

**Steve Leimberg's Estate Planning
Email Newsletter Archive Message #2577**

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Subject: Ed Morrow - IRC §678(a)(1) and the “Beneficiary Deemed Owner Trust” (BDOT)

“Many trust settlors would prefer their beneficiaries be able to avoid the complexities and potential inequities involved in the fiduciary income tax system. 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. Settlor’s can achieve such status without such a drastic provision by including a power to withdraw both traditional accounting income and taxable income attributable to principal, without the more drastic power to withdraw the entire corpus itself.

This newsletter 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.

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

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 income tax drag.

Income tax benefits include simpler tax reporting, lower tax brackets, capital gains tax exclusions for residences, more favorable Section 179 expensing, 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 at first glance, is hardly a disaster and can not only be counteracted but even turned into an advantage over other trust designs.

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 immediately or at predetermined ages.”

Ed Morrow provides members with commentary that focuses on the planning implications of beneficiary-deemed owner trusts. Members will find Ed’s commentary particularly helpful as it contains a supplement with additional details and nuances omitted from his main newsletter as well as a [50-state asset protection chart](#) regarding §678 withdrawal powers and the protections for trust corpus after a lapse.

Edwin P. Morrow III, J.D., LL.M. (Tax), CFP®, CM&AA® is a board-certified specialist in estate planning and trust law through the Ohio State Bar Association, a Fellow of the American College of Trust and Estate Counsel (ACTEC) and a Director in Key Private Bank’s **Family Wealth Advisory Group**. Ed is a co-author with Steve Leimberg, Paul Hood, Jay Katz and Marty Shenkman of [Tools and Techniques of Estate Planning, 18th Edition](#).

Here is Ed’s commentary:

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.¹ 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 newsletter 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.²

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

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 will note the various state asset protection statutes and law around powers of withdrawal and lapses.

A BDOT is an important stop in the continuum of trusts that seek to land on the side of trusting beneficiaries rather than severely restricting them, while still offering the asset protection and estate tax benefits of trusts. With the dwindling and perhaps even disappearing importance of the estate tax, the income tax design aspect of the estate plan becomes more important. The ability for trusts to change to a BDOT structure may offer significant income tax advantages over traditional trust design. The BDOT, especially 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), offers a compelling alternative for families, especially those that may otherwise consider outright dispositions at predetermined ages.

COMMENT:

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

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

“a) General rule

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

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

For simplicity, this newsletter will primarily address how §678 works if no other grantor trust provision applies. For instance, when a grantor of a trust dies, the grantor’s estate does not step into the shoes of the grantor.³ Thus, the only grantor trust provision that could apply to an intervivos or testamentary trust at the grantor’s death (unless there were an additional grantor other than the decedent) would be IRC §678. This would be equally true if all grantor trust powers/rights and dealings (such as borrowing) were released and/or otherwise eliminated during the settlor’s lifetime, but for purposes of this newsletter we will assume that no other grantor trust provisions apply, such as after a settlor’s death.

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

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

In the post-mortem context, the most commonly found variant triggering §678 is a marital trust that grants the surviving spouse an unrestricted right of withdrawal over the entire trust.⁴ 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.⁵ Unfortunately, such a trust usually offers the same asset protection benefits as a revocable trust – close to ***none!***⁶ This is why QTIPs are the more commonly used version of marital trust, especially for blended families.

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

For estate tax purposes, if a beneficiary powerholder holds or uses a presently exercisable power to appoint to a trust for themselves, the entire proceeds will generally be included in their estate.⁷ Releasing such a power without retaining any power that would make the gift incomplete would cause a taxable gift.⁸ 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.⁹

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

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

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

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

A trust that pays all net income, even if that includes all capital gains, to a beneficiary does NOT trigger grantor trust status – such trusts must report under the Form 1041/K-1 Subchapter J tax regime. However, if the beneficiary is also the sole trustee and is entitled to all net income it may be a partially beneficiary deemed owner trust as to the net accounting income.¹⁰

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 withdrawal, this raises the possibility that §678 is triggered, but the conclusion on this point is far from reliable for proactive planning purposes.¹¹

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

Yet.

But there is no reason to ignore “or the income” in the statute and no requirement under §678(a)(1) that a beneficiary/powerholder have any power over corpus beyond the income attributed to corpus to shift all the income taxation to the beneficiary. In fact, the taxpayer in the seminal case upon which the statute was based had no right to withdraw underlying principal.¹²

How is “Income” Defined for §678 Purposes?

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

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

“(b) Since the principle underlying subpart E (section 671 and following), part I, subchapter J, chapter 1 of the Code, is in general that income of a trust over which the grantor or another person has retained substantial dominion or control should be taxed to the grantor or other person rather than to the trust which receives the income or to the beneficiary to whom the income may be distributed, **it is ordinarily immaterial whether the income involved constitutes income or corpus for trust accounting purposes.** Accordingly, when it is stated in the regulations under subpart E that “income” is attributed to the grantor *or another person*, the reference, unless specifically limited, is to *income* determined

for tax purposes and not to income for trust accounting purposes.¹³ [emphasis added][note: §678 is in Subpart E. The §678 regulations mimic the code section and refer to code section 671 and regulations thereunder, both of which refer to *taxable income*.]¹⁴

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.¹⁵

This is the source of significant confusion among practitioners.¹⁶

Let’s start by explaining a trust that provides that the primary beneficiary has the unfettered right to withdraw “all net income”. Unless defined otherwise in the trust, this means the beneficiary is taxed only on fiduciary accounting income (e.g., dividends, interest, rents), but not necessarily all *taxable* income. This is a function of trust accounting and state principal and income law, not §678, and leaves a large gap of unshifted taxable income potentially taxable to the trust. For instance, a traditional IRA distribution might be 100% *taxable* income, but only 10% or less *accounting* income, and extraordinary dividends and capital gains would not usually be accounting income either.¹⁷

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.¹⁸

But a trust could easily define the withdrawal right to include all *taxable* income regardless of whether it is accounting income or income allocated to principal, such as capital gains. We must look to the definition of income in the withdrawal right under the 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.¹⁹ 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.²⁰

Failing to take the withdrawable income is not relevant to the §678 analysis, nor is renouncing the right to prior income (usually).²¹ Such a power has even been ruled effective when held by a minor where there was no court-appointed guardian with authority to exercise it.²²

If the powerholder *actually* withdraws the taxable income withdrawable, it is generally a **non-event** tax-wise that, as noted in Rev. Rul. 67-241, is not a distribution reported under Subchapter J, Parts A-D. 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.²³ For trusts that are partial grantor, partial non-grantor trusts (e.g. five and five power trusts), the analysis might be more complicated.²⁴

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.²⁵ The son's wife was to get \$10,000/yr, and the son could withdraw any income above that. The trustee reported all the income, including the undistributed income that the son could have withdrawn but did not, and deducted the \$10,000 distribution to the wife. The court held that reporting of income/deduction for the \$10,000 was proper, but that the undistributed income that the son could have withdrawn, but did not, must be reported *on his tax return* as income:

[The] "power of the petitioner to receive this trust income each year, upon request, can be regarded as the equivalent of ownership of the income for purposes of taxation.*** income is taxable to the possessor of such power, and that logically it makes no difference whether the possessor is a grantor who retained the power or a beneficiary who acquired it from another.*** Since the trust income in suit was available to petitioner upon request in each of the years involved, he had in each of those years the "realizable" economic gain necessary to make the income taxable to him."²⁶

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

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

The net income from said trust shall be distributed by the Trustee to the beneficiaries [petitioner and Kathleen], jointly or the survivor of them, not less than once each year * * *. Provided, however, the Trustee shall distribute only that part of the net income which is derived *from Capital gains as is requested each year by the beneficiaries* and if no such request be made then all of such capital gains shall be retained as a part of the Trust fund and be reinvested as principal.²⁷

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.²⁸

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

Though it is not a citable precedent as the above authority is, a recent IRS private letter ruling is completely in accord:²⁹ 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.³⁰ 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 §678.³¹ 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.”³² Note that, just as we are exploring in this newsletter, *the beneficiary deemed owner (trust #1) in this PLR did NOT have the power to withdraw corpus or principal of the trust beyond the taxable income.* The IRS ruled that the net capital gains, as well as the net income that would be part of DNI, would be *taxed to the power holder (trust #1), despite the power holder having no power whatsoever over corpus beyond the net capital gains.*

Regulations are clear that someone can be deemed owner of income allocable to corpus as well as ordinary income: “If a grantor or another person is treated as the owner of a portion of a trust, that portion may or may not include both ordinary income and other income allocable to corpus.”³³ Thus, a beneficiary can be deemed the owner for income tax purposes of the accounting income, as in the *Goldsby* case, owner of the capital gains income attributed to principal/corpus, as in *Campbell*, or owner of both, as in PLR 2016-33021 (and likely *Mallinckrodt*).³⁴ None of these variations need require a power to withdraw the entire corpus. To quote the Supreme Court, “the power to dispose of income is the equivalent of ownership of it.”³⁵

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

To understand the practical basics, let’s examine a basic trust with \$2 million, generating \$40,000 of unrealized capital gains, \$40,000 of capital gains and \$40,000 of interest and dividends. With a fully §678(a) trust in which the beneficiary can withdraw all taxable income, including capital gains or other taxable income that might be allocated to principal under trust accounting and the state’s Uniform Principal and Income Act, the beneficiary would simply report all \$80,000 of taxable income, and any expenses and credits allocable thereto, on her Form 1040 regardless of what she actually receives, and *the trust itself can have no income.*³⁶

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

Conclusion

A beneficiary deemed owner trust (BDOT) can be a useful tool, particularly in lieu of situations where someone might prefer outright distributions or a liberal “beneficiary-controlled trust” otherwise. It obviously has no place for severe cases where someone cannot trust a beneficiary at all or needs to severely restrict a beneficiary’s access, such as for minors or those receiving certain disability benefits, or wants to dynastically grow principal for the next generation and does not trust the first generation of beneficiaries to curb their withdrawals. However, 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.

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 \$12,500.³⁷ Taxation of certain income or the permissibility of certain deductions, such as the sale of a personal residence, 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 newsletter, along with additional discussion of the asset protection nuances of withdrawal powers and a [50-state chart of the applicable creditor protection law 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 insurmountable issue when examining state law and the effect of potential cessor clauses on the trust’s protective feature – 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 quite a benefit. Most states have either complete protection, or at least “five and five”/annual exclusion level protection for lapses, and both state law and bankruptcy law honor cessor or trust protector clauses that can remove such powers if needed. 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, and/or the beneficiary can use their power to either spend the excess income or invest or appoint it into a myriad of other asset protection vehicles (life insurance, 529 plan, qualified plan, IRA, SLAT, DAPT, etc.).

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

In conclusion, a BDOT is an important step in the continuum of trusts that seek to land on the side of trusting beneficiaries rather than severely restricting them, while still offering the asset protection and estate tax benefits of trusts. With the dwindling and perhaps even disappearing importance of the estate tax, the income tax design aspect of the estate plan becomes more important. The BDOT offers significant income tax advantages over traditional trust design, especially 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).

HOPE THIS HELPS YOU HELP OTHERS MAKE A *POSITIVE* DIFFERENCE!

Ed Morrow

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CITATIONS:

Citations are at the end of the addendum/supplement to this newsletter below, which contains additional details and nuances omitted from the main newsletter that may interest those intrigued by the possibilities and wanting more detail. In addition, there is a 50 state asset protection chart regarding §678 withdrawal powers and trust corpus after a lapse thereof.

Additional related topics covered in the following addendum include:

- a) Creating Beneficiary Deemed Owner Trust Status for Specific Assets and Income Therefrom – Possible but Usually not Ideal
- b) Advantage – Section 179 Expensing
- c) Advantage – Net Investment Income 3.8% Surtax
- d) Advantage – S Corporation Ownership
- e) Advantage - Miscellaneous but Juicy Deductions Eliminated by ESBTs but not Curbed by BDOTs (or QSSTs)
- f) Advantage – Tax Burn and Asset Protection TurboBoost Through Grantor’s Payment of Trust’s Tax Burden from Outside of Trust Assets Without Requiring Distributions
- g) Advantage – Protecting Unneeded Distributions of Income and Modifying the Withdrawal Right to Keep More Funds in Trust Protected After Lapse
- h) Advantage – Achieving Nearly Identical or Better Protection as a Traditional Mandatory Income, HEMS, or Even Discretionary Trusts
- i) Advantage – Passing Through Capital Losses
- j) Related Advantage – Changing Status from Non-Grantor to Grantor to Unlock Capital Losses
- k) Advantage – Avoidance of Kenan Gain Disasters
- l) Advantage – Selectively Causing Estate Inclusion
- m) Advantage – Seizing the \$250,000 (\$500,000) capital gains tax exclusion for residence under §121
- n) Advantage – No Need to Trace Charitable Donations to Gross Income, Charitable Deduction Carry Forward-ability, no Reduction or Elimination of Contributions Traceable to Business Income
- o) Advantage – Higher Alternative Minimum Tax (AMT) exemptions
- p) Advantage – Life Insurance Transferability (Transfer for Value Rule)
- q) Advantage – Trust Owned Non-Qualified Deferred Annuity Taxation
- r) Advantage – Avoiding Double (or More) State Fiduciary Income Taxation
- s) Advantage - Application to QTIP trusts

- t) Advantage – Tax-Free Transactions Between Beneficiaries and their BDOTs
- u) Advantage - Transactions between beneficiaries' spouses and fully §678(a) trusts as to beneficiaries
- v) Advantage – Ability to Easily Toggle Between Tax Systems
- w) Advantage – Better Step up in Basis for Marital Trusts and OBITs Upon Death of Primary Beneficiary?
- x) Understanding Partially Released (Lapsed?) or Modified Powers over Income Under §678(a)(1)(2) – Rights over Taxable Income
- y) Effect of a Cessor (Forfeiture) Clause on §678(a)(2) Taxation and S Corporation Status
- z) Application of Designated Beneficiary Qualified Plan/IRA See Through Trust Rules to BDOTs
 - aa) Advantage - BDOTs Cascading Into Increasing BDITs Funded with Far More than \$5,000
 - bb) Advantage – Intervivos BDOTs
 - cc) Advantage - Beneficiary Deemed Owner Trust Reporting

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

If our hypothetical beneficiary above only had an unfettered right to withdraw *accounting* (ordinary) income (interest, dividends, rents), then \$40,000 would go onto her Form 1040, the \$60,000 of capital gains would be taxed to the trust and/or beneficiary under non-grantor trust rules and deductible expenses would have to be allocated or apportioned accordingly.³⁸ Similarly, if the beneficiary had a cap on the withdrawal right, e.g., only up to 4% (\$80,000) – then she would only be taxable to the cap, and expenses would be prorated accordingly (regardless of whether she actually takes the \$80,000). There is no reason that a §678(a)(1) power has to be all or nothing, or even the same every year if an independent trustee or trust protector were to change it. It can be more targeted than the traditional distribution structure under Subchapter J, which does not allow tracing of types of income.

For example, let's say a trust grants the beneficiary the unfettered withdrawal right to all income attributable to all assets *except* the municipal bond portfolio, the stock portfolio and the Roth IRA. This leaves income from those assets (top rates 0%, 23.8% for LTCG/QD, 0% respectively) in trust, and only shifts taxation of any ordinary income rent, traditional IRA distribution, annuity or taxable interest to the beneficiary.³⁹ This exploits a

larger delta of the likely tax rate differential between a trust and beneficiary, i.e. a 43.4% or 39.6% trust tax rate down to a likely 15% or 25% taxed to the beneficiary rather than 23.8% to 15%.

This withdrawal power could also be capped – e.g., all income attributable to assets other than the muni bond portfolio above the trust’s top tax rate bracket, or even 28% rate bracket (\$12,500 or \$6,000 respectively), or even reference an external criteria, such as income to a point until his/her taxable income exceeds the beneficiary’s top income tax bracket.⁴⁰

These variations complicate administration, however, and the desire to squeeze every last cent of tax savings leads to diminishing returns that may not be warranted because of greater complexity. Remember that a partial grantor, partial non-grantor trust forces an apportioning of any attributable expenses, such as investment management/trustee, attorney fees, though directly attributable expenses (e.g. real estate taxes on a property) may be traced and be specifically allocated to the §678(a) beneficiary’s income or the non-grantor trust portion, depending on which portion is getting the income so attributed.⁴¹ 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.

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.⁴² Below is a discussion of a few key aspects of the advantages of grantor v. non-grantor trust status.

Advantage – Section 179 Expensing

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.⁴³

For example, an LLC, 50% owned by a trust, invests in \$500,000 worth of machinery and equipment used in the United States in 2017 and the LLC's net income but for this expense would be \$600,000 (the Form 1065 partnership tax return must report the §179 and depreciation expense as a separately stated item on line 12 of K-1, but many tax preparers may be caught unaware of this, since this is not the case for K-1 reporting for individual owners).⁴⁴

An individual owner (whether via beneficiary deemed owner trust or not) would have a mere \$50,000 of net taxable income from the LLC (\$300,000-\$250,000 §179 expense deduction), whereas the non-grantor trust would have this juicy deduction disallowed and may have \$300,000 of income (minus whatever depreciation may be allowed to the partner outside of §179 over the useful life of the asset, e.g. ten year property may be 1/10 of \$500,000, times 50% ownership, or \$25,000).⁴⁵ This is a huge tax difference between the two varieties of trusts! At a 43.4% federal rate, not even counting state income tax, \$275,000 (non-grantor trust income) - \$50,000 (grantor trust income) = \$225,000 times 43.4% = \$96,650.

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, trustees who try to avoid this fate by making higher distributions may be “out of the frying pan into the fire” – in many instances the higher distributions would not be justified under the document but if the trustee could justify making adequate distributions to the beneficiary to avoid trapping the \$275,000 in trust, it would eliminate that much corpus from the various asset protection benefits intended by the trust, and probably put the beneficiary into the highest tax bracket.

By contrast, using a beneficiary deemed owner trust structure avoids all of these fates by permitting the §179 deduction and paradoxically *reducing* the amount of the income subject to access via distribution or withdrawal because it is based on net taxable rather than gross income.

Advantage – Net Investment Income 3.8% Surtax

The 3.8% net investment income tax applies to income of trusts and estates beyond the compressed tax rate bracket of \$12,500, rather than \$200,000 or \$250,000 MAGI for single and married filing jointly taxpayers respectively.⁴⁶

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 nonacquiescence from the IRS and an extraordinarily strict TAM, with the potential for future treasury regulations to change the result.⁴⁷ In short, it's expensive to be right and more expensive to be wrong, and no way to be certain either way.

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 income, where activity of the beneficiary will determine applicability of the surtax. However, as noted in the section below, QSSTs are not taxed the same for any sales of the S corporation stock. Thus, while final regulations did not confirm this, the net investment income surtax treatment for a QSST selling S corporation stock probably has the same requirements, uncertainty, pitfalls and issues noted above.⁴⁸

By contrast, Section §678(a)(1) withdrawal provisions shift the Medicare net investment income “surtaxation” to the deemed owner, 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.⁴⁹

Advantage – S Corporation Ownership

Grantor trusts are also eligible S corporation stockholders, *regardless* of whether there is a QSST or ESBT election, but it cannot be partially grantor as to accounting income or only a portion of the income, it can only have one deemed owner, and the grantor or beneficiary deemed the owner must be a U.S. citizen or resident.⁵⁰ “[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.”⁵¹

For many purposes, a QSST is the same as a §678 beneficiary deemed owner trust for income tax purposes, in fact, the QSST regulations reference §678. However, when the larger tax event of a sale of stock or the company itself occurs, the QSST loses its advantage to pass through income to the beneficiary's tax return similar to a §678(a) trust. Whenever S corporation stock is sold, it reverts back to ordinary non-grantor trust treatment as to the sale, potentially trapping most or even all of the taxable income in the trust. Surprisingly, this is also true when the assets of the company are sold and the company liquidated, or when at least 80% of the company is sold in a §338(h)(10) transaction (i.e. in an "asset deal" as well as a "stock deal").⁵²

While a lifetime power of appointment generally precludes QSST elections, the regulations are clear that a presently exercisable general power of appointment over income (or corpus) still permits the trust to continue as an eligible S corporation owner.⁵³ What if an S corporation is a bit nervous about trust eligibility and wants a "belt and suspenders" approach? A trustee may make an ESBT election to protect the trust if for some reason the IRS does not consider it a fully grantor trust, and if it is, the effect of the election is simply disregarded.⁵⁴ By contrast, the regulations are unclear at best as to whether a fully or partially grantor trust can make a QSST election to protect S status.⁵⁵ If a beneficiary-deemed-owner transfers S corporation stock to a grantor trust with suspended passive losses due to insufficient basis in the S corporation stock, these should still be retained, whereas typically transfers cause the loss to simply expire.⁵⁶ QSST to ESBT (and vice versa) transitions are permitted, but have strict prohibitions against frequent toggling back and forth within 36 months, whereas there is no apparent prohibition regarding grantor trust toggling.⁵⁷

Beneficiary deemed owner trusts have an additional benefit when the primary beneficiary dies because just as with other grantor trusts after an owner's death, a BDOT would have an additional two years after the beneficiary's death to qualify as an S corporation owner without the need for a QSST or ESBT election.⁵⁸

Other Miscellaneous but Juicy Deductions Eliminated by ESBTs but not Curbed by BDOTs (or QSSTs)

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 may be entitled to very significant deductions. ESBTs eliminate some of these,

even more so than other non-grantor trusts. QSSTs allow deductions to pass through similar to a BDOT, but QSSTs are severely hampered by the fact that they have to 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 ESBTs are only allowed a deduction for a narrow category of items.⁵⁹ Notably, there is no income distribution deduction that would otherwise allow tax shifting to the beneficiaries. There are other important deductions, though. 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.⁶⁰ These kinds of deductions can be quite valuable.

Advantage – Tax Burn and Asset Protection TurboBoost Through Grantor'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 in most states but in many states even beyond that, the amount remains sheltered from creditors, increasing the amount 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. It may have a similar effect for state/federal estate tax purposes. Over time, this effect can be extremely valuable.

If there is a current or "hanging power", any minimal power currently accessible or left hanging would likely be subject to creditors and subject to estate tax. However, this is unlikely to ever amount to much, as discussed below.

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

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

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

Beneficiaries may not need to spend all the net income immediately, and may prefer keeping funds in the protective wrapper of the trust. Remember, beneficiaries do not have to take the income to be taxed on it. What if they don't take it and the power lapses? In addition to federal estate tax and asset protection reasons, residents in some states may wish to maximize a trust's corpus to leverage and exploit a state's estate tax exclusion amount.⁶¹ Let's explore how we keep any withdrawable but untaken funds protected from being considered a contribution by the beneficiary for estate/gift and state law asset protection purposes.

The lapse protection under federal estate and gift tax law is fairly well known colloquially as part of a "five and five" power. To the extent a right of withdrawal (presently exercisable general power of appointment) is allowed to lapse, it will not be considered as a taxable transfer to the extent of the greater of \$5,000 or 5%.⁶² So, if someone had a right to withdraw 6% of a trust, and let this power lapse, 5% would not be considered to be a gift, but 1% would be (though, depending on the trust, it may be an incomplete gift or a gift in part to oneself). This may not sound important to many taxpayers who would likely spend the income and even if they didn't, do not have \$11 million estates to worry about gift tax anyway. However, this concept is incorporated into many states' creditor protection laws, so it is still an important concept.

If the power to withdraw is not based on the entire corpus, but on the accounting income alone, the 5% would be calculated based on the accounting income available to withdraw, *not* the entire principal.⁶³

Although the above rule should not apply to a BDOT wherein a beneficiary has the power to withdraw all the taxable income, attorneys might amend the withdrawal power to cover the greater of the net taxable income or 5% of corpus and clarify that the withdrawal power can be satisfied out of the entire corpus of the trust. This should still shift all of the taxable income to the power holder beneficiary under §678(a)(1), but provides access in years of low income/yield and greater assurance that the lapse protection applies to the full 5% of corpus. If the taxable income is less than 5% of the corpus in a given year (which is *very common* in today's investing environment), *the entire amount would remain protected, even if the beneficiary doesn't withdraw a dime.*

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

What if taxable income were 7% and the beneficiary did not take at least 2% (and the lapse is over \$5,000), meaning you have a lapse beyond the "five and five" rule? The estate/gift tax lapse protection often overlaps with state creditor protection law, but we should not assume it mimics federal tax law without verification. Under longstanding common law, the entire amount would be protected, but efforts to modify this through new Restatements and by the Uniform Trust Code and Uniform Power of Appointment Act lead to much variation and in many states, the protected amount would be the greater of the "five and five" amount noted above, or the annual exclusion amount (\$14,000 in 2017), but a surprisingly high number provide unlimited protection unhampered by any 5% rule.⁶⁴

However, if a beneficiary lives in a state with reduced asset protection from the norm or if the applicable state law changes, a beneficiary might simply withdraw any amounts above the 5/5 and/or state creditor lapse protection (which is often higher, often two times the annual exclusion, or could conceivably be zero) and if asset protection is desired, contribute unspent amounts to an IRA/Qualified Plan, cash value life insurance, LLC, homestead, self-settled asset protection trust or other protective structures

afforded by federal or state law, which may include outright gifts or gifts to third party settled irrevocable gifting trusts, probably taxed as grantor trusts. For example, if the beneficiary deemed owner simply sent the taxable income they were entitled to withdraw in a given year to a SLAT (spousal lifetime access trust, basically an *intervivos* bypass trust for spouse and descendants), the beneficiary would still be considered the grantor (thus taxed as a grantor trust under §677/§672 rather than §678), without even having to retain a withdrawal right!⁶⁵

Advantage – Achieving Nearly Identical or Better Protection as a Traditional Mandatory Income, HEMS, or Even Discretionary Trusts

Unlike a *Crummey* clause which has to have a window in time to create a present interest to qualify for the annual exclusion under IRC §2503, forfeiture provisions (a.k.a. “cessor provisions”, usually embedded in a more robust spendthrift clause) can automatically cut off such a withdrawal right in the event of creditor attack (with appropriate limited carve out for marital/conduit trusts), or a trust protector provision might do so as well.⁶⁶ To keep within the §678(a) “sole” power requirement, and improve asset protection, withdrawal rights can be limited to a window in time (e.g. December 15-31, or as one PLR did, simply the last day of the year), similar to how 5/5 power limitations are often drafted, and 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 the “sole power”.

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.*⁶⁷ The Uniform Trust Code will protect mandatory income distributions from garnishment, but only insofar as the trustee makes the distributions within a reasonable time after the designated distribution date.⁶⁸

Advantage – Passing Through Capital Losses

As discussed in prior LISI newsletters,⁶⁹ 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.⁷⁰ By contrast, a fully grantor trust, even a beneficiary-deemed owner trust, wherein the beneficiary is responsible for the gains and losses on a particular asset, may pass through any capital losses directly to the beneficiary.⁷¹ A trust that converts to a beneficiary deemed owner trust may also unlock trapped capital losses.⁷²

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

The prospect of a loss passing through when there is only a §678(a)(1) power over taxable income is a strange one, and merits further exploration – neither the *Mallinckodt*, *Townsend* or *Campbell* cases cited above (nor any other) have dealt with the effect of a withdrawal right pursuant to §678 when the income is *negative*. How do you have the right to withdraw 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) 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.⁷³ Must or may *the beneficiary* report the loss?

There is a regulation seemingly on point. Treas. Reg. §1.671-3(a), quoted below, indicates that the loss must be taken and reported by the beneficiary, but it may not be clear enough to convince everyone. It may depend on whether the beneficiary power holder bears 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).

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 to have the beneficiary take the loss as seemingly provided in Treas. Reg. §1.671-3(a). However, if the beneficiary bears no financial detriment, no decrease in later ability to access income, then it is more logical and appropriate to have the trust as a separate taxpayer “benefit” from the taxable loss and deny the benefit to the beneficiary. In the world of Subchapter J, Parts A-D (ordinary non-grantor trust taxation), even if the trust comes under one of the exceptions to allow capital gains to pass out to beneficiaries, capital 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.⁷⁴ However, rules in Subparts A-D are not necessarily useful guidance as to grantor trusts under Subpart E, since the concepts of income and attribution are so radically different.

One tax court case sheds some light on this issue, but is not conclusive.⁷⁵ In *Edgar*, a taxpayer was considered a grantor as to ordinary accounting income only, not income allocable to principal (such as capital gains). At issue - who got to deduct capital losses passing through to the trust from a partnership? The court held that the grantor could not report the capital losses because he was only the grantor as to ordinary income, and while he was entitled to deductions against that, the capital losses should be allocated to the principal (which was allocated to a separate taxpaying trust under Subchapter J, Parts A-D). Had the grantor been deemed owner of income attributable to principal, the losses would have passed through. This is confirmed by an example in the regulations.⁷⁶

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 with a withdrawal provision would pass through to the beneficiary, without speaking at all to how any net losses should be treated.⁷⁷ 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 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”⁷⁸

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

There are two methods around this uncertainty: first and easiest is to avoid substantial capital losses beyond capital gains inside the trust in the first place by distributing substantial loss property prior to 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).⁷⁹

Secondly, one can build in a fail-safe clause to reduce the future years' withdrawal rights over capital gains by the amount of prior net losses so that the beneficiary does bear both the fruits and the burdens of capital gains and losses. That may be persuasive in helping to conclude that §678(a)(1) should still apply to shift the net loss to the beneficiary. However, to the extent it does not, any net unwithdrawable gains in that future year in which the withdrawal right is reduced would be taxed under Subchapter J, Parts A-D (ordinary non-grantor trust), and the losses previously held in abeyance would then be able to offset the gains in that year. Therefore, even in a worst case scenario, a net capital loss would be treated no worse than a net capital loss in an ordinary irrevocable non-grantor trust taxed under Subchapter J, Parts A-D. For example, if in our \$200,000 capital loss example the IRS concludes it must be reported by the trust under Subchapter J, Parts A-D, rather than the power holder under §678(a)(1), and the next year's trust income is \$50,000 dividends/interest and \$250,000 capital gains, the net withdrawal amount in the subsequent year would be reduced from \$300,000 to \$100,000, with the trust then reporting a \$200,000 gain offset by the prior year's \$200,000 capital loss carryforward – a wash.⁸⁰

Related Advantage – Changing Status from Non-Grantor to Grantor to Unlock Capital Losses

Related to the discussion above, if a trust is currently a non-grantor trust with unusable capital losses, if the trustee (or trust protector or court) amends the trust to grant a withdrawal power over taxable income and cause BDOT status, it may be able to unlock significant trapped losses to be used by the beneficiary and, furthermore, continue to use them should the trust later revert back to non-grantor trust status. Absent abusive facts, such a conversion would not ordinarily be a taxable event.⁸¹ One treatise concludes that “a trust that becomes a grantor trust should be deemed to terminate and to distribute its assets to the grantor, as its beneficiary. Thus, the grantor should be treated as a beneficiary succeeding to the property of the trust, for purposes of Section 642(h), which would allow the grantor to succeed to the unused capital loss carryovers. A capital loss carryover

resulting from an asset sale by a grantor trust should be a personal loss of the taxpayer, under Section 671. The grantor should logically continue to be able to deduct the loss carryover even if the trust ceases to be a grantor trust.”⁸²

Advantage – Avoidance of *Kenan* Gain Disasters

Arguably the most ubiquitous, overlooked and dangerous clauses in trusts are division or distribution clauses based on pecuniary amounts rather than fractional divisions. Many accountants, financial advisors and even many attorneys fail to recognize the malpractice and tax disaster traps associated with these clauses, which are rife in non-grantor trusts and estates.⁸³

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.⁸⁴ For example, if a trustee gives \$50,000 of stock with a basis of \$40,000 to pay towards a \$60,000 obligation (e.g. annuity), the trust incurs \$10,000 gain and the beneficiary has a basis of \$50,000 in the received stock.⁸⁵ This is true even for distributions to charities, though in many cases a charitable deduction up to the gain may be permitted.⁸⁶

If the trust instrument requires the trustee to pay “all net income annually”, and the net income were the same as above, \$60,000, with \$50,000 of stock and \$10,000 of cash distributed, the result would be the same. The distribution would trigger gain even though the trust did not as obviously reference a pecuniary amount.⁸⁷

More dangerously, because of the larger likely dollar amounts, if the trust instrument split into A/B shares based on a pecuniary formula, or GST exempt or non-exempt based on a formula, the result would be the same if appreciated assets in kind were distributed to the separate trust to satisfy the pecuniary obligation. For instance, if a \$3 million traditional IRA and \$50,000 of stock with a \$40,000 basis were allocated to a bypass or GST exempt trust via pecuniary formula to fund a \$5.49 million trust, \$3 million of ordinary income and \$10,000 of capital gain would be triggered.⁸⁸

If the trust had a staggered distribution, for example, 1/3 at age 35, whether this rule applies may depend on the wording of the distribution. If it were an amount equal to 1/3 of the principal or corpus on X date, *an amount frozen in time*, this sounds like a distribution of a pecuniary amount that is simply defined by use of a fraction, not dissimilar to how the distribution of

net income is actually a pecuniary amount, as noted above. In fact, it's very similar to the original *Kenan* case. By contrast, if the 1/3 varied based on the value of the portfolio of assets at the time of distribution, for example if the beneficiary's rights increased or decreased between the measuring date and the distribution date accordingly, it would be no different from a terminating distribution to any residuary beneficiary (i.e. no gain unless a special §643(e) election is made).

However, if this share comes from a beneficiary deemed owner trust, no gain should be triggered at all under Rev. Rul. 85-13. Thus, drafting (or converting) a staggered distribution into a withdrawal right does not have the same danger, and it may offer greater asset protection to the beneficiary as well.

Estate Inclusion Risk (and Advantages) can be Mitigated (and Exploited)

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

However, the beneficiary deemed owner trust is usually intended for the middle and upper middle class who have less than \$11 million taxable estates! Ultra high net worth families have beneficiaries in the highest tax bracket who would often prefer non-grantor trust status to avoid state income tax and enable better charitable tax deductions. Adding to smaller estates is usually a *benefit* because of increased potential for basis step up. In fact, most taxpayers would prefer to trigger estate inclusion over any appreciated assets up to their available exclusion amount. Thus, in most cases a beneficiary deemed owner trust would have a formula testamentary GPOA and/or testamentary limited powers of appointment exercised to trigger the Delaware Tax Trap (IRC §2041(a)(3) causing selective estate inclusion anyway.⁸⁹

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

The most common of the tax savings opportunities for a grantor trust to encounter, applicable to the sub-\$5.49 million dollar estates as well as the wealthiest, 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 granting a beneficiary the right to withdraw capital gains income from sale of a personal residence if an independent trustee doesn't sell the property! A trust might allow the beneficiary to withdraw net capital gains from the sale of a residence, but have ordinary distribution provisions for all other assets.

Grantor trusts are permitted this exclusion provided the other occupancy requirements are met.⁹⁰ 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, but §678 trusts are specifically included in the regulations.⁹¹ *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.⁹² Of course, the goal with this type of provision would be to grant the withdrawal right over the capital gain 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 23.8%, the effect of Pease limitations at approximately 1.2% for itemizers, the phase out of personal exemptions, 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%, there could easily be a tax cost of \$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!*⁹³ 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.⁹⁴ 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.⁹⁵ 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.⁹⁶

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.*⁹⁷ 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.⁹⁸

The beauty of this more limited provision of permitting withdrawal of the capital gains from the sale of the residence is that it has NO effect on the grantor/non-grantor trust status of the trust until such time as the withdrawal right is triggered (upon sale), simplifying reporting. When the trust reverts to a fully non-grantor trust, the distribution provisions can simply take into account any earlier distribution of capital gains from the sale of the residence as part of the surviving spouse's available resources or as a factor that might reduce future distributions accordingly (keeping the mandatory income floor if it is a marital trust).

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

If a beneficiary directs that some of her withdrawable income go to charity, she (not the trust) would be eligible for a Schedule A tax deduction under §170.⁹⁹ Increased income to the beneficiary enables a greater percentage of any charitable deduction to be taken due to the increase in AGI. Because the deduction comes under the individual donation rules rather than the trust/estate deduction rules of IRC §642(c), some very annoying and troublesome restrictions to non-grantor trust/estate charitable deductions are avoided. To wit, there is no need to trace the donation to gross income, which may be difficult if not impossible to deal with for phantom income received from mutual funds or other pass through entities.¹⁰⁰ 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).¹⁰¹ 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.¹⁰²

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.¹⁰³ 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 useable.

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*.

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.¹⁰⁴ 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.**

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.¹⁰⁵ 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.

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 the trust. Gifting it implicates the three year and retained interest rules which may cause significant estate tax.¹⁰⁶ 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!¹⁰⁷

By contrast, a beneficiary can sell a life insurance policy insuring themselves to a BDOT without triggering the transfer for value rule.¹⁰⁸ 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.¹⁰⁹

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.¹¹⁰

One reason that trustees tend to avoid them is that non-grantor trusts generally do not receive the same income tax deferral that an individual would receive, unless the trust is an “agent for a natural person”.¹¹¹ 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).¹¹²

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 they 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.

Advantage – Avoiding Double (or More) State Fiduciary Income Taxation

It’s possible in many situations for beneficiaries not only to get stuck with higher income tax brackets with a trust as a separate taxpayer, but to be stuck with additional and/or multiple states’ tax burdens or be subject to similarly compressed state income tax brackets which might be avoided using a beneficiary deemed owner trust.¹¹³ Of course, for those in the top 0.5% already in the highest tax bracket, we can often avoid taxation in any state at all through using professional trustees in favorable trust jurisdictions, and trapping income in trust is often strategically intended for those.¹¹⁴ However, for the 99+% of the population who is not in the highest tax bracket and does not want to use sophisticated out of state wealth management and trust, this can be a more serious issue.

For instance, let's say we have a settlor decedent from Delaware, Maine, Illinois, Maryland, Michigan, Minnesota, Nebraska, Oklahoma, Pennsylvania, Vermont, Virginia, Washington, D.C., West Virginia or Wisconsin. These states attempt to tax a trust based on the residency of the decedent/grantor no matter where the trust is administered, what law it uses or where its assets, beneficiaries or trustee is located (a.k.a. "founder states").¹¹⁵ 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.¹¹⁶

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?¹¹⁷ The collective state taxation between the three states could conceivably exceed the federal taxation. Non-grantor trust taxation may be based on the residency of the settlor, any current non-contingent beneficiaries, the residency of the trustees or the situs of administration.

There may not always be a full credit granted either – the Supreme Court has permitted multiple states to tax the same income. When a trust as taxpayer has sufficient nexus with different states, each may tax the income.¹¹⁸ While many states allow trusts some form of credit for taxes paid to other states, it is not constitutionally required.

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

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.¹¹⁹ 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".

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

Advantage – Tax-Free Transactions Between Beneficiaries and their BDOTs

When a grantor or beneficiary is deemed to be the owner of the income under §671-679 for income tax purposes, there is no authority to treat a trust deeming the grantor as owner of all taxable income under §673-677 differently from a trust deeming the beneficiary as owner of all taxable income under §678. Indeed, regulations are clear that a §678 beneficiary shall be deemed the owner for income tax purposes: "Where a person other than the grantor of a trust has a power exercisable solely by himself to vest the corpus or the income [remember, "income" here means taxable income not accounting income] of any portion of a testamentary or inter vivos trust in himself, he is treated under section 678(a) as the owner of that portion."¹²⁰

Many readers are undoubtedly wondering – since these techniques can create what is considered a grantor trust to the beneficiary as to ALL trust taxable income, what is to stop beneficiaries from engaging in installment sales, swaps or other transactions with their fully §678(a)(1) trusts under

Rev. Rul. 85-13 and its progeny? Put another way, can a taxpayer engage in a transaction with a BDOT that would be respected for income tax purposes?

The issues are identical to an installment sale or swap with a IGT or a *BDIT* (which relies on *lapses of powers over the entire corpus* per §678(a)(2)). Unlike a BDIT, the trust could have an unlimited seed gift, rather than a mere \$5,000, and with less attendant substance over form risk accordingly.¹²¹

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.¹²² However, the IRS has specifically refused to follow *Rothstein*, no case since has followed it, and the IRS has issued a series of Revenue Rulings that can be relied on for the proposition that one cannot recognize such transactions for income tax purposes:

Rev. Rul. 85-13: Probably the most widely recognized (or should be) Revenue Ruling of all 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.¹²³ It stated that the owner of a grantor trust is not merely taxable on a trust's income, but is treated as the owner of the trust's assets for federal income tax purposes, citing *Ringwald v. United States*, 549 F.2d 89 (8th Cir. 1977), cert. denied, 432 U.S. 906 (1977); *Estate of O'Connor v. Commissioner*, 69 T.C. 165 (1977); Example 5, § 1.1001-2(c) of the regulations; Rev. Rul. 81-98, 1981-1 C.B. 40; Rev. Rul. 78-175, 1987-1 C.B. 144; Rev. Rul. 77-402, 1977-2 C.B. 222; Rev. Rul. 74-613, 1974-2 C.B. 153; Rev. Rul. 72-471, 1972-2 C.B. 201; Rev. Rul. 70-376, 1970-2 C.B. 164; and Rev. Rul. 66-159, 1966-1 C.B. 162; but cf. Rev. Rul. 74-243, 1974-1 C.B. 106.

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

attributing such income directly to a grantor or other person, the Code, in effect, disregards the trust entity.”¹²⁴

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 §1033.¹²⁵

Rev. Rul. 92-84 (rendered obsolete in 1995 by S corp regulations):¹²⁶ 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 this revenue ruling.¹²⁷ Now, it is clear the current income beneficiary of a QSST is NOT treated as the owner of the S corporation stock in determining and attributing the income tax consequences of a disposition of the stock by the QSST. Instead, any consideration received for such dispositions will be treated as received by the trust in its status as a separate taxpayer under IRC §641 and the non-grantor trust rules of Subchapter J, Parts A-D. As noted in the section on S corporations above, this is even true for asset sales and deemed asset sales of the company in a de facto sale.

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

IRS Notice 97-24: Although this is merely an announcement regarding abusive trusts, it does contain some IRS language reinforcing these principals regarding grantor trusts: “2. Grantors may be treated as owners of trusts. The grantor trust rules provide that if the owner of property transferred to a trust retains an economic interest in, or control over, the trust, the owner is treated for income tax purposes as the owner of the trust property, and all transactions by the trust are treated as

transactions of the owner.^{***} *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.*¹²⁸

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*.”¹²⁹

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.¹³⁰

CCA 2013-43021: An IRS Chief Counsel Advisory (“memorandum”) examined the question of whether grantor trusts are disregarded entities for the purposes of IRC §267 and IRC §707(b)(1)(A). In short, the memo reiterated the conclusions of Rev. Rul. 85-13 and again concluded that grantor trusts are disregarded, and that the loss limitation would apply to transactions between related parties. “Rev. Rul. 85-13 reasons that it would be anomalous to suggest that Congress, in enacting the grantor trust provisions, intended that the existence of a trust would be ignored for purposes of attribution of income, deduction, and credit, and yet retain its vitality as a separate entity 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) regulation 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 and if the beneficiary purchases stock Y the trust's gain on the sale must be reported, because the trust is a separate taxpayer as to stock Y, even if the gain from the sale were part of distributable net income (DNI) and distributed to the beneficiary and reported on the beneficiary's K-1.

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

Readers may be wondering, why have no articles or CLEs considered this? At least one highly esteemed author has considered the possibility of sales to beneficiary deemed owner trusts where there is no access to principal, albeit in the qualified subchapter S trust (QSST) context.¹³¹ In his extensive 1278 pages of material on corporate and estate planning, attorney Steven Gorin notes various advantages of the de facto §678 grantor trust status of QSSTs and concludes they:

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

sell assets to a trust in which he or she is a beneficiary and is the deemed owner - a beneficiary grantor trust.³⁷⁹³

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

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, 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.¹³² While this may seem illogical, such asymmetry is altogether possible, as previously discussed in this newsletter in the context of partially grantor, partially non-grantor trusts as to the sale of specific assets of a trust and the portion rules that mandate that income be deemed 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 at a minimum considered a separate taxpayer when it sells S corporation stock. In the BDOT context, the income tax result should be exactly the same whether the BDOT is a buyer or a seller transacting with the beneficiary deemed owner (or other grantor trust as to the beneficiary) – either way

there is no rationale to recognize the transaction as a taxable event because there is not a separate taxpayer.

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 without triggering income or gift tax as well.¹³³ However, interest income on intra-spousal (or intra-spousal grantor trusts) notes is *not* disregarded and there may not necessarily be a fully offsetting deduction for interest paid (or deemed paid through a BDOT) by the other spouse. 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 affect grantor trust status.¹³⁴

Advantage – Ability to Easily Toggle Between Tax Systems

As discussed earlier in this newsletter, a beneficiary's power to withdraw that is fettered or conditioned in some way is generally outside the ambit of §678. For example, if the power may only be exercised with the consent of an adverse or non-adverse party. 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 give the power to another party to toggle 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.¹³⁵ 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* is dependent on whether it follows the 2nd or the 3d Restatement of Property.¹³⁶

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.¹³⁷ Bypass trusts generally would not, unless the beneficiary

decedent held a general power of appointment. With the advent of skyrocketing exclusion amounts and portability, attorneys have begun adding formula testamentary general powers of appointment to trusts to soak up the ability of otherwise unused applicable exclusion amount to increase basis for the remaindermen.¹³⁸ Other practitioners have transitioned to overusing QTIPs for step up (down), despite the many drawbacks to this design.

Here is an overlooked potential drawback of such trusts that could be quite significant.¹³⁹ 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 clawback 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 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.¹⁴⁰ 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 pro rated amount, as a BDOT would be disregarded for income tax purposes. Additionally, if the John Doe Trust, regardless of tax status, were to pass to different taxpayers other than the John Doe Trust, for example, BDOT trust(s) for children, the property would not have been acquired by them before the death of the decedent. It is only where the taxpayer does not change at death that this is potentially an issue.¹⁴¹ The examples in the regulation do not address such a scenario.¹⁴²

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.”¹⁴³ 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 clawback 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.¹⁴⁴

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.

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.¹⁴⁵ This is because the power over the taxable income renews every year unless a cessor clause applies.

Let's take our same hypothetical beneficiary, Kristin, who inherits \$2 million in trust. She only has the unfettered right to withdraw taxable income – initially, this is \$0. None of the trust is subject to creditors. If she is sued over the next year, the most that would be exposed, under an absolute worst case scenario, would be the taxable income rights accrued. As discussed above, this right could be drafted so as not to vest until the end of the year and could be subject to a cessor (forfeiture) clause to protect against creditors prospectively and in most states and situations protected under lapse rules, so as a practical matter, provided these measures are added, the entire \$2 million plus any income is going to be protected.¹⁴⁶

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 within the "five and five" power. 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.

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 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 ($\$2,210,000 \text{ times } 5\% = \$110,500$), so at the end of year two even if Kristin does not take a dime from the trust, the entire amount lapses within the five and five protection and no part of the trust would be deemed to be contributed by her for estate/gift tax purposes, and under most state laws, no part would be considered self-settled for creditor protection purposes.

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.¹⁴⁷ 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.¹⁴⁸ 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).¹⁴⁹

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)? Perhaps, but 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.¹⁵⁰ Merely allowing her withdrawal power to lapse as to taxable income and/or 5% in prior years without coming under the §678(a)(2) “partially released or otherwise modified” does not make her a grantor of lapsed portions for income tax/grantor trust purposes – for her to be deemed the owner requires either a current power, a “partially released or otherwise modified” power pursuant to §678(a)(2) or an exercised power.¹⁵¹ 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, 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.¹⁵²

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.¹⁵³

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 event the trustee should timely file an electing small business trust (ESBT) election to enable the S corporation status to continue.¹⁵⁴

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.¹⁵⁵

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

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

Some practitioners argue that the best practice for large retirement plans is to simply have such assets pay outright or use a separate trust as a receptacle, to better assure “see through trust” status.¹⁵⁶

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

To answer this, let’s divide into the two “flavors” of compliance for such trusts, as indicated by the two examples noted in the Regulations, which

are commonly referred to by practitioners as “accumulation trusts” and “conduit trusts”.¹⁵⁷

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

There is an argument to be made that since a withdrawal power causes grantor status under §678 and Rev. Rul. 85-13 and its successor rulings ignore grantor trusts for income tax purposes, that the trust should be ignored for see through trust designated beneficiary rules as well and hence use the beneficiary power holder’s life expectancy for the RMD payout calculations without regard to any of the uncertain and complicated see through trust regulations.¹⁵⁸ Indeed, some PLRs have permitted an inherited IRA to be transferred to a grantor trust.¹⁵⁹ However, despite the compelling argument that such a trust should still qualify as a designated beneficiary, with such a large amount at stake and little firm guidance, it’s safest to simply keep your standard conduit or accumulation trust clauses in the trust to control retirement benefits.

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

Adapting to Special Needs Trusts, Medicaid qualification

A §678(a) power would **not** work in a special needs trust scenario – the income from the trust would be considered a countable resource to the beneficiary. Although in theory one could give such a §678(a) power to a sibling or someone other than the special needs beneficiary, this is probably contrary to the settlor’s intent, impairs protection for the special needs beneficiary, and may cause *higher* income taxation among the family unit – not only would a special needs beneficiary be in a lower bracket typically, but qualifying non-grantor trusts for special needs beneficiaries (a “qualified disability trust”) even receive an additional personal tax exemption.¹⁶⁰ If the original grantor is still living, grantor trust status for these work well, but it’s probably best to stick to ordinary non-grantor status upon the death of the original grantor for such trusts.

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

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

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

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

The beauty of this would be that the amounts in the newly created subtrust would probably be funded with *much* more than \$5,000, yet the principals behind the BDIT would be the same, 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.¹⁶¹

Advantage – Intervivos BDOTs

Most of this newsletter has concentrated on trust designs after the settlor’s death, but of course settlors can draft and fund a BDOT during lifetime, just as they would a BDIT. With either, a settlor merely has 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).¹⁶² What’s different is that if you only grant a power over the income later to accrue, there would be no qualification for the annual exclusion, as there would be no present interest.

For example, if one gifted \$1,000,000 into an irrevocable trust, avoiding §671-677 grantor powers, but granting 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 not qualify for the annual exclusion. However, all of the taxable income would be taxable to the beneficiary power holder under §678(a)(1).

Similarly, if one transferred \$1,000,000 into an irrevocable trust that was otherwise an *incomplete gift*, non-grantor trust, a.k.a. ING (incomplete gift non-grantor trust), but then the trust distribution committee granted a beneficiary or beneficiaries a withdrawal right over income, it might similarly shift the income taxation (which one may refer to as an incomplete gift, beneficiary deemed owner trust, “IG-BDOT”). Granting the unfettered withdrawal right would complete the gift over the amount of income withdrawable, just as a distribution to any party other than the settlor would.

The one caveat with any intervivos BDOT (or BDIT or DING for that matter) is that even with a perfectly drafted trust, it is still possible through transactions with the settlor and spouse and/or through misadministration of the trust to trigger grantor trust rules under §671-677, which would then override §678.¹⁶³

Advantage - Beneficiary Deemed Owner Trust Reporting

Grantor trusts can often get by with using the deemed owner's social security number without having to obtain a separate EIN.¹⁶⁴ While this is typical for a revocable living trust, it is not recommended for irrevocable grantor trusts, including BDOTs, for two reasons, 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* 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 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.

CITATIONS:

¹ 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.

² 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 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 newsletter focuses on a different but related variant of this concept, where

the beneficiary has a current withdrawal right over taxable income attributed to the corpus only, rather than the entire corpus itself, and further comparison and contrast will be noted later in the newsletter. For great “BDIT” newsletters, 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](#), LSI 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.

³ Rev. Rul. 75-267 (I.R.S. July 1, 1975).

⁴ IRC §2056(b)(5).

⁵ 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.

⁶ This is discussed in more detail in the section of this paper on the asset protection effect of presently exercisable general powers of appointment and their lapses. While there are a few states that protect such assets, applicability would be uncertain at best under any conflict of law analysis if the settlor/trust and beneficiary were in different states, and in bankruptcy even if the settlor and beneficiary lived in a state subject to more protective statutes. See Restatement, Second of Trusts § 156; Restatement, 3d of Trusts § 60 cmt. F. and further discussion and listing of various state’s lapse provisions/protections in the accompanying chart.

Trusts subject to a presently exercisable general power of appointment (withdrawal right) over the entire corpus would also subject the trust to most states’ spousal elective share laws (by contrast, trusts subject only to testamentary powers usually would not except perhaps in Delaware). See, e.g., 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 three cases:

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

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

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

⁷ 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).

⁸ IRC §2514(b).

⁹ PLR 9309023.

¹⁰ One tax court case held that when a beneficiary who was sole trustee was entitled to all net income, it was a beneficiary deemed owner trust under IRC §678 as to the net accounting income, but not the corpus (capital gains), because “[h]e was able to, was required to, and did vest the income of the trust in himself. Petitioner as trustee was required to cause the trust periodically to pay him (as income beneficiary) the entire net income of the trust. Petitioner, as trustee, owed fiduciary duties with respect to the income only to himself, the sole income beneficiary. Accordingly, we conclude that petitioner has the sole power to vest the trust's income in himself and is treated as the owner of the income portion of the trust.” *Goldsby v. Comm.*, TC Memo 2006-274. Partial beneficiary deemed owner trust status as to accounting/ordinary income only is not necessarily a positive result for taxpayers. 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.

¹¹ 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 (and you can find many by shepardizing the *Mallinkrodt* case) find that even the slightest limitation will take a powerholder out of grantor trust status. This paper will assume there are no forfeiture provisions, consent requirements, duties or purposes otherwise fettering the right. For a good argument that sole trustee/beneficiaries limited by ascertainable standards may still trigger §678(a) under its plain language, with some precedent cited, see pages 17-20 of Howard Mobley's CLE

outline at <http://www.howardmoble.com/articles/FixingBrokenTrusts.pdf>.

For the contrary position that I'll assume is correct for planning purposes for this paper, see *Beneficiary as Trust Owner: Decoding Section 678*, by Jonathan Blattmachr, Howard Gans and Alvina Lo, 35 ACTEC Journal 106, 108-114 (Fall 2009). As purely a point of statutory construction, Mobley 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. However, as a practical matter this interpretation is completely impractical and unworkable, as it would force both taxpayers and the IRS to evaluate every year what a judge could possibly approve under state law for HEMS to determine the extent to which §678(a)(1) applies! Treasury should clarify this point by regulation and simply declare that any ascertainable standards nix application of §678.

¹² *Mallinckrodt v. Nunan*, 146 F.2d 1 (8th Cir. 1945).

¹³ 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...”

¹⁴ IRC §671 “Where it is specified in this subpart that the grantor or another person shall be treated as the owner of any portion of a trust, there shall then be included in computing **the taxable income** and credits of the grantor or the other person...”. Treas. Reg. § 1.678(a)-1(a) “Where a person other than the grantor of a trust has a power exercisable solely by himself to vest the corpus **or the income** of any portion of a testamentary or inter vivos trust in himself, he is treated under section 678(a) as the owner of that portion, ***. **See section 671 and §§ 1.671-2 and 1.671-3** for rules for treatment of items of income, deduction, and credit where a person is treated as the owner of all or only a portion of a trust.”

¹⁵ 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.***”

¹⁶ Some authors believe that the above regulation defining “income” in §678 as referring to taxable income is suspect or unreliable because it makes the addition of the word “corpus” in §678(a) “superfluous”, see *Beneficiary as Trust Owner: Decoding Section 678*, by Jonathan Blattmachr, Howard Gans and Alvina Lo, 35 ACTEC Journal 106, 118-119 (Fall 2009) and Michael A. Yuhas & Carl C. Radom, *The Grantor Trust Rules: Competing Powers and Ascertainable Standards*, 85 Prac. Tax Strategies 4, pages 9-10 (July 2010). I respectfully disagree. The regulation can be safely relied upon as a very reasonable, if not mandatory, interpretation of §671 and §678, especially in light of the consistent history, intent, cases and rulings noted in the section of this paper following. It still makes sense for Congress to have added “corpus” in the statute and regulation to clarify that §678 is meant to also cover instances in which a power of withdrawal might not reference income or even if a power of withdrawal were defined to exclude taxable income. Without §678(a) including a power to vest the “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. Taking a position contrary to the regulation that a power to withdraw capital gains or other income attributable to principal would not implicate §678(a)(1) would be foolhardy, as there is no basis or authority for the conclusion and plenty in the regulations, history of the statute and case law to the contrary.

This definition also explains the seemingly confusing contradiction in §678(b): “Exception where grantor is taxable. Subsection (a) shall not apply with respect to a power over income, as originally granted or thereafter modified, if the grantor of the trust *** is otherwise treated as the

owner under the provisions of this subpart other than this section.” A power over the entire corpus is of course a power over all its income unless carved out otherwise and this explains the many rulings holding that §671-677 powers trump §678(a) *Crummey* powers if both exist simultaneously. The only reason for §678(a) to exist is to determine the taxation of “income” (meaning taxable income, which includes capital gains and other income attributable to principal). Since we are not talking about a wealth tax, it does not matter whether §678(a) applies to corpus by itself, the only thing that matters is whether §678(a) applies to taxable income (which may include income attributable to corpus) – if it does, whether through power over accounting income, income attributable to principal or both, then §678(b) says that §671-677 trumps it.

¹⁷ See Uniform Principal and Income Act, §409, §404.

¹⁸ 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.

¹⁹ 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 even clearer in the *Campbell* case discussed later herein.

²⁰ 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 newsletter. For obtaining protections for tax positions taken contrary to authority or regulation, see IRS instructions for Forms 8275 or 8275-R.

²¹ *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 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 not too late for D to make a non-qualified disclaimer of the withdrawal right for §678(d) purposes, as she would have only become aware of her withdrawal power after W’s death.

²² Generally the estate and gift tax effect of general powers of appointment are unaffected by a powerholder’s incapacity. IRC §678(a) should follow – 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. Dec. 22, 1960). 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.

²³ Treas. Reg. §1.671-2(e)(2)(ii).

²⁴ 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.

²⁵ *Mallinckrodt v. Nunan*, 146 F.2d 1 (8th Cir. 1945), this same reasoning is followed in other cases where beneficiaries had no withdrawal right over the entire principal, but only the income. E.g. *Spies v. United States*, 180 F.2d 336 (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 be allowed if it had come from a taxpayer’s grantor trust portion, but ultimately denied the deduction since the contribution was not traced to the ordinary income. The parties and court inexplicably ignored §678(a)(2), which may have helped the taxpayer get a prorated deduction).

²⁶ *Id.* at 5.

²⁷ *Campbell v. Commissioner*, T.C. Memo 1979-495.

²⁸ *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.

²⁹ 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).

³⁰ PLR 2016-33021

³¹ 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.

³² *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.? Personally 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 while still permitting income to be trapped in trust without carrying out DNI (while ordinarily disadvantageous, this might be quite advantageous for high bracket taxpayers in some states and situations). Were there other subtle differences between the trusts not mentioned in the PLR?

³³ Treas. Reg. 1.672-3(b).

³⁴ The regulations that explain how to divide income of a trust that is only partially subject to the grantor trust rules are colloquially known as the portion rules. Treas. Reg. §1.671-3 outlines three different ways that taxable income might be divided if it's not clear that 100% is attributed to an individual or 100% to the trust: 1) Paragraph (a)(2): Individual is deemed owner of specific property and the income therefrom; 2) Paragraph (a)(3): Income divided on a fractional basis; 3) Paragraph (b)(1): Income is divided based on rights to income based on fiduciary accounting principles

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

³⁵ *Harrison v. Schaffner*, 312 U.S. 579 (U.S. Mar. 31, 1941), quoted by the *Mallinkrodt* case.

³⁶ 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.

³⁷ This bracket, like all individual income tax brackets under IRC §1, adjusts annually for inflation and increased from \$12,400 to \$12,500 in 2017. Rev. Proc. 2016-55, §3.01.

³⁸ Treas. Reg. §1.671-3(b) and various portion rules discussed throughout Treas. Reg. §1.671-2 and §1.671-3. Some expenses might be attributed to the asset producing the income, and some, like a trustee fee, might be apportioned. Treas. Reg. §1.671-3(a)(2): “If the portion treated as owned consists of specific trust property and its income, all items directly related to that property are attributable to the portion. Items directly related to trust property not included in the portion treated as owned by the grantor or other person are governed by the provisions of subparts A through D (section 641 and following), part I, subchapter J, chapter 1 of the Code. Items that relate both to the portion treated as owned by the grantor and to the balance of the trust must be apportioned in a manner that is reasonable in the light of all the circumstances of each case, including the terms of the governing instrument, local law, and the practice of the trustee if it is reasonable and consistent.”

³⁹ Treas. Reg. §1.671-3(a)(2)

⁴⁰ For discussion of parsing §678 withdrawal powers, see material from attorney James Blase such as *The Minimum Income Tax Trust: Drafting Techniques to Help Unburden Estate Planners*, Trusts and Estates, May 2014. Rev. Proc. 2016-55, §3.01 contains the 2017 inflation adjustments, taking the top bracket for singles to \$418,400, for married filing jointly to \$470,700, for married filing separately to \$235,350, for head of households to \$444,550 and for trusts and estates to \$12,500. Utilizing the bracket run up would not save a great deal even for a top bracket taxpayer this would only mean about \$1,000 or so of savings, depending on whether it is qualified dividend/long term capital gain or ordinary income.

⁴¹ Treas. Reg. §1.671-3(a)(2)

⁴² See Treas. Reg. §1.671-4 for various alternative methods of grantor trust reporting compliance – if the deemed grantor is trustee a Form 1041 filing can be avoided. If a third party is trustee, a Form 1041 is required. It's not

nearly as complicated though – a Form 1041 is filed with a box checked for grantor trust status and the trustee attaches a statement (not a K-1) showing income, deductions, credits, etc., that would basically be the information from K-1s and 1099s that the trustee would receive.

⁴³ IRC §179(d)(4) “Section not to apply to estates and trusts. This section shall not apply to estates and trusts.” A QSST election may partially solve the issue if the business is an S corporation– QSSTs are in some ways de facto §678(a) trusts except for substantial sales of assets/stock, see e.g., Treas. Reg. §1.1361-1(j)(8). However, the §678(a) solution may be the only good solution to exploit §179 for an LLC/LP taxed as a partnership owned by a trust. The generous \$500,000 expensing provision was made permanent by §124 of the Protecting Americans from Tax Hikes (PATH) Act of 2015. It adjusts upwards for inflation and in 2017 will increase to \$510,000. See Rev. Proc. 2016-55 for inflation adjustments. If the loss of this deduction is not expensive enough, Republican-proposed tax reform may make the §179 expensing *unlimited* and there is no indication that any reform would alter §179(d)(4).

⁴⁴ 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).

⁴⁵ Treas. Reg. §1.179-1(f)(3) provides “Special rules with respect to trusts and estates which are partners or S corporation shareholders. Since the section 179 election is not available for trusts or estates, a partner or S corporation shareholder that is a trust or estate may not deduct its allocable share of the section 179 expense elected by the partnership or S corporation. The partnership or S corporation's basis in section 179 property shall not be reduced to reflect any portion of the section 179 expense that is allocable to the trust or estate. Accordingly, the partnership or S corporation may claim a depreciation deduction under section 168 or a section 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.”

⁴⁶ IRC §1411(a)(2).

⁴⁷ 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 non grantor trust clients on the ability to avoid this surtax, despite the potential authority for doing so.

⁴⁸ Prop. Treas. 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."

⁴⁹ Treas. Reg. §1.1411-3(b)(v) excepts "A trust, or a portion thereof, that is treated as a grantor trust under subpart E of part I of subchapter J of chapter 1. However, in the case of any such trust or portion thereof, each item of income or deduction that is included in computing taxable income of a grantor or another person under section 671 [26 USCS § 671] is treated as if it had been received by, or paid directly to, the grantor or other person for purposes of calculating such person's net investment income."

⁵⁰ IRC §1361(c)(2)(A) "the following trusts may be shareholders: (i) A trust all of which is treated (under subpart E of part I of subchapter J of this chapter) as owned by an individual who is a citizen or resident of the United States." Subpart E of part I of subchapter J is referring to IRC §§671-679, which includes §678(a). See also, *In re Forte*, 234 B.R. 607 (Bankr.

E.D.N.Y. May 6, 1999). PLR 2012-16034 recently followed this, ruling that a beneficiary-grantor trust created via *Crummey* power qualifies as an S corporation shareholder. Conservative practitioners may want to file a QSST election as a “belt and suspenders” approach, but §678(a) does not rely on a properly filed election.

⁵¹ 1995-2 C.B. 135 (I.R.S. July 1, 1995)

⁵² 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).

⁵³ 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.**”

⁵⁴ Treas. Reg. §§ 1.1361-1(m)(2)(v) and § 1.1361-1(m)(8), Example (3) provides example of IRC § 678 trust making an ESBT election.

⁵⁵ Treas. Reg. § 1.1361-1(j)(6)(iv).

⁵⁶ Generally, suspended S corporation losses are personal and *not* transferable to other taxpayers, with exceptions for transfers to spouse on divorce. Treas. Reg. §1.1366-2(a)(6)(i).

⁵⁷ Treas. Reg. §1.1361-1(j)(12).

⁵⁸ IRC §1361(c)(2)(ii).

⁵⁹ 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.

⁶⁰ 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.

⁶¹ 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. Washington state has a \$2 million estate filing (with slightly more sheltered) threshold with 10%-20% progressive rates.

⁶² 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.”

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

⁶³ Rev. Rul. 66-87 describes the calculation of the lapse effect of a power to withdraw accounting (ordinary) income that was not taken and concludes the 5% lapse protection is calculated on the amount of that income only (i.e. it is not calculated based on the corpus). You could make an argument that this revenue ruling is wrong and contrary to statute, since the

“aggregate value of the assets out of which, or the proceeds of which, the exercise of the lapsed powers could be satisfied” refers to and should be considered the entire corpus. However, it may be correct because the trust withdrawal power in Rev. Rul. 66-87 did not permit the lapsed powers to be exercised over ALL of the “proceeds of” the trust assets (i.e. not the income attributable to principal, such as capital gains) which §2514(e) references, therefore it had to apply the smaller value. My conclusion is that this ruling should not apply to a power over all the proceeds (taxable income), but that a broad definition of the lapse may be a “belt and suspenders” approach to ensuring the maximum lapse protection.

⁶⁴ See comparison chart at this link: [50-state asset protection chart](#). Uniform Trust Code (“UTC”) § 505(b), following which are e.g., [D.C. Code § 19–1305.05](#), [Kan. Stat. Ann. §58a-505\(b\)](#), [Fla Stat. Ann. § 736.0505\(2\)\(b\)](#), [Ala Code §19-3B-505\(c\)\(2\)](#), [RSMo § 456.5-505.6](#), [NJS.3B:31-39.b\(2\)](#), [Wisconsin statutes § 701.06\(6\)\(b\)](#). Pennsylvania mimics the UTC in a roundabout way by first defining power of withdrawal to exclude annual exclusion/5&5 powers in [20 Pa. C.S.A. §§ 7703](#), and then carving out in a different code section at 20 PA Cons Stat § 7748.

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

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

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

Surprisingly, quite a few states are much more generous, e.g. [Kentucky RS §386B.5-040\(2\)](#), New Hampshire ([N.H. Rev. Stat. Ann. §564-B:5-505\(b\)](#)); [Michigan MCL § 700.7506\(c\)\(3\)](#); [Tenn. Code Ann. §35-15-505\(b\)](#) adds the same UTC §505(b) language but then backs out some of its 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), 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. If we follow the traditional Restatement of Property, Donative Transfers, we are told 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 withdrawal right and from attaching trust property with respect to which the withdrawal power had lapsed.

Courts in states that have not passed the UTC, nor a specific statute like Texas or Idaho, may find the *Long* and *Rhoadarmer* cases and their citations and earlier restatements to be persuasive, especially if their state has not indicated any intention to follow the third restatement of trusts (which is unlikely without passage of the UTC). California has neither

passed the UTC, nor has any clear statute mimicking UTC §505(b). Cal. Prob. Code § 682(b) clearly applies to subject assets appointable under a general power to a power holder's *estate's* creditors, but it is unclear whether this statute would be persuasive at all for *lifetime* access and lapse. If anything, California statute seems to indicate that a lapse would NOT make the power holder a settlor. [Cal Prob Code § 15309](#) provides that "A disclaimer or renunciation by a beneficiary of all or part of his or her interest under a trust shall not be considered a transfer under Section 15300 or 15301." [provisions that pierce self-settled trusts]. If, as most courts and the IRS has often found, lapses are essentially the equivalent of disclaimers or renunciations, then California law should protect such trusts post-lapse. For California settlor/beneficiaries, there is no way to draft around some of the other creditor-friendly laws (even if you removed withdrawal rights and even if the trust was not deemed self-settled, creditors of California trusts have access to distributable portions of spendthrift trusts *without* withdrawal rights), other than to perhaps use another state's laws, which to pass muster under a conflict of laws analysis would require significant contact/nexus with another state, such as a resident trustee of the state whose law is sought. See discussion of California trust/choice/conflict of laws generally, at Footnote 12 of *Ed Morrow: Asset Protection Dangers When a Beneficiary Is Sole Trustee and Piercing the Third Party, Beneficiary-Controlled, Irrevocable Trust*, LISI Asset Protection Newsletter # 339 (March 9, 2017).

⁶⁵ Treas. Reg. 1.671-2(e)(6), Example 9.

⁶⁶ Carve outs are needed for marital trusts to preserve the marital deduction – a trust wherein the right to net income might be removed later would not qualify as a marital trust in the first place. A conduit trust designed to qualify as a designated beneficiary of retirement assets has a similar issue, but a practitioner might opt for an accumulation trust design in the first place if asset protection is a concern. A QSST has a similar concern, but if the trust is a grantor trust a QSST election is not needed – a trustee can make an ESBT election upon change from a grantor to non-grantor trust.

⁶⁷ 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.

⁶⁸ UTC §506(b).

⁶⁹ *The Optimal Basis Increase Trust*, [LISI Estate Planning Newsletter #2080](#) (March 13, 2013), has been updated and is available at the following link <http://ssrn.com/abstract=2436964>

⁷⁰ IRC §642(h).

⁷¹ Treas. Reg. §1.671-3(a).

⁷² 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 grantor trust status and then back to non-grantor trust status after the reformation/PLR permitted the beneficiaries to unlock the capital losses to offset against their own personal capital gains (and of course, up to \$3,000 of ordinary income).

⁷³ Remember, however, the trustee would typically have a parallel discretion to make distributions (which might or might not be triggered whenever a withdrawal power fails to reach a certain threshold, e.g. 4% or 5%). Thus, it's not like the beneficiary/power holder would be unable to receive any distributions in a down year – it depends on how the trust is drafted. The trust could also be drafted to have two parallel withdrawal rights – one over ordinary income/accounting income and a separate one over net capital gains, in which case the w/d right in the above scenario would be \$50,000.

⁷⁴ 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.

⁷⁵ *Edgar v. Commissioner*, 56 T.C. 717 (T.C. 1971).

⁷⁶ 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.)”

⁷⁷ PLR 2016-33021.

⁷⁸ *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.

⁷⁹ If the trustee transfers this stock in kind pursuant to a distribution power, if the trust were a non-grantor trust taxed under Subpart 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. up to \$50,000, not \$250,000), 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 – 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 property with cost basis higher than fair market value (i.e., loss property).

⁸⁰ 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.

⁸¹ CCA 2009-23024.

⁸² Zaritsky, Lane & Danforth, *Federal Income Taxation of Estates and Trusts* (WG&L), ¶ 7.03[5] Capital Loss Carryovers and Change of Grantor Trust Status.

⁸³ For an example of a trust that does not specify whether it is a fractional or pecuniary staggered distribution, see page 9 of https://www.legalzoom.com/samples/last_will_and_testament.pdf.

⁸⁴ *Kenan v. Comm.*, 114 F. 2d 217 (2d Cir. 1940) the trustees of a trust were directed to pay a beneficiary five million dollars when the beneficiary reached age 40. The trustee paid the beneficiary partly in cash and partly in appreciated securities. The court held that the beneficiary had a general claim against the trust corpus, and the satisfaction of this general claim for an ascertainable value by a transfer of specific assets was an exchange that caused the trust to realize gain. Treas. Reg. §1.1014-4(a)(3) incorporates this rule and has examples.

⁸⁵ Rev. Rul. 68-392.

⁸⁶ Rev. Rul. 83-75 held that a trust distribution of corpus consisting of appreciated securities in satisfaction of its obligation to pay a fixed amount to a qualified charitable organization is a sale or exchange triggering taxable gain, but at least the trust is entitled to a §642(c) charitable deduction equal to the amount of gain recognized upon the distribution.

⁸⁷ 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.*”

⁸⁸ IRS Chief Counsel Memorandum (CCM) 2006-44020.

⁸⁹ Trusts with such clauses are sometimes referred to as Optimal Basis Increase Trusts, see newsletter 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.

⁹⁰ 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 are subject to a withdraw right, as discussed above. This is perfectly consistent with Treas. Reg. §1.671-3(a)(2) and IRC §678(a).

⁹¹ 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 (revocable trust eligible – why someone bothered with a PLR for that is unclear).

⁹² 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). See also Rev. Rul. 67-241.

⁹³ Statistics show that widowers are more likely to remarry much sooner after a death of a spouse than widows.

⁹⁴ See IRC §121(b)(4) and IRC §121(b): **(2) Special rules for joint returns.** In the case of a husband and wife who make a joint return for the taxable year of the sale or exchange of the property—

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

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

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

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

⁹⁵ Uniform Prudent Investor Act (Restatement of Trusts, 3rd), §181.

⁹⁶ Treas. Reg. § 20.2056(b)-5(f)(4), Treas. Reg. §20.2056(b)-7(h), Example 1.

⁹⁷ *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).

⁹⁸ Treas. Reg. §1.163-1(b) (equitable ownership sufficient)

⁹⁹ *Goldsby v. Commissioner*, T.C. Memo 2006-274. See also Treas. Reg. §1.671-2(c) “An item of income, deduction, or credit included in computing the taxable income and credits of a grantor or another person under section 671 is treated as if it had been received or paid directly by the grantor or other person (whether or not an individual). For example, a charitable contribution made by a trust which is attributed to the grantor (an individual) under sections 671 through 677 will be aggregated with his other charitable contributions to determine their deductibility under the limitations of section 170(b)(1).” However, this does leave a potential gap in deductibility for charitable donations from beneficiary deemed owner trusts – if the beneficiary does not direct the payment under his or her withdrawal right, but the trustee uses a concurrent trust power to distribute corpus to charity, not pursuant to the beneficiary’s presently exercisable general power of appointment (withdrawal power), then the above regulation would not apply, and §642(c) would not be available since there would be no gross income to the trust as a separate taxable entity and the deduction lost.

¹⁰⁰ There is a very compelling argument which makes a good deal of practical sense that the “gross income” requirement in IRC §642(c) is simply a quantitative limitation rather than requirement for mechanical tracing, see *Federal Income Taxation of Fiduciaries and Beneficiaries*, §412.8.3. (CCH 2009), by Byrle Abbin, citing *Old Colony Trust Co. v. Commissioner*, 301 U.S. 379 (1937). That said, it is safest to assume in planning that sourcing is required, as this appears to be the IRS position and some courts have so concluded: see Rev. Rul. 2003-123, *Crestar Bank v. IRS*, 47 F.Supp. 2d 670 (E.D. Va. 1999) and *Mott v. United States*, 462 F.2d 512 (Ct. Cl. 1972). This may be easy for dividends, interests and rents, but quite hairy if taxable income is phantom income from a mutual fund or attributed via K-1 from pass through entities. For example, there may be less distribution from an LLC/LP (or none) than the taxable income. And even if a sufficient LLC/LP distribution is made to the trust, must the

trustee be able to trace this distribution to the LLC/LP's gross taxable income? That may not even be possible. There's a good reason they got rid of tracing for the most part in Subchapter J – it's a huge mess.

¹⁰¹ IRC §170(d).

¹⁰² 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.

¹⁰³ IRC §681(a), Treas. Reg. §1.642(c)-3(d) and (e).

¹⁰⁴ IRC §641(c).

¹⁰⁵ These amounts under IRC §55 adjust for inflation, see Rev. Proc. 2016-55, §3.10 for inflation adjusted amounts, including amounts for single, head of household and married filing separately.

¹⁰⁶ IRC §2035, §2036

¹⁰⁷ IRC §101(a)(2)

¹⁰⁸ 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.

¹⁰⁹ 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 have issues with 10 year lookbacks 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).

¹¹⁰ 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).

¹¹¹ 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.

¹¹² 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.

¹¹³ Most states with an income tax 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 scheme such that lower income trapped in trust might be taxed 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.

¹¹⁴ See, *INGs: Not Just for State Income Tax Avoidance*, by this author, available at www.ultimateestateplanner.com

¹¹⁵ 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.

¹¹⁶ Because of continuing jurisdiction by the founder state, it may be 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!*

¹¹⁷ 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.

¹¹⁸ *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.”

¹¹⁹ 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.”

¹²⁰ Treas. Reg. §1.678-1(a).

¹²¹ The IRS has placed BDITs on its “no ruling” list if the trust purchases property from the deemed owner with a note and the value of the assets with which the trust was funded by the grantor is nominal compared to the value of the property purchased. Rev. Proc. 2017-3, 2017-1 I.R.B. 130, §4.01(43). Despite the IRS doubt in this area, there is ample authority that minimal funding can still reasonably support a large sale with proper attention to guarantees. See *Jerry Hesch, Dick Oshins & Jim Magner: Note Sales, Economic Substance and "The 10% Myth," LISI Estate Planning Newsletter #2412* (May 9, 2016).

¹²² *Rothstein v. United States*, 735 F.2d 704, 709 (2d Cir. 1984).

¹²³ Rev. Rul. 85-13, 1985-1 C.B. 184.

¹²⁴ *Madorin v. Commissioner*, 84 T.C. 667, 675 (T.C. Apr. 11, 1985).

¹²⁵ Rev. Rul. 88-103 (I.R.S. July 1, 1988).

¹²⁶ Rev. Rul. 92-84, 1995-2 C.B. 135 (I.R.S. July 1, 1995).

¹²⁷ Treas. Reg. §1.1361-1(j)(8).

¹²⁸ IRS Notice 97-24 available at <https://www.irs.gov/pub/irs-irbs/irb97-16.pdf>.

¹²⁹ Rev. Rul. 2004-86.

¹³⁰ Rev. Rul. 2007-13, 2007-1 C.B. 684.

¹³¹ 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 many treatises in this area. Steve updates his outline quarterly and the quote below is from version printed 3/28/2017, section III.A.3.e.vi. “QSST as a Grantor Trust; Sales to QSSTs” pages 934-943 (citations omitted).

¹³² 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).

¹³³ IRC §1041 (disregarding sales between spouses for income tax purposes).

¹³⁴ 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>.

¹³⁵ IRC §2514/2041.

¹³⁶ Compare the two:

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

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

¹³⁷ 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).

¹³⁸ 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>.

¹³⁹ 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.

¹⁴⁰ The benefit of the depreciation is split between the trust and the spouse/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.

¹⁴¹ Similar to this is an upstream optimal basis increase trust, which is an irrevocable grantor trust in which an older generation beneficiary is granted a testamentary formula general power of appointment and the grantor might remain the deemed taxpayer after death despite estate inclusion and a new basis. See discussion in Part V of the Optimal Basis Increase Trust cited above at www.ssrn.com. Whether trusts are new taxpayers based

on a change in beneficiaries or terms is an interesting question, and has been debated in recent years in the IRS's request for and ACTEC/AICPA's and other group's responses to questions about the tax effects of decanting. The IRS does not encourage, nor do most practitioners seek out, a new EIN just because a beneficiary dies. And even if a new EIN is obtained, this would not necessarily be evidence there is a new taxpayer. One can make a good argument that for example, the John Doe Trust fbo Jane is fundamentally a different taxpayer than the John Doe Trust fbo Child, since the fundamental relationship has changed, but I confess to no particular confidence as to the outcome on that issue.

¹⁴² 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.”

¹⁴³ Treas. Reg. § 1.1014-6(a)(1).

¹⁴⁴ Some LISI newsletters 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).

¹⁴⁵ Recent PLRs 2000-22035, 2001-04005, 2001-47044, 2009-49012 and 2010-39010 involve 5/5 powers and rights to withdrawal that lapse with the IRS implying or specifically concluding that §678(a)(2) applies. For discussion, see *The Beneficiary Defective Inheritor's Trust ("BDIT"): Finessing the Pipe Dream*, Richard A. Oshins, CCH Practical Strategies, November 2008, makes a convincing argument that a lapse should be considered a release, as does J. Blattmachr, Mitchell Gans and Alvina Lo, *A Beneficiary as Trust Owner: Decoding Section 678*, 35 ACTEC Journal 106, at 114 (Fall 2009). Also, Howard Zaritsky cites even more PLRs that I have not confirmed for this proposition that a lapse is a release for §678 purposes in *The Year in Review: An Estate Planner's Perspective on Recent Tax Developments*, TM Estates, Gifts and Trusts Journal (BNA) (1/13/2011): PLRs 2010-39010; 2007-47002; 2001-47044; 2001-04005;

2000-22035; 2000-11058, 200011054–200011056; 199942037; 199935046–199935047; 9812006; 9810006–9810008; 9810004; 9809005–9809008; 9745010; 9739026; 9625031; 9535047; 9504024; 9450014; 9448018; 9320018; 9311021; 9226037; 9140047; 9034004; 9009010; 8936031; 8827023; 8805032; 8701007; 8613054; 8521060; 8342088.

¹⁴⁶ There are always exceptions, even to irrevocable third party spendthrift trusts. California, e.g., may allow courts to access up to 25% of anticipated trust distributions to a debtor. 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.

¹⁴⁷ 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.”

¹⁴⁸ 11 U.S.C. §541(c)(2)

¹⁴⁹ 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.

¹⁵⁰ As mentioned prior, this latter point is debatable under plain meaning of the statute, even with dozens of PLRs holding that a lapse is the same as a

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

¹⁵¹ Treas. Reg. 1.671-2(e)(6), Example 9.

¹⁵² 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.

¹⁵³ Restat 3d of Trusts, § 57, comment d. “Solvency as a condition precedent. The terms of a trust can validly provide that a beneficiary who is not the settlor shall be entitled to the principal of the trust or other benefits only after the beneficiary becomes financially solvent or receives a discharge in bankruptcy.”

¹⁵⁴ 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.

¹⁵⁵ See Treas. Reg. §1.1001-2(c), Example 5.

¹⁵⁶ See *Using Standalone or Separate Trusts Solely to Receive Retirement Benefits*, by Edwin Morrow, Nov/Dec 2007 Journal of Retirement Planning, at http://ultimateestateplanner.com/wp-content/uploads/2014/07/UsingStandaloneTrusts_JORP_Nov2007.pdf, and *Ensuring the Stretchout*, by Phil Kavesh and Ed Morrow, Journal of Retirement Planning, July/Aug 2007, at

http://ultimateestateplanner.com/wp-content/uploads/2014/07/EnsuringTheStretchout_JORP_July2007.pdf.

¹⁵⁷ Treas. Reg. §1.401(a)(9)-5, Q&A7(c)(3), Examples 1 and 2 respectively.

¹⁵⁸ Rev. Rul. 85-13, 1985-1 C.B. 184, concludes that if a grantor is treated as the owner of a trust, the grantor is considered to be the owner of the trust assets for federal income tax purposes.

¹⁵⁹ In PLR 2011-16005, the IRS ruled that a proposed transfer of inherited IRAs to a special needs trust will not cause recognition of income in respect of a decedent (IRD) by the beneficiary, reasoning that, because the special needs trust was a grantor trust for income tax purposes, its assets are deemed to be owned by the beneficiary. See also PLR 2006-20025, PLR 2008-26008.

¹⁶⁰ 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.

¹⁶¹ From a statutory interpretation analysis, it's hard to morph the definition of a lapse into a release, despite the many, many PLRs so holding—Congress certainly knew how to distinguish between the two words, as evidenced by §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, however, and BDITs have certainly passed through audit without ill effect, but I still consider the lapse being deemed a release to be uncertain.

¹⁶² IRC §678(b), Treas. Reg. §1.678(b)-1

¹⁶³ 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).

¹⁶⁴ Treas. Reg. §1.671-4(b).