September 11, 2012

Room 5203
Internal Revenue Service
PO Box 7604
Ben Franklin Station
Washington, D.C. 20044

Re: Notice 2011-101, Transfers by a Trustee From an Irrevocable Trust to Another Irrevocable Trust (Sometimes called “Decanting”)

Ladies and Gentlemen:

These comments are submitted on behalf of the American Bar Association Section of Real Property, Trust and Estate Law Section (RPTE) in response to the request by the Internal Revenue Service for comments regarding Notice 2011-101, Transfers by a Trustee From an Irrevocable Trust to Another Irrevocable Trust (Sometimes called “Decanting”). These Comments represent the views of the RPTE Section only and have not been approved by the ABA’s House of Delegates or Board of Governors and therefore do not represent and should not be construed as representing the position of the ABA.

The Comments were prepared by a working group comprised primarily of members of the Generation Skipping Transfer Tax Committee of the Income and Transfer Tax Planning Group of the RPTE Section. The working group was chaired by Amy E. Heller and Rana H. Salti. Significant drafting contributions also were made by William R. Culp, Anthony L. Engel, Meryl G. Finkelstein, Todd A. Flubacher, Kimberly M. Gill, Toni Ann Kruse, Briani Bennett Mellen, Thomas R. Pulsifer, J. Clare Rose, and James P. Spica. The Comments were reviewed by Carlyn S. McCaffrey on behalf of the Section’s Committee on Governmental Submissions and by Gideon Rothschild on behalf of the Section’s Executive Committee.
Although the attorneys who participated in preparing these Comments have clients who may be affected by the legal issues addressed by the Comments, no such member (or firm or organization to which any such member belongs) has been engaged by a client to make a submission with respect to, or otherwise influence the development or outcome of, the specific subject matter of these Comments.

The Committee and the RPTE Section appreciate the opportunity to submit these Comments, and we respectfully request that the Service consider our recommendations. Members of the Committee and the RPTE Section are available to meet and discuss these matters with the Service and its staff and to respond to any questions. The principal contacts for discussion are listed below.

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Very truly yours,

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The following comments (“Comments”) are submitted on behalf of the American Bar Association Section of Real Property, Trust and Estate Law (the “Section”). Neither the House of Delegates nor the Board of Governors of the American Bar Association approved the Comments. The Comments should not be construed as representing the position of the American Bar Association.

The Comments were prepared by a working group comprised primarily of members of the Generation Skipping Transfer Tax Committee of the Income and Transfer Tax Planning Group of the Real Property, Trust and Estate Law Section of the American Bar Association. The working group was chaired by Amy E. Heller and Rana H. Salti. Significant drafting contributions also were made by William R. Culp, Anthony L. Engel, Meryl G. Finkelstein, Todd A. Flubacher, Kimberly M. Gill, Toni Ann Kruse, Briani Bennett Mellen, Thomas R. Pulsifer, J. Clare Rose, and James P. Spica. The Comments were reviewed by Carlyn S. McCaffrey on behalf of the Section’s Committee on Governmental Submissions and by David M. English and Gideon Rothschild on behalf of the Section’s Executive Committee.

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Date: September 11, 2012

¹ One of the attorneys who participated in drafting the Comments also participated in the preparation New York State Bar Association Tax Section and Trusts and Estates Law Section Report on Notice 2011-101 (April 26, 2012), hereinafter referred to as the “NYSBA Report.” Portions of the text drafted by this attorney in connection with the NYSBA Report are included in these Comments.
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COMMENTS

1. Overview of Trust Decanting

1.1 Description of Decanting

“Decanting” generally refers to the exercise of a discretionary fiduciary power to distribute some or all of the assets from one trust (a “Distributing Trust”) to another trust (a “Receiving Trust”). Decanting authority can be conferred by common law, statute or by the terms of a trust instrument. Decanting powers may be exercised for a variety of reasons, including to address changed circumstances, divide or combine trusts, implement administrative changes, or correct drafting errors.  

1.2 Common Law Authority for Decanting

Any discretionary power of a trustee to distribute trust assets is a special power of appointment within the meaning of many states’ powers of appointment laws and is so classified by the Restatement (Second) of Property: Donative Transfers and Restatement (Third) of Property: Wills and Other Donative Transfers (collectively, the “Restatements”). The Restatements both assert that this special power of appointment implies the power to decant:

Except to the extent that the donor has manifested a contrary intention, the donee of a nongeneral power is authorized to make an appointment in any form, including one in trust . . . that only benefits permissible appointees of the power.

Accordingly, in the view of the Restatements, unless the trust instrument that created the power specifically prohibits decanting, a trustee’s power to make discretionary distributions (as a special power of appointment) includes the power to make distributions in trust for permissible distributees.

Case law in Florida and New Jersey reinforces the Restatements’ view. In Phipps v. Palm Beach Trust Co., the Supreme Court of Florida held that a trustee with “sole absolute discretion” to direct distributions of trust assets for the benefit of one or more of the settlor’s descendants was permitted to direct that such distributions be made in trust. The court explained that a fiduciary power to transfer a fee simple interest in trust assets (i.e., to make outright distributions) includes the power to create any lesser estate (i.e., to make distributions in

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3 See RESTATEMENT (SECOND) OF PROP.: DONATIVE TRANSFERS § 11.1 cmt. d (1986); RESTATEMENT (THIRD) OF PROP.: WILLS & OTHER DONATIVE TRANSFERS § 17.1 cmt. g (2011).
5 Phipps v. Palm Beach Trust Co., 196 So. 299 (Fla. 1940).
trust) unless the trust instrument clearly expresses a contrary intent. In *Wiedenmeyer v. Johnson*, the Appellate Division of the New Jersey Superior Court concluded that trustees who had the “absolute and uncontrolled discretion” to distribute trust assets as they deemed to be “in the best interests” of a beneficiary (but no specific power to decant) had the ability to distribute assets to the beneficiary subject to his obligation to distribute assets to a trust for his benefit.\(^6\)

### 1.3 Statutory Authority for Decanting

To date, seventeen states have enacted decanting legislation. Decanting statutes permit a trustee who has the authority to invade the principal, and in some cases the income, of an existing trust to exercise that authority by transferring some or all of the assets of the trust in further trust.

The first state decanting statute, New York Estates Powers and Trusts Law Section 10-6.6(b), became effective on July 24, 1992. Since the enactment of the New York statute, sixteen other states – Alaska,\(^7\) Delaware,\(^8\) Florida,\(^9\) Tennessee,\(^10\) South Dakota,\(^11\) New Hampshire,\(^12\) North Carolina,\(^13\) Arizona,\(^14\) Nevada,\(^15\) Indiana,\(^16\) Missouri,\(^17\) Ohio,\(^18\) Virginia,\(^19\) Kentucky,\(^20\) and, most recently, Rhode Island\(^21\) and Illinois\(^22\) – have enacted decanting statutes.

The rationale that generally underlies state decanting statutes is that a trustee who has the discretion to distribute trust property to or for the benefit of one or more beneficiaries of a trust has a special power of appointment over the trust property that allows the trustee to distribute the trust property not only outright to the beneficiaries of the Distributing Trust, but also to another trust for the benefit of one or more beneficiaries. As a result, under the majority of the state decanting statutes, the trustee’s power to appoint property to a new trust is expressly equivalent to the exercise by the trustee of a non-general power of appointment.\(^23\)

\(^7\) Alaska Stat. §13.36.157.
\(^8\) 12 Del. C. §3528.
\(^12\) S.D. Codified Laws §§55-2-15 to 5-2-21.
\(^14\) N.C. Gen. Stat. §36C-8-816.1.
\(^17\) Ind. Code §30-4-3-36.
\(^18\) Mo. Uniform Trust Code §456.4-419.
\(^21\) Ky. Prop. § 386. KRS; HB 155 (2012).
\(^23\) This is specifically provided for under nearly all of the state decanting statutes except for a few, including Tennessee, New Hampshire, Missouri and Ohio.
Although the decanting statutes differ in their specific approaches, many of them contain certain common provisions, including those addressing: (i) the level of discretion that the trustee must hold with respect to the power to invade the Distributing Trust, (ii) whether a decanting power may also be based upon a discretionary power to distribute trust income, (iii) the persons for whose benefit the power to invade the Distributing Trust may be exercised and the permissible beneficiaries of the Receiving Trust, (iv) limitations on the trustee’s exercise of the power that are intended to preserve certain tax benefits of the Distributing Trust such as marital and charitable deductions and gift tax annual exclusions, (v) restrictions on the ability of a beneficiary-trustee to exercise a decanting power, and (vi) the procedural aspects of the trustee’s exercise of the decanting power, including method of exercise, notice to beneficiaries, consent and court filing requirements.

Under some decanting statutes, a trustee’s power to invade principal must be “absolute” or unlimited. The vast majority of statutes permit a decanting power to be exercised even if a standard for invasion of trust assets (such as an ascertainable standard) is set forth in the trust instrument. The Alaska and New York statutes require that an invasion standard that appears in the trust instrument of the Distributing Trust must be included in the trust instrument of the Receiving Trust, while the Arizona statute requires that the standard included in the instrument of the Receiving Trust be the same as or more restrictive than the standard provided for in the instrument of the Distributing Trust where the trustee exercising the decanting power is a possible beneficiary under the standard.

All of the decanting statutes apply to a trustee’s discretionary authority to distribute trust principal. In addition, certain state statutes, including the Nevada, North Carolina, South Dakota and Missouri statutes, expressly permit the decanting of trust income. The Arizona and New Hampshire statutes do not distinguish between income and principal as they refer only to the trustee’s power to make distributions from the Distributing Trust.

Virtually all of the decanting statutes require that the power to distribute in further trust be exercised in favor of one or more of the beneficiaries of the Distributing Trust. This generally allows the Receiving Trust to eliminate as beneficiaries one or more beneficiaries of the Distributing Trust. In addition, most of the statutes either expressly or impliedly prohibit the addition of new beneficiaries in the Receiving Trust, but certain statutes permit the interests of remainder beneficiaries of the Distributing Trust to be accelerated under the Receiving Trust. In addition, some statutes permit beneficiaries to be added by permitting the Receiving Trust to grant a current beneficiary of the Distributing Trust a limited power of appointment exercisable in favor of persons who are not beneficiaries under the Distributing Trust.

See, e.g., Florida, Indiana and Ohio.


See, e.g., South Dakota and Missouri.

See, e.g., Delaware, Nevada, New York and North Carolina. Even if a decanting statute does not explicitly give a trustee the power to grant a beneficiary a power of appointment, such a power may exist under common law. See In re Hatch (Moore), 493 N.Y.S.2d 924 (N.Y. Sup. Ct. 1985), which allowed the donee of a general power of appointment that had been partially converted to a special power to create in a permissible appointee under her power a new special power of that included persons who were not objects of the original power. The
Many of the statutes, particularly the more modern statutes, contain provisions intended to preserve tax benefits available to the Distributing Trust, including marital and charitable deductions and annual gift tax annual exclusions. Many (but not all) statutes also contain provisions that prevent the Receiving Trust from extending the permissible period of the rule against perpetuities applicable to the Distributing Trust.

Under all of the decanting statutes, the power to distribute in further trust must be exercised by the trustee of the Distributing Trust, not by its beneficiaries. Where the trustee is also a beneficiary of the trust, some statutes, such as those enacted in Nevada, New York, New Hampshire, North Carolina, South Dakota and Missouri, specifically restrict (or even prohibit) such beneficiary-trustee’s ability to decant.

The statutes also contain varying provisions relating to the method by which a trustee must exercise a power to distribute in further trust, whether notice of the decanting must be given to the beneficiaries of the Distributing Trust and the contents of such notice, and whether court approval of a proposed decanting is required. None of the decanting statutes require beneficiary consent, except the Nevada statute, which requires consent in the limited circumstance where property is specifically allocated for one beneficiary of the Distributing Trust and is no longer allocated for that beneficiary under either the Distributing Trust or the Receiving Trust.

2. Income Tax Issues

The exercise of a power by a trustee to distribute assets from a Distributing Trust to a Receiving Trust raises a number of income tax issues. Section 2.1 addresses issues related to the fiduciary income tax consequences of such a distribution. Section 2.2 addresses issues
related to potential gain recognition by the beneficiaries of the Distributing Trust or by the Distributing Trust itself. Section 2.3 addresses the identity of the grantor following the distribution.

2.1 Fiduciary Income Tax Consequences

Under the rules of Subchapter J of Chapter 1 of the Internal Revenue Code, a distribution from a complex trust generally will carry out a share of the trust’s distributable net income, or DNI, to the beneficiary to whom the distribution is made. The beneficiary, in turn, generally will be required to include in gross income an amount equal to the share of the DNI carried out from the trust. If the trust making the distribution is a foreign trust, the distribution also may carry out a share of the trust’s undistributed net income, or UNI, which will be taxed to the beneficiary as an accumulation distribution, subject to an interest charge.

There does not appear to be any authority that specifically provides that the rules of Subchapter J apply to a decanting distribution from a Distributing Trust to a Receiving Trust. However, the Treasury Regulations and case law indicate that a trust can be a beneficiary of another trust, with the rules of Subchapter J applicable to a distribution to the beneficiary trust. As a general rule, we believe that it is appropriate for the rules of Subchapter J to apply to a decanting distribution from one trust to another trust.

An exception to this general rule, however, may be appropriate when all of the assets of a Distributing Trust are distributed to a Receiving Trust having substantially similar terms. In this case, it seems appropriate to view the Receiving Trust simply as a continuation of the Distributing Trust, such that the distribution to the Receiving Trust does not carry out DNI (or UNI if the Distributing Trust is a foreign trust). This result is consistent with the conclusion reached by the Internal Revenue Service in Private Letter Ruling 200607015.

If all of the assets of a Distributing Trust are distributed to one or more Receiving Trusts, there also is a question as to whether the Receiving Trust or Trusts should succeed to the Distributing Trust’s tax attributes, such as its net operating loss carryovers, its capital loss carryovers and its foreign tax credit carryovers. The Code specifically provides that on the termination of a trust, unused net operating loss carryovers and capital loss carryovers pass out to the trust’s beneficiaries. There does not appear to be specific authority addressing the transfer

37 References to the “Code” are to the Internal Revenue Code of 1986, as amended, references to “Treas. Reg.” are to the Treasury regulations promulgated under the Code.
38 Code §661.
39 Code §662.
40 Code §§665-668.
41 See Treas. Reg. § 1.643(c)-1, which provides that for purposes of Part I of Subchapter J (which includes the fiduciary income tax rules described above), a beneficiary includes an “heir, legatee or devisee (including an estate or trust)” (emphasis added). See also Duke v. Comm’r, 38 BTA 1264, 1269 (1938); Comm’r v. Bishop Trust Co., 136 F2d 390 (9th Cir. 1943), aff’d 42 BTA 1309 (1940); Harwood Estate v. Comm’r, 3 TC 1104 (1945); White Estate v. Comm’r, 41 BTA 525 (1939); Lynchburg Tr. & Sav. Bank v. Comm’r, 68 F2d 356 (4th Cir. 1934).
42 See also Priv. Ltr. Rul. 200723014 (June 8, 2007) and Priv. Ltr. Rul. 200527007 (July 8, 2005).
43 Code §642(h); Treas. Reg. §1.642(h)-3(d).
of other tax attributes to beneficiaries upon the termination of a trust. At a minimum, if all of the assets of a Distributing Trust are distributed to a Receiving Trust that has substantially similar terms and that is viewed as a continuation of the Distributing Trust, we believe that the Receiving Trust should succeed to all of the Distributing Trust’s tax attributes.44

2.2 Gain Recognition

In a number of Private Letter Rulings, the IRS has addressed whether a distribution from one trust to another trust causes gain to be recognized under Code §1001.45 In considering possible gain recognition on such a distribution, there are two separate issues – first, whether gain should be recognized by the beneficiaries of the Distributing Trust, and second, whether gain should be recognized by the Distributing Trust itself.

2.2.1 Gain Recognition by Beneficiaries

As a general matter, gain or loss is realized under Code §1001 upon the conversion of property into cash or upon the exchange of property for other property that differs materially in either kind or extent.46 In Cottage Savings v. Comm’r,47 the U.S. Supreme Court adopted a liberal test for when property received in an exchange would be considered to be materially different from the property transferred. The Court determined that “properties are ‘different’ in the sense that is ‘material’ to the Internal Revenue Code so long as their respective possessors enjoy legal entitlements that are different in kind or in extent.”48

A number of Private Letter Rulings released after the Cottage Savings decision suggest that a distribution from one trust to another might constitute a taxable exchange of an interest by each beneficiary of a Distributing Trust for an interest in a Receiving Trust if the beneficiary’s new interest is “materially different” from its old interest.49 In each of these rulings, the IRS found that the beneficiary’s interests in the two trusts were not materially different and therefore that the beneficiary did not recognize gain. We believe that even in a situation where a beneficiary’s interests in a Distributing Trust and a Receiving Trust do differ materially, a decision by a trustee to decant trust property should not result in gain recognition to the beneficiary. Unlike a holder of securities in Cottage Savings, a beneficiary of a trust that is

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44 Allowing a Receiving Trust to succeed to the tax attributes of a Distributing Trust, even if the terms of the trusts are not substantially similar, would be consistent with other areas of the tax law. For example, if a private foundation transfers all of its assets to one or more private foundations that are effectively controlled by the same persons that control the transferor private foundation, the transferee private foundation is treated as if it were the transferor for purposes of Chapter 42 of the Code. See Treas. Reg. §1.507-3(a)(9). Similarly, in the case of a corporate reorganization, a successor corporation generally succeeds to the tax attributes of a terminating corporation. See Code §381.


48 Id. At 565.

decanted by a trustee has not exchanged any interest. Rather, the trustee has taken the action that causes the property to be distributed from the Distributing Trust to the Receiving Trust.

Other Private Letter Rulings issued by the IRS have been consistent with this view. These rulings indicate that a beneficiary will not recognize gain in the case of a distribution to another trust that is authorized by the trust instrument or by local law. These rulings also are consistent with Treas. Reg. §1.1001-1(h), which provides that a non-pro rata severance of a trust does not constitute an exchange of property for other property differing materially either in kind or extent if applicable state law or the governing instrument authorizes the severance and the non-pro rata funding.

The only authority of which we are aware that suggests that gain may be recognized by a beneficiary on a distribution from one trust to another is Rev. Rul. 69-486. This Revenue Ruling indicates that a distribution may result in gain recognition to a beneficiary in a narrow set of circumstances, specifically where the distribution (1) occurs as a result of an agreement by the beneficiaries and, in addition, (2) is not authorized under the terms of governing instrument or applicable state law. Accordingly, based on Rev. Rul. 69-486, even in a situation where beneficiaries act to effectuate a distribution from one trust to another or where their consent to the distribution is required as a matter of law, we believe that gain should not be recognized as long as the distribution is authorized under the terms of the governing instrument or local law. This conclusion is consistent with Cottage Savings, given that, in such a situation, the beneficiaries’ legal entitlements in the Distributing Trust include the right to have assets distributed to the Receiving Trust.

### 2.2.2 Gain Recognition by the Distributing Trust

There is also a question as to whether a Distributing Trust recognizes gain when appreciated trust assets are distributed to a Receiving Trust. We believe that, as a general matter, there should be no gain recognized by a Distributing Trust in such a situation.

If both the Distributing Trust and the Receiving Trust are grantor trusts deemed owned by the same person for income tax purposes, no gain should be recognized on the distribution based on principles of Rev. Rul. 85-13. Moreover, regardless of whether the Distributing

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51 1969-2 CB 159.

52 Even in a situation where a distribution from one trust to another occurs as a result of an agreement by beneficiaries and is in contravention of the terms of a trust agreement or local law, if the beneficiaries’ interests in the Distributing Trust and the Receiving Trust are discretionary rather than fixed, it would be difficult to conclude that the beneficiaries’ legal entitlements have been modified. A discretionary beneficiary generally has no legal entitlement to trust distributions.

53 See also Treas. Reg. §1.1001-3(c)(1)(ii), which provides that an alteration of a legal right or obligation that occurs pursuant to the terms of a debt instrument generally is not a modification of the instrument that will cause recognition under Code §1001, whether the alteration occurs automatically by operation of the terms of the debt instrument or whether it occurs as a result of the exercise of an option provided to an issuer or a holder to change the terms of the instrument.


55 1985-1 CB 184.
Trust and the Receiving Trust are grantor trusts deemed owned by the same person, no gain should be recognized for the same reason that no gain is recognized when a settlor transfers property to a domestic non-grantor trust. There is no amount realized by the settlor, because the settlor is considered to receive nothing in exchange for the transfer. Nonrecognition treatment also is consistent with CCA 200923024, which concludes that the conversion of a nongrantor trust to a grantor trust is not a transfer of property that requires gain to be recognized.

There are two possible exceptions to the general result of nonrecognition on a transfer of appreciated property from one trust to another. The first such exception results from the application of Code §684. Under Code §684, if a U.S. person transfers property to a foreign nongrantor trust, the transfer is treated as a sale or exchange for an amount equal to the fair market value of the property transferred, with the transferor recognizing gain. Accordingly, a distribution of appreciated assets from a Distributing Trust that is a domestic trust to a Receiving Trust that is a foreign nongrantor trust will result in gain recognition under Code §684. We note that if a transfer of property to a trust were generally to result in the recognition of gain, the special rule of Code §684 would not be necessary.

A second possible exception to nonrecognition on a transfer of appreciated property from one trust to another may apply in a situation where the property that is transferred is encumbered with debt in excess of basis or is a partnership interest with a negative capital account. In such a case, gain may result based on principles of Crane v. Commissioner. In Crane v. Commissioner, the Supreme Court held that a taxpayer’s amount realized includes recourse and nonrecourse liabilities from which the taxpayer is discharged. Based on Crane, the IRS has concluded in several instances that a termination of grantor trust status results in gain recognition if the trust holds property having liabilities in excess of basis or partnership interests with negative capital accounts.

It is not clear, however, that Crane and its progeny are applicable to a distribution from a nongrantor trust. This is because of Code §643(e), which provides that gain generally is not recognized on a distribution of appreciated property from a non-grantor trust. There does not appear to be any authority as to whether Crane overrides Code §643(e). We recommend that

56 June 5, 2009.
57 331 U.S. 1 (1947).
58 See also Treas. Reg. §1.1001-2(a)(1), which provides that “the amount realized from a sale or other disposition of property includes the amount of liabilities from which the transferor is discharged as a result of the sale or disposition.”
60 Code §643(e) is not applicable in a case where the Distributing Trust is a grantor trust. This is because Code §643(e) applies for purposes of Subparts A, B, C and D of Part I of Subchapter J. The grantor trust rules are found in Subpart E of Part I of Subchapter J. Accordingly, in the case of a distribution of property encumbered with debt in excess of basis or negative capital account partnership interests from a grantor trust to a non-grantor trust or to a grantor trust deemed owned by a different person, gain may be recognized under principles of Crane.
61 Under Code §643(e), gain is recognized on a distribution of appreciated property from a trust if an election is made to recognize gain under Code §643(e)(3) or if the distribution of appreciated property is made in satisfaction of a pecuniary amount. Code §643(e)(1) provides that “the basis of any property received by a beneficiary in a distribution from an estate or trust shall be (A) the adjusted basis of such property in the hands
any forthcoming IRS guidance address this point. However, regardless of whether Crane trumps Code §643(e), if all of the assets of a Distributing Trust are distributed to a Receiving Trust that is viewed as a continuation of the Distributing Trust (as described above in Section 2.1) or if both the Distributing Trust and the Receiving Trust are grantor trusts deemed owned by the same person, gain should not be recognized on the distribution.

2.3 Identity of the Grantor

If property is distributed from one trust to another trust, it is important to be able to identify the “grantor” of the Receiving Trust for income tax purposes. Among other reasons, identifying the grantor of the Receiving Trust may be necessary in order to determine whether the Receiving Trust is a grantor trust under Code §§671 through 679.

Treas. Reg. §1.671-2(e)(5) provides that if a trust makes a transfer to another trust, the grantor of the Distributing Trust generally will be treated as the grantor of the Receiving Trust. There is an exception to this general rule if property is distributed from a Distributing Trust to a Receiving Trust pursuant to the exercise of a general power of appointment. In such a case, the person exercising the power of appointment will become the grantor of the Receiving Trust. This result is consistent with Code §2514, which provides that a person who exercises a general power of appointment will be treated as making a transfer of property for gift tax purposes.

We generally agree with the positions taken in the regulations on this issue. However, we believe further refinement is needed in circumstances where a transfer from a Distributing Trust to a Receiving Trust is treated, in whole or in part, as a gift by a trust beneficiary who does not hold a general power of appointment over the Distributing Trust. An example would be a situation in which the consent of a mandatory income beneficiary of a Distributing Trust were required in order to distribute assets to a Receiving Trust. In this case, the beneficiary would be treated as making a taxable gift to the Receiving Trust equal to the value of his or her income interest in the Distributing Trust. It seems to follow that the income beneficiary of the Distributing Trust should be treated as the grantor for the portion of the Receiving Trust attributable to his or her transfer.

3. Gift Tax Issues

Under Code §2512, a gift arises when property is transferred for less than adequate and full consideration in money or money’s worth. The gift tax is imposed on the donor’s act of making a transfer rather than on the receipt of property by the donee. While both direct and

of the estate or trust immediately before the distribution, adjusted for (B) any gain or loss recognized by the estate or trust on the distribution” (emphasis added). It is not clear whether the basis increase in respect of gain recognized on the distribution relates only to a basis increase resulting from gain that is recognized as a result of the application of Code §643 (e.g., because an election is made to recognize gain under Code §643(e)(3)).

Similar uncertainty exists in other situations, such as where an installment note is transferred from a Distributing Trust to a Receiving Trust that is not a grantor trust deemed owned by the same person. In such a case, it is not clear whether Code §453B(a) would override Code §643(e) and cause gain to be recognized.

See Code §2502(c), which provides, “The tax imposed by section 2501 shall be paid by the donor.” See also Treas. Reg. § 25.2511-2(a).
indirect gifts may be subject to the gift tax, in order for a gift tax to be imposed, there must be a voluntary and intentional act of transfer.\textsuperscript{64}

We believe that a decanting distribution from a Distributing Trust to a Receiving Trust should result in the imposition of a gift tax in only limited circumstances. Section 3.1 addresses the gift tax consequences of an exercise of a decanting power by a trustee who is not a beneficiary of a Distributing Trust. Section 3.2 addresses the gift tax consequences of a decanting by a trustee who also has a beneficial interest in the Distributing Trust. Section 3.3 examines the special case of a decanting that creates a power of appointment and the so-called “Delaware tax trap.” Section 3.4 addresses the elimination of a power of appointment.

### 3.1 Decanting by a Trustee who is not a Beneficiary

As a general matter, a trustee’s exercise of a discretionary power to distribute trust assets in a manner that favors one or more beneficiaries over other beneficiaries does not give rise to a taxable gift.\textsuperscript{65} If, however, the terms of applicable state law or a trust instrument require that a beneficiary consent to a decanting, and the beneficiary in fact consents in a manner that reduces his or her beneficial interest, the beneficiary may be deemed to make a transfer that is subject to the gift tax.\textsuperscript{66}

As described above in Section 1.3, we are aware of only one state statute that requires that beneficiaries consent to a decanting, and only under limited circumstances.\textsuperscript{67} A number of state statutes, however, require that notice of a decanting be given to the beneficiaries of a Distributing Trust.\textsuperscript{68} The receipt of notice of a decanting does not give beneficiaries a legal right to prevent a decanting, as long as the trustee’s exercise of the decanting power is consistent with the terms of applicable state law or the governing instrument and is not an abuse of discretion.\textsuperscript{69}


\textsuperscript{65} See Treas. Reg. § 25.2511-1(g)(1), which provides that a transfer by trustee who has no beneficial interest in property is not gift by trustee.

\textsuperscript{66} See Cerf v. Comm'r, 141 F.2d 564 (3d Cir. 1944) (holding that a beneficiary’s consent to an amendment of trust that eliminates the beneficiary’s control over the right to receive income constitutes a taxable gift). But see Estate of Franklin Lewis Hazelton, 29 T.C. 637 (1957) (holding that where, at the request of a beneficiary, a trustee of a trust transferred property to a new trust that had been created by the beneficiary in order to enlarge the beneficial interest of another person in the original trust did not result in a deemed gift by the beneficiary) and Matthew Lahti, 6 T.C. 7 (1946). See also Code §2514(b) and Treas. Reg. §25.2514-3(b).

\textsuperscript{67} See Nev. Rev. Stat. §163.556(2)(e), which requires a beneficiary to consent to a decanting if property specifically allocated to the beneficiary under the terms of the trust agreement of the Distributing Trust ceases to be allocated to the beneficiary under the terms of the trust agreement Receiving Trust. If the consent of a beneficiary were required in order to enlarge (rather than reduce or eliminate) the beneficiary’s interest, arguably the beneficiary would have a general power of appointment over all or a portion of the Distributing Trust. See Treas. Reg. §25.2514-3(b) (discussed further below in Section 3.2).

\textsuperscript{68} The statutes of Florida, Indiana, Missouri, New Hampshire, New York, North Carolina and South Dakota statutes contain beneficiary notice provisions. FLA. STAT. § 736.04117(4) (2012); S.D. CODIFIED LAWS §§ 55-2-18 (2011); N.H. REV. STAT. ANN. § 564-B: 4-418(d) (2012); N.C. GEN. STAT. § 36C-8-816.1(f)(2) (2012); IND. CODE § 30-4-3-36(e) (2012); MO. REV. STAT. § 456.4-419.3. (2011).

\textsuperscript{69} Restatement (Third) of Trusts §50.
Accordingly, a beneficiary who receives notice of a decanting does not make a voluntary transfer to other beneficiaries simply because he or she received notice of the decanting. Furthermore, even in a situation where a trustee exercises a decanting power in a manner that is not consistent with the terms of applicable law or the trust’s governing instrument or is an abuse of discretion, no gift should result by a beneficiary who does not exercise a right to object to the decanting if the beneficiary lacks the information required to know that the decanting was unauthorized or if the potential costs of preventing or reversing the decanting could reasonably exceed the benefits to the beneficiary.\textsuperscript{70}

We also believe that a decanting should not result in a taxable gift under any circumstances if the decanting results only in changes to a trust’s administrative provisions or otherwise does not modify the beneficial interests of beneficiaries who consent to the decanting.\textsuperscript{71}

Similarly, if a beneficiary whose interest is reduced in a decanting consents to the decanting at the trustee’s request or agrees to release the trustee, we believe that the beneficiary should not be deemed to make a taxable gift as long as the decanting could have been effectuated by the trustee under the terms of the trust instrument or state law without the beneficiary’s consent.

3.2 Decanting by a Trustee who is a Beneficiary

If a trustee who also is a beneficiary exercises a decanting power in a manner that decreases his or her beneficial interest in a trust, he or she may make a taxable gift to other beneficiaries.\textsuperscript{72}

\textsuperscript{70} See I.R.S. Gen. Couns. Mem. 38584 (Dec. 10, 1980) (recognizing that under certain circumstances, permitting the statute of limitations to expire on a previously enforceable debt may not result in a gift if the lapse of the limitations period was allowed in the ordinary course of business, as described by Treas. Reg. § 25.2512-8); \textit{See also} Treas. Reg. § 25.2512-8 (“[A] sale, exchange, or other transfer of property made in the ordinary course of business (a transaction which is bona fide, at arm’s length, and free from any donative intent), will be considered as made for an adequate and full consideration in money or money’s worth). \textit{But see} Rev. Rul. 86-39, 1986-1 CB 300 (where a surviving spouse had an enforceable right to require that a marital trust be adequately funded, the spouse’s failure to enforce such right under local law resulted in a taxable gift by the spouse of the underfunded amount).

\textsuperscript{71} See \textit{e.g.}, Priv. Ltr. Rul. 9826050 (June 26, 1998) (modification of trust that is administrative in nature and does not result in any change in the quality, value or timing of any of the powers, beneficial interests, rights or expectancies provided in the original trust does not result in a taxable gift by beneficiaries).

\textsuperscript{72} See Treas. Reg. §25.2511-1(g)(2), Code §2514(b) and Treas. Reg. §25.2514-3(b). \textit{See also} \textit{Estate of Regester}, 83 T.C. 1 (1984) (holding that the exercise of a special power of appointment over trust corpus by the life income beneficiary resulted in a taxable gift equal to the value of the income beneficiary’s life income interest); Rev. Rul. 79-327, 1979-2 C.B. 342 (finding that the exercise of a special power to appoint trust corpus by the life income interest resulted in a taxable gift because the exercise of the power relinquished the right to income as to the that portion of the trust corpus); and Priv. Ltr. Rul. 8824025 (June 17, 1988) (ruling that consent of co-trustee that is sole income beneficiary of trust to distribution of principal to remainder beneficiaries would result in a taxable gift). \textit{But see Self v. U.S.}, 142 F. Supp. 939 (Ct. Cl. 1956) (finding no taxable gift by an income beneficiary of a trust when the income beneficiary exercised a power to appoint trust corpus to his two children, resulting in a reduction of the income beneficiary’s life income interest). The \textit{Self} decision was rejected by the Tax Court in \textit{Regester}. \textit{See also} \textit{Estate of Franklin Lewis Hazelton and Matthew Lahti}, discussed above in footnote 62.
However, there are likely to be few instances in which the exercise of a decanting power by a trustee-beneficiary will result in a taxable gift. A number of state statutes preclude trust beneficiaries from participating in decanting distributions altogether. Other state statutes allow a trustee who is a beneficiary to participate in a decanting distribution but only in limited circumstances that will not result in the application of a gift tax. For example, some state statutes allow a trustee-beneficiary to whom distributions can be made based only on an ascertainable standard to participate in a decanting distribution only if the Receiving Trust limits distributions to the same standard.

Even in a case where applicable state law or the terms of a trust instrument do not limit the ability of a trustee-beneficiary to participate in the exercise of a decanting power, if the interest of the trustee-beneficiary in the Distributing Trust is discretionary, the decanting may not result in a taxable gift by the trustee-beneficiary. This is because the trustee-beneficiary has no enforceable right to distributions from the Distributing Trust. And, even if the decanting does result in a taxable gift in such a case, the gift is likely to have little value, if any.

Furthermore, a decanting by a trustee-beneficiary should not result in a taxable gift if the decanting results only in changes to a trust’s administrative provisions or otherwise does not modify the beneficial interests of beneficiaries.

3.3 Creation of a Power of Appointment and the Delaware Tax Trap

As described above in Section 1.3, a number of state decanting statutes specifically permit the trustee of a Distributing Trust to give a beneficiary of the Distributing Trust a power to appoint the trust fund of the Receiving Trust. A trustee’s grant of a power to of appointment to a beneficiary should not have gift tax consequences. As described above in Section 3.1, a trustee’s exercise of a discretionary power to distribute trust assets to a beneficiary does not give rise to a taxable gift. If a trustee can distribute trust assets to a beneficiary without causing a taxable gift, then the trustee should be able to grant a lesser interest in the property, such as a power of appointment, to the same beneficiary without giving rise to a taxable gift. A later exercise of the power of appointment by the beneficiary would have to be evaluated separately to determine whether it constituted a taxable gift by the beneficiary.

Under Code §2514(d), if a holder of a limited power of appointment exercises the power during his or her lifetime, and by such exercise creates a further power of appointment that can be exercised in a manner that may postpone the vesting of an interest in the property that was subject to the first power for a period ascertainable without regard to the date of the creation of

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73 See e.g., N.Y. EPTL §10-6.6(s)(2), N.C. Gen. Stat. § 36C-8-816.1(d).
74 See e.g., NRS 163.556-3(a)(2) and N.H. RSA §564-B:4-418. See also Treas. Reg. § 25.2511-1(g)(2) (providing that if a trustee has a beneficial interest in trust property, a transfer of the property by the trustee is not a taxable transfer if it is made pursuant to the exercise of a power of which is limited by a reasonably fixed or ascertainable standard which is set forth in the trust instrument).
75 See e.g., Priv. Ltr. Rul. 8535020 (May 30, 1985).
76 See e.g., Priv. Ltr. Rul. 9826050, discussed at footnote 71.
77 See Treas. Reg. § 25.2511-1(g)(1).
78 See discussion at footnote 72.
the first power, a gift tax will apply upon the exercise of the first power. This is sometimes referred to as the “Delaware tax trap.”

Most state decanting statutes have been drafted to avoid triggering the Delaware tax trap upon a trustee’s exercise of a decanting power. State statutes generally preclude a trustee from exercising a decanting power in a manner that could postpone the vesting of interests in property beyond the time by which vesting would have been required by the trust instrument of the Distributing Trust. However, under certain circumstances, it is possible that the exercise of a decanting power by a trustee could create a second power of appointment exercisable in a manner that could extend the time for vesting of a beneficial interest. For example, the Delaware tax trap has the potential to apply anytime a trustee exercises a decanting power over a Distributing Trust that is not subject to a traditional perpetuities period if the Receiving Trust is not subject to a traditional perpetuities period and confers a power of appointment on a beneficiary.

However, even in such a case, we believe that no taxable gift should result to the trustee. First, the legislative history to Code §2514(d) indicates that the Delaware tax trap was not intended to apply to fiduciary powers of appointment. Furthermore, if the trustee who exercises the power of appointment has no beneficial interest in the trust, it would be consistent with principles of Treas. Reg. §25.2511-1(g)(1) (discussed above) for there to be no gift tax consequences to the trustee.

3.4 Elimination of a Power of Appointment

A beneficiary’s loss of a presently exercisable withdrawal right or general power of appointment as a result of a decanting may result in a taxable gift by the beneficiary to the extent the value of the assets affected by the loss exceeds the greater of $5,000 or 5% of the aggregate value of assets from which the power could have been exercised (the “5 and 5 Amount”). This is because a decanting distribution by a trustee that extinguishes a beneficiary’s general power of appointment in excess of the 5 and 5 Amount may be considered to be a lapse of such power under Code §2514(e) and, as such, may be taxable to the beneficiary under Code §2514(b).\[82\]

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\[79\] See e.g., Alaska Stat. § 13.36.157(a)(3) (2008); Del. Code Ann. Tit. 12, § 3528(c) (2012), Del. Code Ann. Tit. 25, § 504 (2012); Fla. Stat. § 736.04117(3) (West Supp. 2008); N.Y. EPTL §10-6-6(p); N.C. Gen. Stat. §§ 36C-8-816.1(c)(8), (d), and 41-23(e) (2011); S.D. Codified Law §§ 43-5-5 and 55-2-20 (2012). See also Estate of Murphy v. Comr., 71 T.C. 671 (1979) (creation of new special power of appointment did not violate Delaware tax trap because Wisconsin law requires that the permissible perpetuities period be measured from the date the first power is created).

\[80\] See S. REP. No. 82-382, at 1 (1951), as reprinted in 1951 U.S.C.C.A.N. 1535, 1535.

\[81\] For a further discussion of this point, see William R. Culp and Briani Bennett Mellen, Use of Trust Decanting to Extend the Term of Irrevocable Trusts, 37 Est Pln 3 (2010).

\[82\] If a beneficiary’s general power of appointment is limited by an ascertainable standard, a decanting distribution that eliminates or reduces the power in excess of the 5 and 5 Amount should not result in a taxable gift by the beneficiary. See Treas. Reg. § 25.2514-3(e), Ex. 2. Similarly, a decanting distribution that eliminates a beneficiary’s special power of appointment generally should not result in a taxable gift. Under Code §2514(b), the release or lapse of a general power of appointment, but not a special power of appointment, is treated as a transfer for gift tax purposes.
Most, if not all, state decanting statutes limit a trustee’s ability to exercise a decanting power in a manner that would extinguish a beneficiary’s general power of appointment. State decanting statutes generally either preclude a trustee from exercising a decanting power over property of a Distributing Trust that is subject to a beneficiary’s presently exercisable withdrawal right or permit such a decanting power to be exercised only to the extent that the beneficiary has a similar withdrawal right over property of the Receiving Trust.\(^8^3\)

4. **Estate Tax Issues**

A trustee’s exercise of a power to distribute assets from a Distributing Trust to a Receiving Trust may under certain circumstances have federal estate tax consequences. Section 4.1 addresses the identity of the transferor for estate tax purposes following a decanting. Section 4.2 discusses the situations in which a decanting may cause the trust fund of a Receiving Trust to be includible in the estate of the transferor.

4.1 **Identity of the Transferor**

If property is distributed from one trust to another trust, we believe that the person who is considered to have transferred property to the Distributing Trust for federal estate tax purposes generally should be considered to be the transferor of property to the Receiving Trust for federal estate tax purposes. This should be the case regardless of whether such person is considered to be the creator of the Receiving Trust under state law.\(^8^4\) We also believe that an exception to this general rule should apply if a decanting results in a taxable gift. In such a case, the beneficiary who is deemed to have made the gift should be considered the transferor of property to the Receiving Trust for federal estate tax purposes to the extent of the transfer.\(^8^5\)

4.2 **Estate Inclusion**

If, prior to a decanting, the property of a Distributing Trust was includible in the estate of the transferor due to certain retained powers or interests, and the powers or interests that caused estate inclusion are present in the governing instrument of the Receiving Trust, property of the Receiving Trust also will be includible in the transferor’s gross estate. Similarly, if, prior to a decanting, property of a Distributing Trust was not includible in the estate of the transferor and the governing instrument of the Receiving Trust confers no additional powers or interests on the transferor, the property of the Receiving Trust also should be not be includible in his or her gross estate.

There are, however, certain situations where property of a Receiving Trust may be includible in the transferor’s gross estate even though the assets of a Distributing Trust were not includible in the transferor’s estate. For example, if the transferor did not have any dispositive powers over the Distributing Trust but is given a dispositive power over the Receiving Trust, the

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\(^8^3\) See e.g., NRS 163.556-2(d); N.C. 36C-8-816.1(c)(6); Del. Code §3528(a)(4); S.D. Cod. Law §55-2-15(7).

\(^8^4\) Under decanting statutes, the trustee generally is viewed as the creator of the Receiving Trust for state law purposes. See e.g., DEL. CODE ANN. tit. 12, § 3528(e).

\(^8^5\) This approach is similar to the approach discussed above in Section 2.3 for determining the identity of the grantor for income tax purposes and the approach discussed below in Section 5.6 for determining the identity of the transferor for generation-skipping transfer tax purposes.
trust fund of the Receiving Trust may be includible in the transferor’s estate under Code §2038.\textsuperscript{86} Similarly, if the assets distributed to the Receiving Trust include a life insurance policy on the transferor’s life, and the trust instrument of the Receiving Trust gives the transferor a power that is an incident of ownership with respect to the policy, the value of the policy may be includible in the transferor’s estate under Code §2042(2).

5. **Generation-Skipping Transfer (“GST”) Tax Issues**

The GST tax consequences of a decanting distribution from a Distributing Trust to a Receiving Trust turn on the GST tax status of the Distributing Trust. Section 5.1 addresses a Distributing Trust that is not exempt from the GST tax. Section 5.2 addresses a Distributing Trust that is exempt from the GST tax because it became irrevocable prior to certain dates set forth in the Tax Reform Act of 1986, the legislation that adopted the GST tax in its present form (a “Grandfathered Trust”).\textsuperscript{87} Section 5.3 addresses a Distributing Trust that is exempt from the GST tax by reason of the allocation of the transferor’s GST exemption to the trust. Section 5.4 addresses a Distributing Trust that is not within the scope of the GST tax because its transferor was a non-domiciliary of the United States who funded the trust in a manner that was not subject to the United States gift or estate tax. Section 5.5 addresses a Distributing Trust and a Receiving Trust that are subject to or protected from the GST tax in different proportions. Finally, Section 5.6 addresses the identity of the transferor a trust for GST tax purposes following a decanting distribution. In each of Sections 5.1 through 5.4, we assume that the decanting distribution does not result in the imposition of an estate or gift tax on a person other than the transferor. To the extent estate or gift tax is imposed on another person, any exemption from the GST tax that applied to the Distributing Trust would not carry over to the Receiving Trust.

\textsuperscript{86} As a general matter, many powers that cause inclusion under Code §2038 also cause inclusion under Code §2036. However, if a power or interest described in Code § 2036 is first granted to the transferor under the trust instrument of the Receiving Trust, the assets of the Receiving Trust generally should not be includible in the transferor’s gross estate under Code §2036. This is because Code §2036 generally is applicable only in the case of powers or interests retained by the transferor from the time of his or her initial transfer to a trust. If at the time of the transferor’s initial transfer of property to a Distributing Trust, the transferor and the trustee had an agreement or understanding that the trustee would later exercise its decanting power to create a Receiving Trust under which the grantor would hold a power or interest described in Code § 2036, the property of the Receiving Trust could be includible in the estate of the grantor. See Treas. Reg. § 20.2036-1(c)(1)(i) (“An interest or right is treated as having been retained or reserved if at the time of the transfer there was an understanding, express or implied, that the interest or right would later be conferred.”). For a discussion of whether estate inclusion under Code §2036 or §2038 may result when a grantor is involved in a decanting, please see page 29 of the NYSBA Report.

\textsuperscript{87} Section 1433(b)(2)(A) of the Tax Reform Act of 1986 provides that the GST tax does not apply to any transfer from a trust that was irrevocable on September 25, 1985 (the day before the House Ways and Means Committee began considering the bill containing the GST tax provisions). Section 1433(b)(2)(B) of the Tax Reform Act of 1986 provides that the GST tax does not apply to any transfer under a Will or revocable trust that was executed before October 22, 1986 (the date that Congress enacted the Tax Reform Act of 1986), if the decedent died before January 1, 1987. The regulations generally confirm as exempt from GST tax any GST under a trust that was irrevocable on September 25, 1985 to the extent assets are not added to the trust after that date. Treas. Reg. §26.2601-1(b)(1)(i).
5.1 Distributing Trust Not Exempt from the GST Tax

If a Distributing Trust is not exempt from the GST tax, a decanting distribution from the trust generally will trigger a GST tax if the distribution is one of three types of generation-skipping transfers identified in the Code: a direct skip, a taxable termination or a taxable distribution.\(^{88}\) If a decanting distribution is not one of these types of generation-skipping transfers, the distribution will not trigger a GST tax.

Whether a distribution is a generation-skipping transfer generally will turn on the identity of the transferor and the beneficiaries of the Distributing Trust and the identity of beneficiaries of the Receiving Trust. For GST tax purposes, the transferor generally is the person with respect to whom property most recently was subject to federal estate or gift tax.\(^{89}\) If all of the present interests in a Receiving Trust are held by persons two or more generations below the transferor (e.g., the transferor’s grandchildren or more remote descendants), the Receiving Trust will be classified as a “skip person.”\(^{90}\) In such a case, a distribution from the Distributing Trust to the Receiving Trust will be a direct skip if the distribution triggers a gift tax or an estate tax.\(^{91}\) However, as described above in Sections 3 and 4, the circumstances in which a decanting distribution will trigger a gift tax or an estate tax are limited. In a more typical situation in which a decanting distribution is not subject to gift or estate tax, the distribution generally will result in a taxable termination if the entire trust fund is distributed to a Receiving Trust and a taxable distribution if only a portion of the trust fund is distributed to the Receiving Trust.\(^{92}\)

5.2 Distributing Trust is a Grandfathered Trust

If the trustee of a Grandfathered Trust decants trust property to a Receiving Trust, the key GST tax question is whether the decanting will cause a loss of GST exempt status. The Treasury Regulations provide two safe harbor rules for when a trustee’s distribution of property from a Grandfathered Trust to a Receiving Trust will not cause a loss of GST exempt status.

The first safe harbor provides that a distribution from a Distributing Trust that is a Grandfathered Trust to a Receiving Trust will cause neither the Distributing Trust nor the Receiving Trust to be subject to the GST tax if (1) at the time the Distributing Trust became irrevocable, the governing instrument or applicable state law authorized distributions from the Distributing Trust to other trusts without the consent or approval of any beneficiary or court and (2) the governing instrument of the Receiving Trust does not extend the time for the vesting of any beneficial interest beyond the longer of (a) 21 years after the death of any life in being at the time the Distributing Trust became irrevocable and (b) 90 years after the creation of the Distributing Trust (referred to as the “Regulatory RAP”).\(^{93}\) As discussed above in Section 1.3,

\(^{88}\) Code §2611.

\(^{89}\) Code §2652(a); Treas. Reg. §26.2611-1.

\(^{90}\) Code §2613(a)(2). A Receiving Trust also will be a skip person if (1) no person holds an interest (as defined in Code §2652(c)) in the trust and (2) distributions can never be made from the trust to an individual whose generation assignment is fewer than two generations below the transferor’s generation assignment. Id.

\(^{91}\) Code §2612(c).

\(^{92}\) See Code §2612(a), regarding a taxable termination, and §2612(b), regarding a taxable distribution.

the first decanting statute was enacted in 1992, seven years after the date by which a trust generally needs to have been irrevocable in order to be a Grandfathered Trust. Accordingly, it is not possible to satisfy the first safe harbor on the basis of any state decanting statute. In some cases, it may be satisfied by the terms of the governing instrument or by the common law of the applicable state.

The second safe harbor provides that a distribution of property from a Distributing Trust that is a Grandfathered Trust to a Receiving Trust will not cause the Distributing Trust to be subject to the GST tax if (1) the distribution does not cause a beneficial interest to be shifted to a beneficiary in a lower generation and (2) the governing instrument of the Receiving Trust does not extend the time for the vesting of any beneficial interest beyond the period provided for in the original trust instrument. We note that the Regulations do not provide a definition of the term “vesting.” The meaning of the term differs from state to state and, within a given state, may be interpreted differently by a court depending on the purpose for which the interpretation is sought.

5.3 Distributing Trust is Exempt by Reason of GST Exemption Allocation

If a Distributing Trust is exempt from the GST tax because of an allocation of GST exemption, the GST tax consequences of a decanting distribution are less clear than if the Distributing Trust is a Grandfathered Trust. Concern as to this issue is based on the hundreds of private letter rulings which predated the issuance of the safe harbor regulations described in the

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94 As discussed above in Section 1.2, a decanting power arguably existed on September 25, 1985 under the common law of some states.
95 See Treas. Reg. §26.2601-1(b)(4)(i)(D). The Treasury Regulations make it clear that if the requirements of the first safe harbor are satisfied, there will be no GST tax consequences to either the Distributing Trust or the Receiving Trust. If the requirements of the second safe harbor are satisfied, the Treasury Regulations provide that there will be no GST tax consequences to the Distributing Trust but say nothing about consequences to the Receiving Trust. This presumably is because the first safe harbor specifically addresses distributions between trusts, while the second safe harbor addresses the GST tax consequences of a variety of modifications of a Grandfathered Trust (with a distribution from such a trust being just one of these modifications). A number of Private Letter Rulings confirm that if the requirements of the second safe harbor are satisfied, property that is distributed to a Receiving Trust will retain its GST exempt status. See e.g., Priv. Ltr. Rul. 200227020 (April 1, 2002), Priv. Ltr. Rul. 9804046 (Jan. 23, 1998), Priv. Ltr. Rul. 9737024 (June 17, 1997).
96 See Example 4 of Treas. Reg. §26.2601-1(b)(4)(i)(E), which provides that changing the situs of a trust from a jurisdiction with a rule against perpetuities to a jurisdiction with no rule against perpetuities does not extend the time for vesting of any beneficial interest in a trust if the trust will terminate at the same time both before and after the change in situs, pursuant to the terms of the trust instrument. The Regulation also provides that if as a result of the change in situs, the time for vesting of a beneficial interest in the trust is extended beyond the period prescribed by the terms of the original trust instrument, the trust will lose its GST exempt status. The Regulations however, do not define or describe what is meant by the term “vesting.” See also Carol A. Harrington, Lloyd Leva Plaine, Howard M. Zaritsky, Julie K. Kwon, Generation-Skipping Transfer Tax, 2nd edition (Warren Gorham & Lamont 2001, with 2012 cumulative supplement), Priv. Ltr Rul. 200643039 (Oct. 28, 2005), Priv. Ltr. Rul. 200607015 (Feb. 17, 2006), 200839025 (Sept. 26, 2008), Priv. Ltr. Rul. 200841027 (Oct. 10, 2008).
97 See Carol A. Harrington, Lloyd Leva Plaine, Howard M. Zaritsky and Julie K. Kwon, Generation-Skipping Transfer Tax, 2nd edition (Warren Gorham & Lamont 2001, with 2012 cumulative supplement) ¶ 7.06[2][f][ii], explaining that “a court may be more likely to construe an interest as vested to avoid a violation of the rule against perpetuities than might be the case if vesting will allow a creditor to seize that interest.”
In these rulings, the IRS took the position that a modification of a trust that was protected from GST tax by the grandfather rules that did not “change the quality, value or timing of any powers, beneficial interests, rights or expectancies” originally provided for under the terms of the trust would not result in the loss of protected status. The negative implication is that if such a change occurred, loss of protected status would result. The rationale seemed to be that the trust would no longer be the same trust. It is possible that the IRS could take the same position with respect to trusts protected by the GST exemption because the safe harbor rules described above in Section 5.2 do not apply to trusts to which GST exemption has been allocated.

In a number of Private Letter Rulings, however, the IRS has extended the safe harbor rules to trusts to which GST exemption has been allocated. In many of these rulings, the IRS has acknowledged the lack of guidance applicable to such trusts and has suggested that it may be possible to decant a trust to which GST exemption has been allocated without disrupting its GST exempt status in situations broader than those covered by the safe harbor rules:

No guidance has been issued concerning the GST tax consequences of the modification of a trust created after September 25, 1985. At a minimum, it seems appropriate to conclude that a change that would not affect the exempt status of a trust that was irrevocable on September 25, 1985 would similarly not affect the exempt status of such a trust.

With the exception discussed in the next paragraph, we recommend that guidance confirm that the safe harbor regulations apply to property which is protected from the GST tax by the allocation of GST exemption that is decanted into a Receiving Trust.

We believe that the provision of the safe harbor rules that requires the Regulatory RAP to be satisfied in order for GST exempt status to be preserved when a Grandfathered Trust is decanted should not be applicable in the case of a Distributing Trust that is exempt from the GST tax by reason of an allocation of GST exemption. When Congress enacted the GST tax in its present form, the common law rule against perpetuities was in effect in almost all states. Since this time, many states have lengthened their statutory perpetuities periods or have abolished them altogether. Accordingly, there now exist many trusts that are exempt from the GST tax by reason of an allocation of GST exemption that have perpetuities periods in excess of the Regulatory RAP. Under the current GST tax rules, a trust that has acquired GST exempt status by reason of GST exemption allocation may retain this protection beyond the Regulatory RAP. Unless this rule is changed, we believe that it should be possible to decant such trusts without a

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98 See e.g., Priv. Ltr. Rul. 9424026 (March 16, 1994).
99 See id.
loss of GST exempt status as long as any perpetuities period applicable to a Distributing Trust is maintained for the Receiving Trust.  

5.4 Distributing Trust has Non-U.S. Transferor

Special GST tax rules apply if the transferor of property to a trust is neither a U.S. citizen nor a U.S domiciliary. As a general matter, a trust created by a non-U.S. transferor is within the scope of Chapter 13 only if the initial transfer of property to the trust was subject to federal estate or gift tax. We believe that a decanting distribution from a Distributing Trust that is not within the scope of Chapter 13 because of the non-domiciliary status of its transferor should be subject to the GST tax or should cause the Receiving Trust to be within the scope of Chapter 13 only if the distribution itself results in the application of a federal estate or gift tax.

5.5 Distributing Trust and Receiving Trust Have Different Degrees of Protection from the GST Tax

Suppose, for example, that a Distributing Trust and a Receiving Trust have the same transferor. The Distributing Trust has an inclusion ratio of zero and the Receiving Trust has an inclusion ratio of 1. The Receiving Trust is not a skip person. As a result, the decanting does not trigger the imposition of a GST tax. The regulations provide a method for calculating the new inclusion ratio of the Receiving Trust to adjust for the inclusion ratio of the Decanting Trust.

We recommend that guidance confirm that the same approach should be used to adjust the portion of a Receiving Trust that will be protected from future GST taxes by reason of the Decanting Trust’s status under the grandfather rule or the non-domiciliary status of its transferor. We also recommend that guidance confirm that the transferor will be able to allocate any or all of his or her remaining GST exemption to the Receiving Trust.

5.6 Identity of the Transferor

As described above in Section 5.1, for GST tax purposes, the “transferor” of property to a trust generally is the person with respect to whom the property most recently was subject to a

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102 In proposed regulations issued in 1996, the IRS sought to apply the Regulatory RAP to situations involving trusts other than Grandfathered Trusts. Prop. Treas. Reg. §26.2652-1(a)(4) provided that the “transferor” of a trust generally would shift if a power of appointment was exercised in a manner that extended perpetuities period beyond the Regulatory RAP. The provision relating to the Regulatory RAP was not included in the final regulation. See T.D. 8720, 1997-1 C.B. 187. As a result, the Regulatory RAP appears only in Treasury Regulations addressing Grandfathered Trusts. Recent proposals would limit the length of an allocation of GST exemption to a period of 90 years from the creation of the trust. See DEPT. OF THE TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION’S FISCAL YEAR 2013 REVENUE PROPOSALS 81-82 (2012). See also DEPT. OF THE TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION’S FISCAL YEAR 2012 REVENUE PROPOSALS 129-30 (2011) (same proposal).

103 Code §2663(2); Treas. Reg. §26.2663-2(b)(2). A transfer to a trust by a non-U.S. transferor generally will be subject to federal estate or gift tax only if the property transferred is situated within the United States. See Code §2104 (addressing when property is situated in the United States for federal estate tax purposes) and Code §2511 (addressing when property is situated in the United States for federal gift tax purposes).

federal estate or gift tax. We recommend that guidance confirm that the transferor with respect to a Distributing Trust also is the transferor with respect to the Receiving Trust except to the extent a decanting results in the imposition of a gift or an estate tax on another person. If the decanting triggers a gift or an estate tax, the person with respect to whom there has been a taxable gift or an estate inclusion should become the transferor, consistent with Code §2652(a).

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We appreciate your consideration of our comments in response to Notice 2011-101 and would be pleased to answer any questions about our comments.