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Are You Aware Decanting Causes Tax Issues?

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Decanting is the act of distributing the assets of an old trust to a new one with more favorable terms. It provides an easy, inexpensive method for correcting errors or ambiguities, adapting a trust to changes in a settlor's objectives or changes in a beneficiary's circumstances, taking advantage of new planning opportunities or adding flexibility to a trust.

However, because trust decanting is a relatively new estate planning strategy, its tax consequences have not yet been clearly established. The IRS is considering ways to address these tax consequences and in Notice 2011-101 asked for comments from the public. ACTEC laid out the potential income, gift and estate and GST tax issues suggested by Notice 2011-101 along with its proposed answers. The proposed answers to the key tax questions are summarized below.[1]

Income Tax Questions

1. *Does a decanting distribution from a non-grantor trust to another non-grantor trust result in gain recognition by the transferor trust under IRC § 1001?*

Decanting generally doesn't result in a realization event for the distributing trust if the decanting is authorized by either the trust's governing instrument or state law.[2] If the decanting is non-pro rata, the governing instrument or state law must authorize decanting on a non-pro rata basis.[3] Decanting could be a taxable exchange if it is not authorized by the governing instrument or applicable state law, however.[4]

2. *Does decanting from a grantor trust to a non-grantor trust result in gain recognition by the transferor trust?*

When grantor trust status terminates during the grantor's life, there is a deemed disposition of the trust assets from a grantor trust to a non-grantor trust. Gain is recognized to the extent that the liabilities of the transferred assets exceed the trust's basis in the assets.[5]

3. *Does decanting from a grantor trust to a non-grantor trust result in gain recognition by the transferor trust?*

There is no deemed transfer and no income recognition on a decanting from a non-grantor trust to a grantor trust.[6]

4. *Does decanting from a grantor trust to another grantor trust results in gain recognition by the transferor trust?*

There can be no gain recognition because transactions between a grantor and a grantor trust or between two grantor trusts are treated as non-events for federal income tax purposes. The two trusts are treated as the same taxpayer.[7]

5. *Does a decanting distribution results in gain recognition by any trust beneficiary under IRC § 1001?*

The basic rule under IRC §1001 is that a taxpayer only realizes gain or loss when the taxpayer sells or disposes of property in exchange for property that is materially different.[8] *Cottage Savings v. Commissioner*[9] concluded that property is materially different if its owners have legal entitlements that differ in kind or extent. Thus, a distribution from one trust to another might be a taxable exchange of an interest in the old trust for an interest in the new trust if the two interests are significantly different.[10] There is probably no gain recognition, however, if the decanting is authorized by the governing instrument of the distributing trust or under state law.[11]

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

Decanting could be considered either a continuation or modification of an existing trust. If the terms of the new trust are essentially the same as the terms of the old trust, the decanting should be treated as a continuation. The original trust and the new trust would be treated as the same trust for income tax purposes, there would be no distribution and no DNI would be carried out of the trust.[12] If the terms of the new trust were significantly different, the decanting should be treated as a modification. The transfer of assets should carry out DNI, resulting in income to the receiving trust under IRC §662(a). However, there would be a corresponding distribution deduction for the distributing trust under IRC § 661(a).

7. *What effect does decanting have on the original trust's tax attributes?*

The Code and Regulations specifically provide that if a trust is terminated, its unused NOL and capital loss carryovers pass on to the trust's beneficiaries (in this case, the receiving trust).[13]

There is no specific authority on whether beneficiaries succeed to a terminated trust's other tax attributes. However, if the second trust has similar terms and is treated as a continuation of the first trust, there should be carryover.[14] Even if there are significant differences, the tax attributes might carry over under general tax principles—like they do for corporate attributes under IRC § 381.

8. *Does a decanting power prevent a trust from qualifying as a QSST?*

One of the requirements for a QSST is that it have only one income beneficiary.[15] Decanting is generally allowed only pursuant to a trustee's power to invade corpus of the distributing trust and the trustee of a QSST could invade corpus only for the benefit of the single income beneficiary. Thus, a distributing trust that was a QSST could only be decanted to a receiving Trust for the exclusive benefit of the income beneficiary of the distributing trust, avoiding any violation of the QSST qualification requirements.

Gift and Estate Tax Questions

1. *Does a beneficiary whose interests in a trust are reduced by decanting make a taxable gift?*

Reg. § 25.2512-8 suggests that when a beneficiary consents to or acquiesces in a decanting that reduces the beneficiary's interest, the beneficiary has made a taxable gift. This conclusion is consistent with Revenue Ruling 81-264, which holds that a taxable gift can occur when a taxpayer allows legal rights to expire.

On the other hand, regulations under IRC § 2511require a voluntary act of transfer to have a taxable gift. [16] Thus, a taxable gift should occur only if the beneficiary has a legal right to object to the exercise of authority to decant. Under the law of most states, beneficiaries would have no such right, so generally there should be no gift, but the IRS refuses to rule on the issue.[17]

2. *Does decanting result in gift tax for a trustee/ beneficiary?*

If the trustee has absolute discretion to distribute to herself, she would be treated as having a general power of appointment under IRC §§ 2514 and 2041. If decanting reduces a trustee/beneficiary's presently exercisable general power of appointment it could cause the beneficiary to incur gift tax.[18] If the beneficiary's general power of appointment is not presently exercisable, however, it should not cause a taxable gift under IRC §2514. A trustee/beneficiary might also make a taxable gift even if he only has the power to make distributions to others (Reg. § 25.2511-1(g)(2))

There should be no taxable gift, however, if distributions by the trustee/beneficiary are subject to an ascertainable standard, but there are PLRs that arguably suggest otherwise. [19]

3. *Does a beneficiary whose interests in a trust are reduced by decanting make an IRC § 2036 or § 2038 transfer?*

Decanting could result in estate inclusion if a beneficiary was deemed to make a gift but the gift was incomplete (e.g., because the beneficiary retained a limited power of appointment). If the power was not exercised during life, the gift would be completed at death and the property included in the gross estate under IRC § 2036(a)(2) or 2038. Again, however, the beneficiary would likely need to have the ability to object to the decanting.

GST Issues

1. *Does a GST grandfathered trust that receives*

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decanted property lose its grandfathered trust status?

A trust can be GST exempt either because it is a pre-September 25, 1985 grandfathered trust or because it allocates sufficient GST exemption to the trust. Regulations provide that a grandfathered GST exempt trust retains its exempt status following a decanting if it qualifies under either a discretionary distribution safe harbor[20] or a trust modification safe harbor.[21]

No guidance has been issued on when decanting from a trust exempt from the GST because of exemption allocation loses its exempt status. The IRS has suggested in rulings, however, that the same two safe harbor tests should apply.[22]

2. *Does decanted property have the same GST inclusion ratio in the transferee trust that it had in the transferor trust?*

There is no law directly on point. It appears that the receiving trust should have the same inclusion ratio as the transferor trust under IRC §2654(b) provided that the receiving trust doesn't extend the time for vesting or shift beneficial interests to a lower generation.[23]

3. *Does decanted trust property continue to have the same transferor for GSTT purposes following decanting to a new trust?*

For GSTT purposes, IRC § 2652(a) defines the transferor as (a) in the case of a transfer subject to estate tax, the decedent and (b) in the case of a transfer subject to gift tax, the donor. Reg. § 26.2652-1(a) similarly provides that the individual with respect to whom property was most recently subject to gift or estate tax is the transferor for GST tax purposes. Thus, if a decanting is subject to gift or estate tax, the transferor can change for GSTT purposes.

Loss of grandfathered status does not change the transferor for GSTT purposes, however.[24] The same rule should apply for loss of exempt status by a trust that is exempt by reason of allocating GST exemption amount.

Conclusion

Decanting is one of the most important developments in estate planning in a long time. However, if a sizable GST trust is involved or if substantial changes will be made, like changing beneficiaries' interests or lengthening the term of a trust, planners may wish to wait until the tax consequences become clear or, at least, prepare their clients for the worst case scenarios so they can make an informed decision whether to proceed.

CITATIONS:

[1] Comments of The American College of Trust and Estate Counsel on Transfers by a Trustee from an Irrevocable Trust to Another Irrevocable Trust (Sometimes called "Decanting")(Notice 2011-101) Released December 21, 2011.
[2] Reg. § 1.1001-1(h); PLR 200743022).
[3] PLR 200810019.
[4] Rev. Rul. 69-486. There are exceptions to the general rule. For example, gain is recognized on a transfer of negative basis assets (e.g., LLC or partnership interests with a negative capital account or property with debt in excess of basis). Also, adding a power of appointment to the new trust might result in an exchange for materially different assets, triggering gain recognition under *Crane v. United States,* 331 U.S. 1 (1947).
[5] *Madorin v. Commissioner*, 84 T.C. 667 (1985); rev. Rul. 77-402; Reg. § 1.1001-2(c), Example 5; *Crane v. United States*, 331 U.S. 1 (1947).
[6] CCA 20092303.
[7] Rev. Rul. 85-13; PLR 200228019.
[8] Reg. § 1.1001-1(a); *Cottage Savings v. Commissioner*, 499 U.S. 504 (1991).
[9] 499 U.S. 504 (1991).
[10] For example, in PLR 200231011, the IRS took the position that a switch from annuity payments to unitrust payments triggered gain recognition where the change was not specifically authorized under state law. If the interests are not materially different, however, no gain is recognized (See PLRs 201207001, 201136014, and 199951028).
[11] Reg. § 1.1001-1(h). The rationale is that the new property isn't materially different because the beneficiaries always had a right to it under either the governing instrument or under state law.
[12] See PLRs 200527007, 200607015 and 200723014.
[13] IRC § 642(h); Reg. § 1.642(h)(3)(D).
[14] PLR 200607015.
[15] IRC § 1361(d)(3).
[16] Reg. §§ 25.2511-1(a) and 25.2511-2(a).
[17] Rev. Proc. 2013-3, 2013-1 I.R.B. 113, §5.01(23).
[18] IRC § IRC §2514(b), (e); Regs. §§25.2514-3(a), (c)(4).

[19] See, e.g., PLRs 8905035, 8535020, 201122007, 9451049, 200243026.
[20] Reg. § 26.2601-1(b)(4)(i)(A). A trust qualifies for the discretionary distribution safe harbor if (1) When the trust became irrevocable, either the terms of the trust instrument or local law (i.e., common law or state statute) authorizes the trustee to make distributions to a new trust, (2) Neither beneficiary consent nor court approval is required for the decanting; and (3) the new trust will not

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suspend or delay the vesting of an interest in trust beyond the federal perpetuities period.

[21] Reg. § 26-2601-1(b)(4)(i)(D)). A trust qualifies for the trust modification safe harbor if (1) The modification doesn't shift a beneficial interest in the trust to a beneficiary occupying a lower generation than the person holding the interest under the original trust; and (2) doesn't extend the time for vesting of any beneficial interest in the trust beyond the period provided in the original trust.

[22] PLRs 201134017 and 200839025.

[23] PLRs 201134017 and 200839025.

[24] PLR 9522032.

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