarndyce v. Jarndyce* type cases are normally undesired and unplanned – normally assets can be assigned and transferred out to beneficiaries and most estates are closed within 2 years.

[357] UTC § 505 provides the general rule for UTC states. Ohio is an exception to this rule by virtue of older case law that Ohio's version of the UTC §505 left alone: *Schofield v. Cleveland Trust Co.*, 21 N.E.2d 119 (Ohio 1939).

probably NOT susceptible to the settlor's estate's creditors.[358] These subtrusts are just irrevocable trusts like any other, only they're funded at death. Again, why would we do this? Because Eileen already utilized her GST exemption, these trusts emanating from her revocable living trust would be GST *Non-Exempt*, and it would be better for the GST non-exempt trust to get the income tax bill for the GST Exempt Trust. In many circumstances for simplicity the plan may call for both the GST exempt and GST non-exempt trusts to grant the primary powerholder the right to withdraw income, and of course the powerholder would withdraw needed funds from the latter first.

However, there may be state income tax reasons to prefer the shifting of income from a GST exempt trust to a GST non-exempt non-grantor trust rather than to its primary beneficiary. For example, if the GST non-exempt trust were a resident of a state with low or no income tax and the beneficiary resides in a state with a higher applicable state tax rate.

State Income Tax and other Administrative Reasons to Shift Income Between Trusts Administered in Two States – Uniqueness of INGs as a Category of Non-Grantor Trust

Sometimes it makes sense to carve out state source income and have it be taxed to the beneficiary through a BDOT power, as discussed previously and in a separate article.[359] Other times it makes sense to shift all of the income to a trust in another state. What a BDOT structure also likely permits is to sever the contacts and administrative functions between trusts so as to permit administration or trustee residency in a state that would otherwise use this innocent and sometimes accidental fact to tax the income of the trust.

Example: Settlor lives in one of the many states that tax a trust based on where it is administered, such as California, Oregon, Colorado, Arizona, etc..[360] Settlor really wants his spouse, son, friend, accountant, attorney or local bank who happen to live in one of those states to be trustee for their non-grantor trusts (or investment trustee, distribution trustee or other fiduciary role that would trigger taxation). Assume that a direct BDOT power granted to the beneficiaries would not help because the beneficiaries live in the same state with high tax rates. Should they give up on *any* administration in their preferred home state and just name a corporate trustee in Ohio, Florida, Delaware or many of the other states that would not tax the income of the trust? They may not need to go this far. They could create two trusts, one in a

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[358] E.g., *Estate of Reisman*, 266 Mich. App. 522 (2005).

[359] *Ed Morrow, Jonathan Blattmachr and Marty Shenkman on Using Decanting and BDOT Provisions to Avoid a Peppercorn of Income Potentially Triggering State Income Tax on a Trust's Entire Income*, LISI Income Tax Planning Newsletter #204 (September 15, 2020).

[360] See the 50 State (plus D.C.) hyperlinked comparison chart at: https://www.actec.org/assets/1/6/Morrow_State_Residency_and_Source_Income_Factors_for_Taxation_of_Irrevocable_Non-Grantor_Trusts.pdf?hssc=1

tax-favored state and one in the higher tax but still preferred for administration reasons state, and just have the latter grant a §678 BDOT power to the former. This shifts the income tax burden to the tax-favored state and away from the higher tax state, while still allowing some of the administration to be done in the taxpayer's preferred state of administration.

Just because the income is deemed to be owned by the former trust does not mean that the actions of the latter trust are also deemed to it for Constitutional due process purposes (or other purposes, such as debtor/creditor, trust administration or contract law, etc.). This is a subtle contrast to the deeming of income, deductions and distributions to a powerholder trust as discussed in the section above. It would be a very difficult argument for a state taxing authority to claim that all the administration decisions of the deemed owned trust should be attributed somehow to the deemed owner trust for due process and state income tax law purposes. This permits the family to continue to manage most of the trust assets in a tax-disadvantaged state.

For example, John and his family reside in the great city of Portland, Oregon. He likes the idea of a Nevada or other favorable state bank or trust company to act as trustee for income tax reasons, but really in his heart prefers his local family, friend, or advisor in Oregon, or perhaps even someone a few hours south in California. He establishes a trust in Nevada that can withdraw all the annual income from a second trust in Oregon, where his family/friend/preferred entity manages the bulk of the investments. The Nevada trust withdraws enough to pay the tax and its trustee and administration fees. Because no fiduciary of the Nevada trust resides in Oregon and no administration of the trust is done there, Oregon should not have any minimum contacts with the trust sufficient to meet minimum contacts/due process requirements to be able to tax the income (assuming there is no *source* state income). Just because the Oregon trust is ignored for federal income tax purposes does not mean that all of its parties/actions are attributed to the Nevada trust for minimum contacts, debtor/creditor, contract, or other law. The two trusts (which have different trustees) are clearly two separate entities (or more accurately, legal/equitable relationships) for those purposes. This nuance permits a structure that allows settlors and trustees to plan around a state's trust tax statute that may base "residency" on the residency of a fiduciary or administration in state.

Does this sound gimmicky? Perhaps, but most use of out of state trusts to avoid state income tax is a legal charade, and most of the opportunity arises from loopholes emanating from state supreme court and/or US Supreme Court Constitutional due process holdings and from the fact that non-grantor trusts are considered separate taxpayers (even though a trust is not an entity) but grantor trusts are not, and that **the more meaningful equitable ownership is ignored in favor of analyzing the residency, contacts and actions of the legal owner**, who may have no equitable rights to trust income at all. Is it right or logical that North Carolina cannot tax a trust's income even when all the beneficiaries live in North Carolina? Of course not, but a unanimous Supreme Court in *Kaestner* was compelled to answer otherwise due to these various disconnects at the intersection of state and federal tax law. It makes no logical or public policy sense to tax non-source income based on where the *legal* owner of the property resides, but that's the state of the law for the foreseeable future.

Could states change their law to still tax such trusts without violating Constitutional due process? Of course, but it's unlikely that any of them will. They could adopt Pennsylvania's approach, which is to tax grantor trusts as a separate entity despite what federal law says. The above strategy does not work if the trustee of the deemed owned trust resides in Pennsylvania because Pennsylvania would tax the beneficiary deemed owned trust separately, as it does other grantor trusts, and would have enough minimum contacts to do so Constitutionally if the trustee resided in and/or administration were done in that state.[361] Pennsylvania, however, recently decided to abandon its unique structure starting January 1, 2025.[362] States don't have to follow the federal grantor/non-grantor trust distinction, as New York and California have shown in adopting anti-ING statutes.

Speaking of INGs – could an ING trust design (assuming they "work" and one can safely establish one based on the various PLRs issued between 2013-2022) simply grant another trust outside of the state that is a completed gift a withdrawal right over taxable income (similar to PLR 201633021, but with the trust #2 having the withdrawal right being funded via separate gift as a completed gift non-grantor trust)? This could in theory get around NY and CA anti-ING statutes by shifting the income from the "ING" to a completed gift non-grantor trust administered out of state. The anti-ING statute should not apply if the "ING" grants a 678/BDOT withdrawal right, since it would not really be an ING if a BDOT power is granted shifting the income to another taxpayer (hence my use of quotes to describe it above).

Even if we can get past the lack of authority and issues with INGs in general, this begs the question of whether the granting of an unfettered power of income to another taxpayer completes the gift as to such income. Let's take an example: S live in CA or NY and establishes a

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[361] See citations in Footnote 319. Here is an Excerpt from the Pennsylvania Department of Taxation's Personal Income Tax Guide: "**Grantor Trusts** Pennsylvania does not follow Federal grantor trust rules. For federal income tax purposes, the income of the grantor trust is treated as income of the settlor. For Pennsylvania personal income tax purposes, income of a grantor trust is taxable income to the trust. Because of this discrepancy, when a Pennsylvania resident trust receives income sourced to another state that follows a federal income tax base, Pennsylvania will tax the income as income of the grantor trust and the other state will tax the income as income of the trust settlor. Because the trust and the settlor are different taxpayers for Pennsylvania income tax purposes, the trust and/or the settlor cannot claim a resident credit for taxes paid to the other state on the trust income."

[362] https://www.jdsupra.com/legalnews/pennsylvania-amends-tax-treatment-of-3622875/

completed gift trust#1 with $1 million administered in NV, DE, OH, etc where CA/NY tax might be deferred if no assets, administration or trustee lives in CA/NY. S establishes an "ING" trust #2 in DE, NV, OH or some other DAPT state that would not tax the trust, with $100 million low basis assets anticipated to be sold, but unlike an ordinary ING it grants trust #1 the power to withdraw taxable income. Trust #2 sells the asset for $90 million capital gain. Trust #1 (completed gift trust) has the right to withdraw $90 million and under federal and state law must report and pay the income tax bill. Assume trustee#2 makes no distributions to CA/NY resident in that year. Because this would not come under NY/CA's anti-ING statute, nor under its throwback tax, the $90 million may escape state income tax (or at least be deferred until later distribution). Let's assume that Trust #1 does not withdraw any income (as discussed previously, this may not necessarily be a breach of duty if the beneficiaries are the same, since trustee #2 owes duties to the beneficiaries, not the trust, and they will be better off if trustee#2 does not take the money). This structure raises additional questions, such as

1) does this cause a completed gift over the $90 million that trust#1 may withdraw? Recall that all of the ING PLRs held that once distributions are made to anyone other than the settlor, this completes the otherwise incomplete gift. But if this withdrawal right is never exercised, is the gift still incomplete due to the settlor's retained strings? Maybe, maybe not. One old Second Circuit case hints that granting an unfettered power over income would complete the gift.[363] In *Richardson v. Comm.*, a wife established five trusts for children where the income could be accumulated annually but granted her husband the power to revoke it and take the funds (a power of withdrawal). The court held that: "the failure of the trustee [who was the husband] to revoke the trusts resulted in fact in gifts of the annual income to the children, subject to the gift tax".

2) If the right to withdraw $90 million gain lapses, does it cause any gift tax issues to trustee#2 or trust #2's beneficiaries? This is a tricky issue, since "trustees" don't make taxable gifts, individuals do. How does trust #1 get the money to pay the $20 million or so federal tax bill? If distributions are made, this certainly completes the incomplete gift. If loans are made, it may not.

UTMA Custodians for Minors and Up to Age 21/25-Year-Old Beneficiaries:

There are many reasons that someone may want to shift income tax burden to a minor and/or otherwise give a minor a withdrawal right (minor for purposes of this section may include up to age 21, or 25 in some states). Recall that income tax shifting to minors and even some older college students up through age 23 of unearned income is limited by the "kiddie

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[363] *Richardson v. Comm.*, 151 F.2d 102, 105-106 (2nd Cir 1945).

tax" – generally anything above $2,300 is going to be taxed at the youngster's parents' top marginal rate (if a parent is still living and the child is not married filing jointly).[364]

Must a UTMA custodian withdraw the full amount available? Do they have a duty to? These are legitimate questions. Traditionally at common law, fiduciaries could not disclaim. A failure to withdraw could be seen as similar to a disclaimer for some purposes.

Fiduciaries may now disclaim for their beneficiaries under most state laws now, but this an area where you will see a wide variation among the jurisdictions. Some states will require approval of the local probate court. Often it is a "best interests" standard.[365]

A guardian for the estate of a minor can disclaim for a minor, and a UTMA custodian can disclaim, but state law and the local probate court may set a high bar for such disclaimers.[366] It is possible, but a court would likely want to be convinced that it would be in the minor's benefit to do so.

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[364] The kiddie tax is outlined in IRC § 1(g). The amount to which this (presumably higher) tax rate applies is adjusted for inflation and is $2,300 for tax year 2022.

[365] *Estate of Henry A. Lassiter*, T.C. Memo 2000-34, concerned a decedent who was only age 48 at the time of death, leaving a widow and four children, one of whom was still a minor. The family desired for the children to disclaim their lifetime income interest in a trust Mr. Lassiter had established for his wife in order for it to qualify for the QTIP marital deduction. A *guardian ad litem* was appointed for the minor and any unborn beneficiaries. The adult children and guardian thereafter filed a qualified disclaimer with the probate court. The tax court refused to question the probate court's order or the validity of the disclaimers despite the IRS arguing that the disclaimers were not in the minor's best interest. The tax court did not find the disclaimer to be a violation of fiduciary duties by the guardian and *upheld* the planning fix.

In a somewhat similar case, *Estate of Goree v. Comm*., T.C. Memo 1994-331, the IRS also asked the tax court to ignore qualified disclaimers for minor children of the decedent. The IRS claimed the disclaimers were not valid under Alabama law even though they were approved by a local probate court. The tax court rebuffed the IRS argument in that case as well, because under the standard set forth in *Bosch,* the tax court does not undergo a *de novo* review of the facts decided by the state court, but must determine what standard/law the highest court in the state would follow. In this case, a state's highest court would give due regard to factual determinations by the trial court and only overturn those that were an abuse of discretion or "plainly and palpably erroneous". Interestingly, the probate judge was called as a witness and testified in the case.

For a case with a contrary result, see *In re Estate of Horowitz*, 531 A.2d 1364 (N.J. Super. Ct. App. Div. 1987), where the court found that a disclaimer would not be in the "best interests" of an infant beneficiary.

[366] See above cases and discussion of qualified disclaimers by UTMA custodians in the article *How Donees Can Hit the Undo Button on Taxable Gifts*, LISI Estate Planning Newsletter #2831 (October 19, 2020).

Disclaimers involve completely giving up an interest in property, however. By contrast, allowing a withdrawal right to lapse and continue in trust for the beneficiary may actually *strongly benefit* the beneficiary more than holding funds in a UTMA account until age 21/25 for a beneficiary, due to reduced administration costs and superior asset protection of the trust.

Does a UTMA custodian have a duty to withdraw the maximum amount available and place in an account that becomes completely available at age 21 (or up to age 25 in quite a few states)? At first, we might conclude or fear that this must be the case, but this would rarely be the case, since courts have even permitted UTMA custodians to disclaim, which is much more drastic, and in most cases the beneficiary will be better off having let the withdrawal right lapse. Until age 18, it may not even be necessary to have a UTMA custodian involved.

Surprisingly, the IRS does not even require a custodian or guardian to be appointed at all, much less analyze whether it was prudent to fail to take a portion of the money! The key factor for income tax purposes – is there a power to vest the income, even if it requires an extra step? In Rev. Rul. 81-6, the IRS held that a minor beneficiary with a withdrawal right (*Crummey* power) was treated as the owner for §678 purposes even if local law requires a court appointed guardian to do so and *none has ever been appointed*. Similarly holding is *Trust No. 3 v. Commissioner*,[367] which concerned several minors who had rights to withdraw/terminate a trust. Although a withdrawal power is therefore effective for §678(a) regardless of a beneficiary's legal capacity, it would be prudent to specifically allow a custodian under UTMA or court-appointed guardian to exercise the right. Do not include language in the trust that prohibits an agent/custodian/guardian from acting, as this probably would take the trust outside of IRC §678's purview and the holding of Rev. Rul. 81-6.

Language dictating a UTMA custodian's right to withdraw income may also be helpful for when a beneficiary becomes an adult (age 18 usually) yet before a UTMA account must be paid outright by (age 21, or 25 in many states), because the UTMA custodian may be a superior choice as a powerholder during that time window than the young adult themselves.

Single Member LLC (not electing C/S corporate status): This same concept can be applied to other entities as well. Most intriguing would be the possibility of using a single member LLC (SMLLC) that would be disregarded as a separate entity.[368] Could this allow someone to establish an LLC managed or controlled by someone other than the owner and pass

[367] *Trust No. 3 v. Commissioner*, 285 F.2d 102 (7th Cir. 1960).

[368] IRC §7701, Treas. Reg §§301.7701-1(a), and 301.7701-2(c)(2); Rev. Rul. 2004-77 (even if there may be multiple entities or members for state law, if there is only one taxpayer for federal tax purposes, it's disregarded). This does not mean that it is disregarded for other purposes, such as state law or estate tax, see Rev. Rul. 2004-88 and *Pierre v. Comm*., 133 T.C. No. 2 (Aug. 24, 2009).

through the income to them under IRC §678 without granting them access? If so, this might improve upon the asset protection for powers of withdrawal while still shifting the income. However, if the SMLLC is ignored for income tax purposes, it should also be ignored for IRC §678. Thus, if a SMLLC manager were different from the owner, and only the manager and not the owner had the sole power to withdraw, this would probably not trigger §678(a) because the owner of the SMLLC would not have the sole power to withdraw the income.

Example: Settlor establishes during life or at death a trust that would otherwise be a non-grantor trust for Child X. Desiring to shift the income but not the control over the income, the settlor (or trustee) also established a SMLLC managed by the trustee as sole voting member but 100% of economic interest is owned by Child X. The trust grants the SMLLC the right to withdraw all taxable income. Does this trigger IRC 678(a)? Presume that either a management agreement, operating agreement or state law permits such an arrangement – many allow a non-owner member to control the LLC.[369] In my opinion, this does not trigger IRC §678(a), because the purported taxpayer ("person" under IRC §678(a)) does not have the power to vest the income by themselves, the access is controlled by another party (in our example, the trustee, but this would be true no matter who else controlled the SMLLC). By contrast, if the SMLLC owner had the unfettered right to fire the SMLLC manager, this may trigger §678(a). What if the manager could be fired, but there is a substantial *contractual penalty* for doing so? This becomes a rather grey area, and it's anyone's guess how the IRS or a court would interpret this.

Partnership (LLC/LP taxed as partnership), S corporations and C corporations: In contrast to SMLLCs which are largely ignored for most income tax purposes, partnerships (and LLCs/LPs taxed as partnerships) are not. They are pass through entities. S corporations are similar, while C corporations are taxed as separate entities.

Can such entities establish trusts? Yes. Can they be deemed owned by the entity? Of course – grantor trusts such as Rabbi Trusts are quite common. However, analysis and discussion of the many other creative ways that BDOTs may be used to shift income to and from entities gets much messier with overlapping issues. Trusts usually don't (and often

[369] For example, Delaware LLC law, §18-301(d), permits a non-economic LLC membership interest, and division between voting and non-voting interests, which allows one member with no economic rights (no "limited liability company interest") to control the LLC even though another member has 100% of the economic benefit (all of the "limited liability company interest"). This is different from the ability which probably exists in most states to form an LLC with the manager already appointed before funding and distributing the interest. Mere managers can typically be fired (though it may be a breach of contract), but members cannot be, especially if the member controls all the voting and management rights. See also Miss. Code. Ann. Sec. 79-29-301(2)(a). A.R.S. Section 29-3401(D), Ohio R.C. Section 1706.27(C), C.R.S. Section 7-62-401(1.5).

shouldn't) have a business purpose. Is there any clear business purpose for the trust like there would be with a Rabbi trust? Remember that if there is a personal rather than business purpose to the trust, the IRS will deem a contribution to a trust from an entity to be a (potentially taxable) distribution to the owners/shareholders who would be deemed the true grantors.[370] Can a trust name an LLC/corporation/entity as a beneficiary and give it a withdrawal right, shifting income to it? Of course. Any person can be a beneficiary of a trust and the definition of "person" in the UTC and restatement, as well as in the federal tax code, includes such entities.[371] That said, I'd be very cautious of being too creative in using BDOTs with business entities that are supposed to have a business purpose.

[370] Treas. Reg. §1.671-2(e)(4): "If a gratuitous transfer is made by a partnership or corporation to a trust and is for a business purpose of the partnership or corporation, the partnership or corporation will generally be treated as the grantor of the trust. For example, if a partnership makes a gratuitous transfer to a trust in order to secure a legal obligation of the partnership to a third party unrelated to the partnership, the partnership will be treated as the grantor of the trust. However, if a partnership or a corporation makes a gratuitous transfer to a trust that is not for a business purpose of the partnership or corporation but is for the personal purposes of one or more of the partners or shareholders, the gratuitous transfer will be treated as a constructive distribution to such partners or shareholders under federal tax principles and the partners or the shareholders will be treated as the grantors of the trust. For example, if a partnership makes a gratuitous transfer to a trust that is for the benefit of a child of a partner, the gratuitous transfer will be treated as a distribution to the partner under section 731 and a subsequent gratuitous transfer by the partner to the trust."

[371] See, e.g., UTC §103(10), IRC §7701(a)(1).

II.nn **Comparing/Contrasting IRC §661(a) "Crediting" with BDOTs**

It is easy to overlook that a trustee of a non-grantor trust can always shift the income tax burden to a beneficiary (if it is justified under the distribution terms of the instrument) by granting a withdrawal right to the beneficiary and "*crediting*" that as a distribution to them. This may not even need specialized drafting in the trust to do so. And the trustee can even elect to credit distributions within 65 days after the end of the year.[372]

IRC §661(a)(2), the trust beneficiary distribution deduction section, provides that in determining non-grantor trust income that:

> "[There] shall be allowed as a deduction***(2) any other amounts properly paid **or credited** or required to be distributed for such taxable year;*" [not to exceed DNI]

Example: A Non-Grantor Trust has $70,000 of accounting income, $30,000 of capital gains, and its trustee has sufficient discretion in the trust instrument to justify a distribution of $100,000. The trustee sets aside $100,000 in an account and tells the beneficiary that they can withdraw it at any time. This "crediting" is deemed to be a distribution under IRC §661(a)(2) even if the beneficiary does not withdraw the funds, which generates a deduction for this amount, up to DNI ($70,000). If the trustee can justify pursuant to the instrument and Treas Reg § 1.643(a)-3(b) the allocation and inclusion of the capital gains to DNI, this would be $100,000. See also Reg. § 1.662(a)-3(a).

At first blush, this seems very similar and may even accomplish many of the goals of a BDOT but be easier, maybe even superior, but is it exactly the same? In simple examples, it appears to lead to the exact same result as §678. In our simple example above, the shifting of $100,000 of income to be taxed to the beneficiary. However, once you consider the expenses, deductions, limitations etc., there are notable differences between deeming someone the owner of income directly via §678(a) v. crediting income via §661(a)(2):

IRC §678 taxes all taxable income v. §661 up to DNI
§661 allows cherry-picking deductions against specific income on Form K-1
Application of IRC §67(e) allows more/better deductions under §661 than §678
Application of IRC §121 – grantor trusts can get, non-grantor trusts cannot
Application of IRC §179 – grantor trusts can get, non-grantor trusts cannot
Rev. Rul. 85-13 concepts §678 treats the beneficiary as "the owner" of trust for income tax purposes, but §661 would not.

§661 crediting may often be better, and any trustee/trust protector clause may want to permit toggling between a BDOT power and §661 power for this reason.

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[372] IRC §663(b)(1) "If within the first 65 days of any taxable year of an estate or a trust, an amount is properly paid ***or credited***, such amount shall be considered paid **or credited** on the last day of the preceding taxable year."

Let's go back to the example above and factor in a bundled trustee fee for managing the trust of $20,000, $10,000 of which would be deductible as administration rather than money management under §67(e), accounting fees for preparing the Form 1041 of $1,000, and state and local income taxes of $5,000 that would not be deductible by the beneficiary due to the current $10,000 SALT cap.[373] With a BDOT, the net income added to the beneficiary's tax return is $100,000. With §661(a) crediting, the $16,000 of deductions can be taken from the $100,000 of gross income because the non-grantor trust can deduct this, and the beneficiary's net income is only $84,000! Moreover, less income is exposed to a beneficiary's creditors or an unwise withdrawal.

When you consider the above advantages, the §661 crediting idea appears to be very enticing – flexible, easier to draft, administer, explain to accountants, and often much better deductions and more protective. What's not to like?

Unfortunately, there is not much in the way of regulations or case law to fully flesh out and clarify what is necessary to fully "credit" a beneficiary with a distribution. Can this power over a credited amount ***lapse*** just like a BDOT power of withdrawal? There is no clear authority, but case law *hints* that it cannot simply lapse. In interpreting what it means to "credit" (under an older similar statute), the Second Circuit noted years ago that: "The income must be so definitively allocated to the legatee as to be *beyond recall*; "credit" for practical purposes is the equivalent of "payment."[374] This "beyond recall" language seems to prevent any lapse over the credited amount from occurring, and those protections are extremely important and are a great advantage to BDOT/§678 powers. How can a power that lapses be *beyond recall*? This is uncertain.

What is required to allocate and "credit" the funds? One case held that cash does not need to be physically set aside, but that mere bookkeeping entries may be insufficient – the tax court cited *Stearns*. [375] Can this credited amount be reinvested in the interim? One 4th Circuit case implies "No",[376] holding that funds reinvested by the trust were not "allocated beyond recall", implying that there needs to be cash available for the beneficiary to have easy access to. A later case refers to a requirement that income be "available and distributable".[377] While these are mostly older court cases interpreting the concept of "credited", they are reported under IRC §661 interpretive cases and are fair game for the IRS to cite. The *burden of proof* of whether income is available and distributable on demand seems to be on the fiduciary because they are claiming a deduction. By contrast, IRC §678 involves no deduction.

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[373] IRC §164(b)(6).

[374] *Commissioner v. Stearns*, 65 F.2d 371, 373 (2d Cir. 1933), cert. den. 290 U.S. 670.

[375] *Estate of Johnson v. Comm.*, 88 T.C. 225, 235-237, aff'd 838 F.2d 1202 (2d Cir. 1987).

[376] *Lynchburg Trust & Savings Bank v. Comm*., 68 F2d 356 (4th Cir. 1934).

[377] *Alma Igoe*, 19 T.C. 913 (1953).

This uncertainty about §661 crediting is problematic – no one wants to keep large amounts of cash available and not have it invested, even if in short term bonds – and how long does this setting aside or making available of cash need to occur? More importantly, w*hen can the power over it, if ever, lapse?* The lapse is crucial to controlling estate inclusion, keeping GST exempt status, and protecting funds from creditors.

If the power to withdraw the amount credited to the beneficiary lapses, and the IRS/court finds that was therefore not *beyond recall* and not eligible for §661(a) "crediting" as a distribution, this may not be a complete disaster. Any funds that the beneficiary actually withdrew from this credited amount should qualify as a §661(a) distribution and carry out DNI. Any amounts not withdrawn should shift taxation of that amount under §678 if not §661, but we have no authority to confirm this and exactly how it is calculated. Counterintuitively, it may not cover the entire amount, because instead of being able to withdraw taxable income under a withdrawal right defined by a specific reference to income as a BDOT would, the beneficiary of an attempted §661 crediting would probably be deemed to be able to withdraw a *pecuniary amount,* similar to a 5x5 power.

It may help to go back to our recent example. There is $100,000 of gross income, $16,000 of non-grantor trust eligible deductions and an attempt at an $84,000 distribution deduction by way of the trustee crediting this amount under §661(a). The beneficiary allows the $84,000 to remain in the trust and the power over it lapses. Let's postulate that the IRS/court, citing the above cases, decides that the $84,000 really did not qualify as §661 crediting due to the lapse causing it not to be beyond recall. But, if the beneficiary had an unfettered right to withdraw that amount of corpus, it should still trigger §678(a). The trickier question is - over how much? Is it over a pecuniary amount, no different than a 5x5 power, or over "income"? For example, if the corpus were $2 million, and the withdrawal right is over a pecuniary amount of $84,000, this could make the trust a 4.2% beneficiary deemed owner trust under §678(a) due to the power over that percentage of corpus ($84,000/$2,000,000), shifting only $3,528 of income under §678(a) and trapping the remaining amount in trust.[378] Alternatively, there is also an argument that the power to withdraw the $84,000 is a power over that much *income* under §678(a), such that it shifts the entire $84,000 of income to the beneficiary (but caution, the $16,000 remaining gross income to the non-grantor trust portion would be unable to use most of the $16,000 of deductions, the deductions must be prorated between the grantor and non-grantor portion and the larger portion allocable to the deemed owner would be lost since they are not deductible). There is no clear guidance on these issues.

For further discussion of §661 crediting, see Steve Gorin's excellent paper *Structuring Ownership of Privately-Owned Businesses: Tax and Estate Planning Implications*, section II.J.4.f. Making Trust a Partial Grantor Trust as to a Beneficiary, available by emailing Steve directly at sgorin@thompsoncoburn.com. It's a great idea, especially if the lapse issue is ever cleared up, particularly when dealing with a trust that has already been drafted without a withdrawal right.

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[378] See, e.g., *Oppenheimer* at footnote 48, Rev. Rul. 67-241, PLR 2001-04005, Treas. Reg. §1.671-3(b)(2).

II.oo Exit Strategies for SLATs – Turning SLATs into SLANTs or BDOTs Post-Divorce

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. Available on www.ssrn.com

"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), $15,000 as of 2018-2020, adjusted annually for inflation

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

In many states that have debtor-friendly self-settled domestic asset protection trust (DAPT) statutes, there is even greater protection for such power holders than below. Those statutes often require a qualifying trustee/administration in that state. This chart assumes non-DAPT trust.

For comparison of DAPT statutes, see http://www.actec.org/assets/1/6/Shaftel-Comparison-of-the-Domestic-Asset-Protection-Trust-Statutes.pdf

(See responses to Q40 regarding DAPT specific statutory protection of beneficiary withdrawal powers and lapses in AK, CT, DE, NV, NH, SD, TN, WY)

Note that most statutes refer to "power to withdraw" or "power of withdrawal" rather than "presently exercisable power of appointment" (a.k.a. "PEG Power"). All powers of withdrawal are PEG powers. However, not all PEG powers are powers of withdrawal: e.g., a power only exercisable with consent of a non-adverse party trustee is NOT considered a power of withdrawal under the UTC, but would be a PEG power. Often, however, the two terms are equivalent. Additionally, a PEG power is *not* always the same for state law creditor or rule against perpetuity issues as it is for IRC § 2514/2041 gift and estate tax purposes. For example, a presently exercisable power to appoint with consent of an adverse party may be "general" for state law, but not federal gift/estate tax law. See cites to Restatement 2nd and 3d of Property below.

		Level of Protection			**Loopholes, Exceptions or Unique Features in Statute**
			Lapses		
State	**State Statute or Case w/ Hyperlink**	**Current Power Protected**	**5/5 + Ann Protected**	**Unlimited Lapse Protected**	**(and where applicable, excerpt from statute)**
Alabama	Ala Code §19-3B-505(c)(2)	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.

Alaska	AS §34.40.115	Yes, unless exercised	Yes	Yes	Not a UTC state: "The property that a donee of a power of appointment is authorized to appoint is *not subject* to the claims of the creditors of the donee *except* 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; *and* (2) *effectively exercises the power* of appointment in favor of the donee, the creditors of the donee, the donee's estate, or the creditors of the donee's estate."
Arizona	ARS §14-10505(B)(2)	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."
Arkansas	AR Code § 28-73-505(b)(2)	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.
California	Cal Prob Code § 15309	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 *Carmack v. Fealy* discussion in material, where a court permitted a creditor to attach overdue distributions.

				One recent appellate decision, CARNE v. WORTHINGTON, 246 Cal.App.4th 548 (2016), noted on a different issue that: "California trust law is essentially derived from the Restatement Second of Trusts. Over a number of years, the Restatement Second of Trusts has been superseded by the Restatement Third of Trusts. As a result, we may look to the Restatement Third of Trusts for guidance." citing Lonely Maiden Productions, LLC v. GoldenTree Asset Management, LP (2011) 201 Cal.App.4th 368, 379 [135 Cal.Rptr.3d 69]. The Second and Third Restatements differ considerably on these points, see appendix.
Colorado	*Univ. Nat'l Bank v. Rhoadarmer* , 827 P.2d 561 (Colo. App. 1991) cert. den. (3/3/1992)	Yes, unless exercised	Yes	Follows common law. *Univ. Nat'l Bank v. Rhoadarmer* , 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: *Beren v. Beren (In re Estate of Beren)* , 2013 COA 166 (Colo. Ct. App. Dec. 5, 2013).
	Colorado's Trust Code, SB 18-180			Although Colorado passed a version of the Uniform Trust Code on April 26, 2018 (effective Jan 1, 2019), it omitted Article 5 (including UTC Section 505) altogether, similar to its omission of a similar section in its passage of the Uniform Power of Appointment Act.
Connecticut	*Ferri v. Powell-Ferri* (SC 19432, SC 19433, Aug 8, 2017)	probably, unless exercised	Probably	The closest case to address this may be the Connecticut Supreme Court case of *Ferri v. Powell-Ferri* , which found that a trust which granted a presently exercisable general power of appointment that was later decanted to remove it should not be considered self settled because: "a beneficiary can only be deemed to be a settlor of a trust if he or she has some affirmative involvement with the creation or funding of the trust. In the present case, the trial court determined that, although Ferri may have been entitled to withdraw the funds, he was still required to request the moneys from the plaintiffs, which was never done."

	HB 7104, Public Act No 19-137 (Connecticut's version of Uniform Trust code), generally effective January 1, 2020.	Yes, up to 5/5	Yes		On July 12, 2019, CT's governor signed into law a version of the UTC along with other substantial trust legislation (HB 7104, Public Act No. 19-137): "Sec. 40. (NEW) (Effective January 1, 2020) (a) For all purposes under this section and section 39 of this act, a creditor of a beneficiary, other than a creditor of the settlor if the settlor is a beneficiary of the trust, may not attach or compel a distribution of property that is subject to: (1) A power of withdrawal held by the beneficiary if the value of the property subject to the power does not exceed the greater of the amount specified in Section 2041(b)(2) or 2514(e) of the Internal Revenue Code of 1986, or any subsequent corresponding internal revenue code of the United States, as amended from time to time, and the regulations thereunder, or Section 2503(b) of said Internal Revenue Code and the regulations thereunder, in each case as in effect on January 1, 2020;***(b) A beneficiary holding a power set forth in subsection (a) of this section shall not, during the period the power may be exercised or upon the lapse, release or waiver of the power, be treated as a settlor of the trust."
Delaware	12 Del. C. § 3536(c)(1)	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)
District of Columbia	D.C. Code § 19–1305.05	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.

Florida	Fla Stat. Ann. § 736.0505(2)(b)	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, **if the donor was married at the time of the transfer to which the power of withdrawal applies, twice the amount** specified in s. 2503(b),
Georgia	GA Code § 53-12-83	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. **The lapse, release, or waiver of a power of withdrawal shall not cause the holder to be treated as a settlor of the trust.**"
Hawaii	In 2021, Hawai'i is considering SB385, its version of the UTC that includes Section 505, but as of June 2021 it is not yet law.	Probably		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. Its **proposed** version of UTC 505 carves out an exception for trusts qualifying under its self-settled DAPT statute (Permitted Transfers in Trust Act).
Idaho	Idaho Code § 15-7-502(5)	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."
Illinois	760 ILCS 5/16.2	No	Yes	No	"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."

	Illinois Trust Code §505(b) (effective January 1, 2020)	No	Yes	No	Illinois' version of the UTC, effective January 1, 2020, does not change this provision in any substantive way. Section 505 provides that: "(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."
	Illinois Uniform Power of Appointment Act, §502/503, 760 ILCS 105/503 (effective January 1, 2019), note the significant deviation from UPOAA §503(b), but query whether the new IL trust code above overrides this section.	No		Yes	Sec. 502. Creditor claim: general power not created by powerholder. (a) Except as otherwise provided in subsection (b), 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: (1) the powerholder, to the extent the powerholder's property is insufficient, if the power is presently exercisable; and (2) the powerholder's estate if the power is exercised at the powerholder's death, to the extent the estate is insufficient, subject to the right of the deceased powerholder to direct the source from which liabilities are paid. *** Sec. 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) A power to withdraw property from a trust ceases to be treated as a presently exercisable general power of appointment upon its lapse, release, or waiver.
Indiana	Irwin Union Bank & Trust Co. v. Long, 312 N.E.2d 908 (1974)	Yes, unless exercised	Yes	Yes	Not a UTC state, follows common law. 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. 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.

Iowa	Iowa Code §633A.3105	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 GPOA, but is silent as to lapses. One law review article analyzing Iowa common law citing cases *Ober v. Seegmiller* , 160 N.W. 21, 23–24 (Iowa 1916), *Darling v. Dodge* , 206 N.W. 266 (Iowa 1925) and *Ober v. Dodge* , 231 N.W. 444, 447 (Iowa 1930) concluded thus: "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 **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.**"ASSET PROTECTION (FOR THE RICH AND NOT) IN IOWA, by David M. Repp., Drake Law Review.
Kansas	Kan. Stat. Ann. §58a-505(b)	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	Kentucky RS §386B.5-040(2)	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, *the holder is not treated as the settlor* of the trust.**" See also *St. Matthews Bank v. De Charette* , 259 Ky. 802 (Ky. 1935)
	KRS §390.330(1)	yes	yes	yes	Kentucky recently passed the UPOAA in March of 2020, effective July 15, 2020. It modified the UPOAA on this point, however, consistent with the above statute as to lapses, but more protective as to currently held powers: "(1) Appointive property subject to a general power of appointment created by a person other than the powerholder is not subject to a claim of a creditor of the powerholder or the powerholder's estate." As to current powers, the two statutes conflict.

Louisiana	LA Rev Stat § 9:2004	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."
Maine	18-B ME Rev Stat § 505(2)	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."
Maryland	MD Est & Trusts Code § 14.5-507	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.
Massachusetts	ALM GL ch. 203E, § 505	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, *State Street Bank & Trust Co. v. Reiser* 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: *Shattuck v. Burrage* , 229 Mass. 448, 118 N.E. 889 (1918); *Crawford v. Langmaid* , 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.

Michigan	Michigan MCL § 700.7506(c)(3)	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.”
Minnesota	Minn. Stat. § 501C.0505 Minn. Stat. § 502.86, §502.87	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 if 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."
Mississippi		Probably	Probably	Probably	Mississipi 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 http://www.sos.ms.gov/Policy-Research/Documents/1Tentative.pdf
Missouri	RSMo § 456.5-505.6 Mo. Rev. Stat § 456.1105	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." 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.
New Hampshire	N.H. Rev. Stat. Ann. §564-B:5-505(b)	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.

New Jersey	NJS.3B:31-39.b(2)	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."
New Mexico	NM Stat § 46A-5-505(b)	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."
New Mexico	NM Stat § 46-11-503				Also passed UPOAA §503, which parallels UTC § 505(b)
New York	NY CLS EPTL § 10-7.2	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.
	New York is considering and has introduced AB 7677, its version of the UTC, but as June 2021 it has not yet passed.				The section of the proposed AB 7677 that follows UTC 505, which would be Section 7-A-5.6(C), refers to Section 10-7.2 and would keep the same rule on this point: "(C) DURING THE PERIOD THE HOLDER OF A POWER OF WITHDRAWAL MAY EXERCISE SUCH POWER, THE PROPERTY SUBJECT TO THE POWER IS SUBJECT TO THE CLAIMS OF THE POWERHOLDER'S CREDITORS, THE CREDITORS OF THE POWERHOLDER'S ESTATE AND THE EXPENSE OF ADMINISTERING THE POWERHOLDER'S ESTATE TO THE EXTENT PROVIDED PURSUANT TO SECTION 10-7.2 OF THIS CHAPTER."

North Carolina	N.C. Gen Stat. § 36C-5-505	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 *not* be deemed to be an exercise of the power and shall not cause the holder to be treated as a settlor of the trust."
	N.C. Gen. Stat. § 31D-5-503				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."
North Dakota	N.D. Code §59-13-05	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."

Ohio	Ohio R.C. §5805.06(B)(2)	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."
	HB 7 (passed and signed by Gov. on May 20, 2021, effective 8/17/21)	No	Yes	Yes	HB 7 will delete all of paragraph (B)(2) above in order to clarify that a lapse, release or waiver does *not* create a self-settled trust, *regardless* of the amount. It will not change treatment of a current power.
Oklahoma	Okla. Stat. §60-175.85	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."
Oregon	Oregon ORS §130.315(3)	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.

Pennsylvania	20 Pa. C.S.A. §§ 7703	No	Yes	No	Pennsylvania mimics UTC §505(b) in a roundabout way be 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.”
Rhode Island	RI Gen L § 34-22-13	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."
South Carolina	SC Code § 62-7-505(b)				SC is a UTC state but like many has a more debtor-friendly variation that follows common law. It did not adopt/modify UTC §505(b) but instead modified UTC 103(14) in its definition of a "settlor" .
	SC Code § 62-7-103(14)	Yes	Yes	Yes	"(14) "Settlor" means a person, including a testator, who creates, or contributes property to, a trust. If more than one person creates or contributes property to a trust, each person is a settlor of the portion of the trust property attributable to that person's contribution except to the extent another person has the power to revoke or withdraw that portion. **Neither the possession of, nor the lapse, release, or waiver of a power of withdrawal shall cause a holder of the power to be deemed to be a settlor of the trust, and property subject to such power is not susceptible to the power holder's creditors**."
South Dakota	South Dakota CL §55-1-26	Yes, unless exercised	Yes	Yes	SD is not a UTC state and the law appears to be even more debtor friendly than common law: *“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.”

Tennessee	Tenn. Code Ann. §35-15-505(b)	Yes, but limited to 5/5+ann	Yes	Yes	UTC state, but with substantial debtor-friendly modifications to UTC 505(b): "(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." While this appears to foreclose protection beyond 5/5+ann. excl similar to the UTC, also note Tenn. Code Ann. §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." Also see TN's protective debtor-favorable law on powers of appointment at Tenn. Code Ann. § 35-15-509.
Texas	Texas Property Code § 112.035(e)	No	Yes	No	"(e) A beneficiary of the trust may not be considered a settlor merely because of a lapse, waiver, or release of: (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 Unform Powers of Appointment Act, though it substantially modified that paricular 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?
Vermont	14A V.S.A. § 505(b)	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."
Virginia	Va. Code § 64.2-747(B)	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."
	Va. Code §§ 64.2-2736, 64.2-2737				Virginia's UPOAA mirrors its UTC provision noted above.

Washington	RCW § 11.95.160	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."
West Virginia	W.V. Code § 44D-5-505(b)	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."
Wisconsin	Wisc. Stat. §701.0505(2)(b))	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."

Wyoming	WY Stat § 4-10-505.1	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	Uniform Trust Code §505(b) (while 32 jurisdictions have passed the UTC, many have modified this section, see above)	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	Uniform Trust Code §103(11) (definitions section that defines "power of withdrawal" used in §505(b) above				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." [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] Generally, the UTC does not further define "presently exercisable general power of appointment", leaving it to common law (see below) although some states' UTC versions might, e.g. Illinois Trust Code Section 103(27), but even that leaves issues to common law.

	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*** ." [contrast with below]
	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."
	Uniform Power of Appointment Act, §205(b) [follows Restat. 3d of Prop. above]				"If a powerholder may exercise a power of appointment only with the consent or joinder of an adverse party, the power is nongeneral".
<u>N/A</u>	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). IL passed it in 2018, effective January 1, 2019.	**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.

N/A	Restat 2d of Prop: Donative Transfers, § 13.2	**Yes, unless statute overrides**	**Yes**	**Yes**	"§ 13.2 *Creditors of the Donee -- Unexercised General Power Not Created by Donee* . 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* ." See also 3 Scott & Ascher §14.11.3.
N/A	Restat 3d of Trusts, § 56	**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."

Restat 3d of Trusts, § 58, Comment f	**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 *not* 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 *contributor* even if he/she is beneficiary, a conclusion that many readers likely doubt but has been followed by bankruptcy court in *In re Reuter*, 499 B.R. 655, 671 (Bankr. W.D. Mo. Sept. 12, 2013). In the context of *upstream* 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 The Optimal Basis Increase Trust, available at https://ssrn.com/abstract=2436964.

 Updates in July 2019 revised Connecticut case law and added citations to three states enacting versions of the Uniform Trust Code since the first draft of this chart in 2017: Connecticut (effective January 1, 2020), Illinois (effective January 1, 2020), Colorado (effective January 1, 2019, but omitting UTC Section 505). Also, IL recently enacted the Uniform Power of Appointment Act (effective January 1, 2019), as well as Kentucky (effective July 15, 2020, with substantial modification to UPAA 503). 2021 update includes Ohio revisions signed into law in May and effective in August 2021, and proposed UTC introductions in NY and HI. Thanks to S.C. ACTEC attorney David C. Sojourner, Jr., for apprising me of South Carolina's unique UTC version noted above.