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## Structuring Tax-Efficient Trust Decantings After ‘the Guidance’

By Michael Borger  
Moritt Hock & Hamroff LLP

*In the aftermath of a much-referenced IRS Chief Counsel Advice, Moritt Hock & Hamroff’s Michael Borger analyzes the legal landscape and sets forth key planning considerations in structuring a trust decanting to achieve client objectives tax-efficiently.*

The publication of Chief Counsel Advice Memorandum [202352018](#) (“the CCA”) shook up the tax and estate planning community as it provided practitioners a glimpse into how the IRS may soon begin to analyze tax issues arising from a popular estate planning technique known as “trust decanting” — invading the corpus of one trust and transferring the assets into another — more than a decade after it had solicited public comments on the matter.

While some practitioners have called the CCA the “death of irrevocable trust decanting,” and others have opined that the CCA may have a “chilling effect” on estate planning attorneys and their clients on future trust decantings, the reality is that “the Guidance” did not directly involve the type of situation contemplated by the Notice — namely, a trust asset transfer resulting in a change of beneficial interest. Rather, it dealt with a trust modification authorizing the creation of a tax reimbursement clause for the benefit of the grantor, resulting in a gift tax being imposed on beneficiaries who expressly consented to the modification.

Which leaves practitioners navigating relatively uncharted trust decanting waters trying to avoid the potential tax consequences that were identified in the Notice.

### A Matter of Fiduciary Discretion

The power to decant typically arises where a trustee is given a special power of appointment over trust assets or if the governing instrument bestows discretion upon the trustee to invade trust corpus for the benefit of a class of beneficiaries. The authorized trustee transfers assets from

the “distributing” or “invaded” trust into the “receiving” or “appointed” trust.

There are virtually limitless scenarios in which an authorized trustee may want to effectuate a decanting or other form of trust modification, such as changing the situs, achieving favorable tax status, modifying trustee provisions, addressing complex family dynamics such as hostility among fiduciaries and beneficiaries, correcting or clarifying ambiguities in the trust, or even changing the beneficial interests of certain individuals.

Virtually all states have either recognized the power of a trustee to decant via the common law — i.e., in instances where the governing instrument grants the trustee the absolute discretion to invade the corpus of the trust — or have enacted statutes expressly authorizing the same.

While practitioners must make sure to adhere to the terms of the governing instrument and state law with respect to effectuating a trust decanting or modification, from a federal taxation standpoint, they must also beware that the process can lead to unintended tax consequences if not done properly.

### Longstanding ‘Materially Different’ Standard

*Cottage Savings Ass’n v. Commissioner* established that so long as the beneficial interests in the appointed trust are not “materially different” from that of the original invaded trust, there should be no taxable event following a trust decanting under the Internal Revenue Code (IRC).

The IRS has consistently taken the position that the Supreme Court’s decision in that 1991 case governs trust decantings. In [PLR 200607015](#), for example, the IRS stated:

“[I]t is consistent with the Supreme Court’s opinion in *Cottage Savings* to find that when Trust is divided into three successor trusts and the assets distributed into the successor trusts on a pro-rata basis, the division does not result in the realization or recognition of gain or loss.”

Thus, where a trust decanting was effectuated for the primary purposes of changing the situs of multiple trusts, implementing certain administrative modifications regarding individual and corporate trustees, appointing a new corporate trustee, and granting the trustee the power to terminate a trust under certain conditions, the IRS ruled

that the trustees' appointment of four trusts into four new trusts would not be viewed as a distribution or termination under §661 and should therefore not result in the realization of any income, gain, or loss by the invaded trusts, the appointed trusts, or any beneficiary thereof under [§661](#) and [§662](#).

### Issues Still Under Study

Following *Cottage Savings* and numerous private letter rulings (PLRs) addressing tax issues around trust decantings and modifications, the IRS in [Notice 2011-101](#) solicited public comments on a number of facts and circumstances that could result in tax consequences to the trust, grantor, and beneficiaries. This included situations in which a beneficiary's right to or interest in trust principal or income is changed (including the right or interest of a charitable beneficiary); trust principal or income may be used to benefit additional beneficiaries; and a beneficial interest (including any power to appoint income or corpus, whether general or limited, or other power) is added, deleted, or changed.

The Notice advised that while the IRS is studying these issues, it will not publish PLRs with respect to trust transfers that result in a change in beneficial interests, but will continue to do so with respect to such transfers where the beneficial interests and the applicable rule against perpetuities period remain unchanged.

Earlier that year, in [Rev. Proc. 2011-3](#), the IRS had affirmatively stated that it would not render any opinions or rulings concerning three specific issues arising as a result of a trust decanting, namely: (i) whether a trust decanting resulting in a change in beneficial interests is a distribution for which a deduction is allowable under §661 or which requires an amount to be included in the gross income of any person under §662; (ii) whether a trust decanting resulting in a change in beneficial interests is a gift under [§2501](#); and (iii) whether the distribution of property by a trustee from an irrevocable generation-skipping transfer tax (GST) exempt trust to another irrevocable trust resulting in a change in beneficial interests is the loss of GST exempt status or constitutes a taxable termination or taxable distribution under [§2612](#).

Thirteen years later, however, these issues are still under study, which is clear from [Rev. Proc. 2024-3](#), which states that the IRS will continue to refrain from rendering any opinions or rulings concerning the same issues arising in connection with trust decantings identified in the 2011 revenue procedure.

### The CCA Doesn't Specifically Address Trust Decanting

Just days before the publication of Rev. Proc. 2024-3, CCA 202352018 addressed the narrow issue of whether beneficiaries of a trust would incur gift tax consequences when the trustee of an irrevocable trust in which the grantor is treated as the owner, modifies the trust, with the consent of the beneficiaries, to add a tax reimbursement clause that provides the trustee the discretionary power to make distributions of income or principal from the trust in an amount sufficient to reimburse the grantor for the income tax attributable to the inclusion of the trust's income in the grantor's taxable income.

The CCA held that the modification to add the tax reimbursement clause will constitute a taxable gift by the trust beneficiaries because the addition of a discretionary power to distribute income and principal to the grantor is a relinquishment of a portion of the beneficiaries' interest in the trust. The result would be the same if the modification was pursuant to a state statute that provides beneficiaries with a right to notice and a right to object to the modification and a beneficiary fails to exercise their right to object.

Many commentators and practitioners sounded the alarms as the CCA seemingly gave a glimpse into the future of how the IRS will analyze the numerous trust decanting issues identified in the Notice. That is, a future without irrevocable trust decanting as a viably tax-efficient estate planning tool.

However, the CCA's subject transaction was merely a trust modification that resulted in "materially different" terms, and thus, undesirable tax consequences, and the IRS's position is consistent with that taken in numerous PLRs published since *Cottage Savings*.

### Key Planning Considerations

#### *Terms of Appointed Trust Must Not Be Materially Different From Invaded Trust*

Based on *Cottage Savings* and the PLRs rendered in its wake, practitioners seeking to avoid unintended tax consequences should exercise extreme caution in modifying any terms of the appointed trust that would result in any material change of any beneficial interest thereunder.

Thus, if the terms of the original trust provide that a trustee has absolute discretion to make payments of income to certain beneficiaries, the appointed trust should not provide that those same beneficiaries receive mandatory payments of income on a scheduled basis.

Likewise, if the beneficiary of the invaded trust was only entitled to receive discretionary payments of principal for the beneficiary's health, education, maintenance, and

support, the appointed trust should not provide that beneficiary with an annual annuity payment of a fixed percentage of the value of the principal, even if such terms was implemented for the practical purpose of removing discretion from a trustee or streamlining the administration of the trust.

Moreover, the appointed trust should not accelerate the time in which a beneficiary's interest will vest by removing age limitations or other contingencies.

*Shifting Beneficial Interest to Lower Generation Could Cause Grandfathered Trust to Lose GST Exemption*

The GST tax provisions set forth in the I.R.C. generally do not apply to any generation-skipping transfer under a trust that was irrevocable on September 25, 1985. These trusts are referred to as "exempt trusts" under the Treasury Regulations and, importantly, an exempt trust can lose its coveted status as a result of a decanting under certain circumstances.

Fortunately, [Reg. §26.2601-1](#) provides a safe harbor where a trust modification or decanting of an exempt trust will not cause it to lose its status if the modification does not shift a beneficial interest to any beneficiary who occupies a lower generation than the preceding holder(s) of that interest, so long as the vesting time is not extended.

Examples therein indicate that no loss of exempt trust status will result from the following modifications:

- Division of the exempt trust into multiple trusts, so long as the terms of the appointed trust do not shift any beneficial interest in the trust to a beneficiary who occupies a lower generation;
- Merger of two trusts into one trust to save administrative costs and enhance the management of the investments;
- Modification to allow a trustee to allocate capital gains to the income; and
- Modification pertaining to the administration of the exempt trust, such as decreasing the number of trustees to achieve lower administrative costs.

It is worth noting that while a trust decanting that results in a change in situs to a new jurisdiction will not necessarily make an exempt trust lose its status, it will do so if the new jurisdiction extends the time for vesting beyond the period prescribed under the terms of the original trust instrument.

*Appointed Trust Must Include Qualifying Language to Maintain Zero Exclusion Ratio of Annual GST Exclusion Gifts*

[Section 2642\(c\)\(2\)\(A\)](#) provides that in order for the GST tax annual exclusion to apply to transfers into a trust, the following terms must be included:

1. During the beneficiary's lifetime, no portion of the corpus or income of the trust may be distributed to (or for the benefit of) any person other than such beneficiary; and
2. If the trust does not terminate before the beneficiary dies, the assets of such trust must be includible in the gross estate of such beneficiary.

Thus, in order to qualify for future annual GST exclusion gifts, the appointed trust should maintain separate shares for each beneficiary holding a withdrawal right, and the interest in each share should be limited to said beneficiary — not their issue — especially if the grantor's GST lifetime exemption is exhausted.

*New Trustee Provisions Must Be Carefully Drafted to Avoid Inadvertent Change of Beneficial Interests*

In [PLR 200743022](#), the IRS took the position that no taxable event has occurred as a result of modifications and provisions where:

- Trustee administrative provisions in each of the new trusts are amended to permit the surviving trustees to continue to appoint individuals as successor trustees whenever there is a vacancy;
- The new trusts will allow the trustees to calculate individual trustees' fees under an external standard that sets a ceiling on trustee compensation;
- The terms of the new trusts require that the new trustees not be related or subordinate to the beneficiaries; and
- No beneficiary or potential beneficiary of the new trusts may serve as a trustee.

It is important to note that while the IRS placed favorable weight on the fact that the appointed trust prohibited beneficiaries from serving as trustees thereunder, [PLR 200420011](#) explained that under Cottage Savings, allowing each child and grandchild to serve as trustee of their subtrust is merely a change in the way that the new trusts are administered and would not be considered "materially different" because "the amounts that will be paid to the beneficiaries will continue to be controlled by the terms of the trust, and the children and grandchildren will be required to continue to exercise the

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same standard of fiduciary responsibility as the trustee previously exercised with respect to Trust.”

Thus, practitioners who wish to decant trusts for the purposes of changing trustee provisions should be careful to ensure that the trustees of the appointed trust do not have any more discretion to make distributions than in the original invaded trust.

### *Trust Modifications Benefiting Grantor May Result in Gift Tax*

As explained above, the CCA took the position that in a scenario in which the grantor is treated as the owner of the income for purposes of income taxation, and upon consent of the beneficiaries, the trust was modified to authorize the trustees to make distributions of income or principal for the purposes of reimbursing the grantor for the payment of any tax liability which he incurs as the result of the grantor being considered the owner of the trust for income tax purposes, such a provision will constitute a taxable gift by the beneficiaries as a result of their relinquishment of a portion of their interest for the benefit of the grantor.

Thus, practitioners should be mindful of the consequences of modifying a trust to add a provision which benefits the grantor at the expense of the beneficiaries, as this will likely result in a gift tax consequence to the beneficiaries of the trust.

Additionally, in accordance with state law or the terms of the governing instrument, a beneficiary should be advised to either withhold consent or affirmatively object to the decanting if the imposition of a gift tax is not acceptable.

### *Timely File Gift Tax Return to Limit Window for IRS Scrutiny*

While the IRS generally has three years from the filing of a gift tax return to assess additional tax, if no return is filed, or if the gift is not adequately disclosed on or with the gift tax return, then the IRS may assess at any time. Thus, the adequate disclosure of a completed transfer on a gift tax return will commence the running of the period of limitations for assessment of gift tax on the transfer even if the transfer is ultimately determined to be an incomplete gift. See the Tax Court’s decision in [\*Schlapfer v. Commissioner\*](#) (2023).

Accordingly, practitioners who are concerned about the potential for the IRS to later determine that a trust decanting or modification resulted in a taxable gift, the timely filing of a gift tax return which asserts that the transaction was not a gift will not only help to establish a record of the transaction and clarify this position with the IRS, but also start the statute of limitations on any possible gift tax issues related to the modification or decanting.

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### **Author Information**

[Michael J. Borger, Esq., LL.M.](#), is an associate member of the Institutional and Corporate Fiduciary Group with Moritt Hock & Hamroff LLP.