

BESSEMER TRUST

630 FIFTH AVENUE
NEW YORK, NY 10111

OFFICE OF FIDUCIARY COUNSEL

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Via E-Mail

CC:PA:LPD:PR (Notice 2011-101)

Internal Revenue Service
Room 5203
Post Office Box 7604
Ben Franklin Station
Washington, DC 20044

Comments of Bessemer Trust on Transfers by a Trustee from an Irrevocable Trust to Another Irrevocable Trust ("Decanting") (Notice 2011-101, 2011-52 I.R.B. 932 (December 20, 2011))

Ladies & Gentlemen:

With this letter, Bessemer Trust Company, N.A., together with its affiliated trust companies (collectively "Bessemer Trust"), submits its comments regarding Notice 2011-101, 2011-52 I.R.B. 932 (December 20, 2011) regarding when (and under what circumstances) transfers by a trustee of all or a portion of the principal of an irrevocable trust (the "Distributing Trust") to another irrevocable trust (the "Receiving Trust"), sometimes called "decanting," that result in a change in the beneficial interests in the trust are not subject to income, gift, estate and/or generation-skipping transfer ("GST") taxes.

Bessemer Trust is a privately-owned wealth management firm founded in 1907 and headquartered in New York, New York. Our firm focuses on the following services: investment management; fiduciary services; estate planning; tax planning; financial services; and family company, philanthropic, insurance and real estate advisory services for clients with a minimum of \$10 million in investment assets. Our firm currently has \$62.4 billion under supervision and 17 regional offices throughout the United States, London and Cayman Islands.

Bessemer Trust serves as the sole or co-trustee of over 4,000 irrevocable trusts holding over \$22 billion of assets. As trustee, Bessemer Trust exercises discretion over those assets on a daily basis and has engaged in several so-called decanting distributions over the years. In fact, the seminal court decision regarding discretionary distributions in further trust, *Phipps v. Palm Beach Trust Company*, 196 So. 299 (Fla. 1940), involved the predecessor to Bessemer Trust Company of Florida.

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A. General Approach for Developing Guidelines for Tax Effects of Decanting Transactions

A trustee's decision to make a distribution for the benefit of a beneficiary into a continuing trust (i.e., a decanting transaction) rather than to make a distribution outright to a beneficiary is an exercise of the trustee's discretionary power to make distributions. It is hard to imagine how discretionary distribution decisions made by a trustee who is not also a beneficiary may result in a beneficiary's being treated as having made transfers that have transfer tax impacts to the beneficiary or the trust. Trustees make discretionary decisions repeatedly that may have an impact on the beneficial interests of the beneficiaries in relation to each other. Such decisions, of course, include distribution decisions but also include decisions regarding what types of investments the trust will hold and in what proportions and decisions on whether receipts or expenses should be allocated or apportioned to income or principal. Discretionary distribution decisions are made frequently by trustees, but such decisions have never been believed to have transfer tax implications for the trust.

A trustee's authority to make decanting distributions to a Receiving Trust is a very helpful tool to enable trustees to adapt to changing circumstances. Bessemer Trust, as a corporate fiduciary serving as trustee of thousands of trusts, has exercised its discretion to make decanting distributions to a Receiving Trust to adapt to changing circumstances in a wide variety of situations that are not abusive of the federal transfer and income tax systems. Bessemer Trust encourages the Department of the Treasury (the "Treasury") and the Internal Revenue Service (the "IRS") to exercise restraint in developing guidelines for decanting transactions; any rules adopted should be as least restrictive as possible in order to prevent clear abuses of the tax system. We strongly urge that the Treasury and IRS not adopt rules that effectively prevent trustees from implementing their decanting authority under state law to address a host of innocuous situations that were not contemplated when the trust was created.

B. Estate and Gift Tax Issues

1. Consent or Acquiescence of a Trust Beneficiary Who is Not a Trustee

In general, the exercise of a power to decant by an independent trustee should be analyzed in the same manner as a power held by an independent trustee to make discretionary distributions. Thus, a decanting generally should not be treated as a gift by any beneficiary.

A beneficiary may be deemed to have made a gift, however, if such beneficiary has the ability under local law to object to the decanting, thereby preventing the trustee from acting, and such beneficiary's interest under the Receiving Trust is reduced from what it had been under the Distributing Trust.¹ Whether the beneficiary's ability under local law to object to a decanting

¹ See Treas. Reg. § 25.2512-8 (indicating that the failure to exercise a right, or release of a right, can be a transfer for inadequate consideration and therefore a gift); Rev. Rul. 81-264, 1981-2 C.B. 185 (concluding that an individual

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will give rise to gift tax consequences should be determined under the principles of *Commissioner v. Bosch*, 387 U.S. 456 (1967).²

Under *Bosch*, if a decanting is consistent with state law, including rulings of the highest court of the state and after giving proper regard to relevant rulings of other state courts if there is no ruling by the highest court, that governs administration of the trust, the decanting should have no gift tax consequences to any beneficiary who is not also a trustee. In this situation, such beneficiary would have no ability to impede or prevent the decanting by objecting, and so failure to object should not constitute a taxable gift. Similarly, if such beneficiary were to consent to the decanting, since such consent would have no legal impact on the efficacy of the decanting, no taxable gift should result.³ The principles outlined in the preceding provisions of this paragraph should apply equally if the decanting is consistent with an applicable state decanting statute.

The Restatement of Law (Third) of Trusts ("Restatement 3d"), § 50, provides guidance regarding the circumstances in which a beneficiary may successfully object to a decanting. Restatement 3d § 50 indicates that an impending transaction by a trustee may be subject to "judicial control" only if necessary to "prevent misinterpretation or abuse of discretion by the trustee." If a beneficiary has the ability to object to a decanting in a state that follows this rule, then, under *Bosch*, the IRS could conceivably determine that a gift was made if such beneficiary failed to object. Gift tax consequences should actually arise, however, only if such beneficiary had more than the mere ability to object but in fact had a reasonable chance of *successfully* objecting to the decanting. Thus, in a state that follows the Restatement 3d § 50, if it could be established that a decanting would indeed result from "misinterpretation or abuse of discretion," the beneficiary's failure to object to such a decanting that reduces such beneficiary's interest

who permits the statute of limitations to expire on the recovery of a loan to a family member has made a gift if the debtor had some financial resources available to repay the loan).

² In *Bosch*, the United States Supreme Court held that federal authorities, including the Internal Revenue Service (the "IRS"), are not conclusively bound by a determination of a property interest made by a state trial court or a state intermediate court in a case to which the United States was not a party. Instead, the state law as determined by the highest court of the applicable state is to be followed. However, if such court has not rendered a decision that will control the situation at issue, then the IRS must determine the applicable state law after giving "proper regard" to the relevant holdings of the other courts of the state.

³ In an analogous situation, the IRS has stated that where a beneficiary consents to an action by a trustee that does not require the beneficiary's consent, no adverse consequences should result under the GST tax. Treas. Reg. § 26.2601-1(b)(4)(i)(A), discussed in more detail below, establishes a "safe harbor" for decanting "grandfathered" trusts without losing GST exempt status. One of the safe harbor requirements is that the trustee be authorized to decant from the trust without the consent or approval of any beneficiary or court. In the preamble to T.D. 8912, 2001-1 C.B. 452, 2001-5 I.R.B. 452 (2001), issuing the final version of regulation, the IRS noted that it had received a comment to the proposed regulation suggesting that the final regulation specify that, as long as the trustee has the power to decant without obtaining beneficiary consent or court approval, the fact that the trustee nevertheless obtains such consent or approval should not result in the loss of the exempt status of the trust if all other requirements of the regulation are satisfied. In response, the IRS stated that "This change was deemed unnecessary. An action that satisfies the requirements of the regulations will not cause loss of exempt status even if, for whatever reason, the trustee seeks a court's or a beneficiary's approval of such action." The regulation, by its terms, addresses only the GST tax implications of decanting, and expressly does not address the estate, gift or income tax implications of decanting, but there is no apparent policy reason why the giving of consent where none is necessary should change the gift, estate or income tax implications of any decanting.

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under the Receiving Trust may give rise to a taxable gift (depending on the differences between the Distributing Trust and the Receiving Trust).

2. Elimination or Reduction of Future Power or Interest and Authorization of Decanting Pursuant to a Binding Court Decree

In Rev. Rul. 73-142,⁴ under the terms of a trust instrument, the grantor held a power to remove and replace the trustee. This power was unrestricted with no prohibition on the grantor appointing himself as trustee. The trustee had absolute discretion regarding distributions. A state court interpreted the grantor's power to remove and replace the trustee as a power that could be exercised only once. In addition, the state court concluded that the grantor did not have the power to appoint himself as trustee. The IRS stated that, even though the state court's rulings may be contrary to a decision of the highest court of the state, notwithstanding *Bosch*, the IRS could not disregard a lower-court decree that was binding on the parties. Thus, the IRS ruled that the state court's interpretation of the trust instrument, which eliminated the grantor's powers that would have caused inclusion in the grantor's gross estate under Internal Revenue Code ("IRC") §§ 2036 and 2038, would be respected where the decree "was handed down before the time of the event giving rise to the tax (that is, the date of the grantor's death)."

Rev. Rul. 73-142 should be considered solid precedent for the proposition that a binding court decree, or, for that matter, a binding non-judicial settlement agreement, authorizing or approving a decanting that effectively removes or reduces an interest or power that could have *future* tax consequences upon the occurrence of a future event (such as the death of an individual) should not in and of itself give rise to gift or estate tax consequences upon the occurrence of that future event. When such decree or agreement becomes binding on all parties, a decanting transaction pursuant to or a subsequent decanting transaction authorized under such binding decree or agreement should be recognized for tax purposes, and the gift and estate tax consequences of future events should be determined based on provisions of the Receiving Trust's governing instrument.

3. Powers Exercisable in the Future

If a trustee, whether or not a trust beneficiary, holds a discretionary distribution power that could be used for decanting purposes under applicable state law (hereinafter, a "decanting power") but that could be exercised only at some point in the future, no gift, estate or GST tax consequences should arise from holding such power.

4. Consent of the State Attorney General

A state attorney general is often considered an interested party in matters involving charitable trusts administered in the attorney general's state. For example, if the trustee of a charitable trust seeks to obtain a judicial modification of the trust, the attorney general may enter an appearance in the matter to represent the public interest.

⁴ 1973-1 C.B. 205.

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However, any requirement under applicable state law that the attorney general consent to a decanting should not give rise to tax consequences to a beneficiary of either the Distributing Trust or the Receiving Trust. An attorney general is an independent third party whose acts or omissions should have no tax impact on a decanting.

5. Trustee Who Is Also A Beneficiary

a. **Decanting by a Trustee/Beneficiary During Life While Serving as Trustee.** A trust beneficiary should be deemed to have made a gift if: (i) the beneficiary is also acting as trustee; (ii) such trustee/beneficiary has the discretion to distribute principal to him or herself which is not subject to an ascertainable standard relating to health, education, support or maintenance; and (iii) such beneficiary's interest is diminished through a decanting. Under IRC § 2514(c), such discretion would be considered a general power of appointment because it is a power over trust property exercisable by the trustee/beneficiary in favor of him or herself, his or her estate, his or her creditors or the creditors of his or her estate. However, a discretionary distribution power exercisable by a trustee/beneficiary which is limited by an ascertainable standard should not be deemed a general power of appointment.⁵

In the case of a decanting power exercisable by a trustee/beneficiary only in conjunction with another person, if the power must be exercised with the consent of the grantor, such power should not be deemed a general power of appointment. In addition, if the power is exercisable only in conjunction with another beneficiary whose interest would be adverse to the exercise of the decanting power in a manner that would benefit the trustee/beneficiary (or his or her estate, the creditors of the trustee/beneficiary or the creditors of the trustee/beneficiary's estate), the decanting power should not be deemed to be a general power of appointment. For this purpose, if a successor trustee/beneficiary would hold the decanting power (that is exercisable for his or her benefit or for the benefit of his or her estate, his or her creditors or the creditors of his or her estate) after the current trustee/beneficiary ceases to act as trustee, such successor trustee/beneficiary should be deemed to have an interest that is adverse to the current trustee/beneficiary's exercise of the decanting power.⁶

If a decanting power is exercisable only in conjunction with another person and such decanting power is deemed a general power of appointment with respect to the trustee/beneficiary, such trustee/beneficiary should be deemed to hold a general power of appointment only with respect to a fractional part of the property subject to such power. This fractional amount should be determined by dividing the value of such property by the number of such persons (including the trustee/beneficiary who holds the power) in favor of whom such power is exercisable.⁷

b. **Decanting Power Held at Death of Trustee/Beneficiary.** At the death of a trustee/beneficiary who then holds a decanting power exercisable in favor of such

⁵ IRC § 2514(c)(1); Treas. Reg. § 25.2511-1(g)(2).

⁶ IRC § 2514(c)(3)(A)&(B).

⁷ IRC § 2514(c)(3)(C).

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trustee/beneficiary, his or her creditors, his or her estate or the creditors of his or her estate, the value of the property subject to the decanting power should be included in the gross estate of such trustee/beneficiary.⁸ No estate tax inclusion should arise, however, if a trustee/beneficiary holds a decanting power at death which is subject to an ascertainable standard.⁹

In the case of a decanting power held by a trustee/beneficiary at his or her death, which is exercisable only in conjunction with another person, rules similar to those discussed above in Item B.5.a should apply.¹⁰

6. Preventing a Gift if Beneficiary Has Power of Appointment Over Receiving Trust.

In exercising a decanting power, the trustee should be able to protect against the making of a taxable gift by a beneficiary (including a beneficiary who is also a trustee) if the Receiving Trust confers a power of appointment on the beneficiary.¹¹ The gift tax regulations make clear that "[a] gift is also incomplete if and to the extent that a reserved power gives the donor the power to name new beneficiaries or to change the interests of the beneficiaries as between themselves...."¹² Thus, a power of appointment, which essentially is a "power to name new beneficiaries or to change the interests of the beneficiaries," granted to a beneficiary of a Receiving Trust will prevent such beneficiary from making a completed gift. Only if the beneficiary exercises or releases this power, will the gift be complete.¹³ If the beneficiary dies while possessing the power of appointment, the value of the property subject to such power will not be included in the beneficiary's gross estate if: (a) the beneficiary did not confer the power on him or herself (*i.e.*, the beneficiary was not a trustee exercising the decanting power); or (b) the power is not a general power of appointment.

7. Delaware Tax Trap.

The so-called "Delaware Tax Trap" is sprung when a lifetime limited power of appointment existing under a first trust is exercised so as to create a second trust that itself confers a limited power of appointment whose exercise *could* extend the beneficial interests under the second trust past the perpetuities period applicable to the first trust. The exercise of the

⁸ IRC § 2041(a)(2).

⁹ IRC § 2041(b)(1)(B).

¹⁰ IRC § 2041(b)(1)(C).

¹¹ Treas. Reg. § 25.2511-2(b) provides that:

if upon a transfer of property...the donor reserves any power over its disposition, the gift may be wholly incomplete, or may be partially complete and partially incomplete, depending upon all the facts in the particular case. Accordingly, in every case of a transfer of property subject to a reserved power, the terms of the power must be examined and its scope determined.

¹² Treas. Reg. § 25.2511-2(c).

¹³ Treas. Reg. § 25.2511-2(f) ("The relinquishment or termination of a power to change the beneficiaries of transferred property...completes the gifts and causes the tax to apply.... The receipt of income or of other enjoyment of the transferred property by the transferee or by the beneficiary (other than by the donor himself) ...operates to free such income or other enjoyment from the power, and constitutes a gift").

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power of appointment under the first trust in this situation, to the extent of the value of property subject to the power of appointment arising under the second trust, is treated as a taxable gift.¹⁴ Applying this general rule in the context of a decanting, the decanting should not trigger the Delaware Tax Trap with regard to any beneficiary if the decanting is accomplished in furtherance of the trustee's fiduciary duty to the trust or its beneficiaries.¹⁵

8. Beneficiary's Power to Remove and Replace the Trustee

In Rev. Rul. 95-58¹⁶ the IRS ruled that a grantor's reservation of an unqualified power to remove a trustee and appoint an individual or corporate successor trustee that is not related or subordinate to the decedent (within the meaning of IRC § 672(c)) is not considered a reservation of the trustee's discretionary powers of distribution over the property transferred by the grantor to the trust. Under the ruling, if the grantor held a power to remove such trustee and could replace such trustee with a person who was related or subordinate to the grantor, the value of the trust property would be includable in the grantor's gross estate under IRC §§ 2036 and 2038. In private letter rulings, this possibility of inclusion in the gross estate has been extended to non-grantor/beneficiaries acting as trustees, potentially causing them to be deemed to hold a general power of appointment.¹⁷

In the decanting context, if a beneficiary of the Receiving Trust has the power to remove the trustee of the Receiving Trust and replace such trustee with him or herself or someone who is related or subordinate to the beneficiary, the value of the property composing the Receiving Trust may be included in the beneficiary's gross estate.

9. Administrative Changes

There are some administrative changes that may be made by means of a decanting that can affect beneficial interests. For example, the governing instrument of a Receiving Trust could grant the trustee more flexible investment powers than the terms of the Distributing Trust, and such flexibility could lead to realization of greater trust accounting income, resulting in an increase in distributions to mandatory income beneficiaries. Similarly, the governing instrument of a Receiving Trust could confer on the trustee greater discretion in allocating items between income and principal. However, such administrative changes in and of themselves are innocuous and should not give rise to estate or gift tax consequences.

Bessemer Trust has been involved in a number of decanting situations involving administrative changes that allow the flexibility of taking into consideration changing

¹⁴ IRC § 2514(d); see Wareh & Dorsh, *Decanting: A Statutory Cornucopia*, TRUSTS & ESTATES, March 2012, at 22.

¹⁵ Culp, Jr. & Mellen, *Trust Decanting: An Overview and Introduction to Creative Planning Opportunities*, 45 REAL PROPERTY, TRUST & ESTATE LAW JOURNAL 1, 32 (2010) (note 209 explains that "... the regulations clarify that the gift tax is applicable only to a transfer of a beneficial interest in property. See Treas. Reg. § 25.2511-1(g)(1). As such, a gift should not result from a trustee's distribution of property to beneficiaries other than himself if the trustee has no beneficial interest in the distributed property.").

¹⁶ 1995-2 C.B. 191.

¹⁷ See, e.g., Pvt. Ltr. Rul. 200551020 (Dec. 23, 2005).

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circumstances in a manner that is very helpful to the trust and trust beneficiaries but that are not abusive of the federal transfer and income tax systems. Examples include:

- Changing investment standards to comport with modern fiduciary investing principles;
- Allowing direction advisors to direct investment decisions as to closely-held business interests or concentrated non-diversified investment positions;
- Converting a beneficiary's income interest to a unitrust interest in accordance with the provisions of Treas. Reg. § 1.643(b)-1;
- Changing the trustee succession mechanics or directly changing the current trustee, successor trustees or co-trustees (obviously, trustee changes could have transfer tax implications if the trustee holds tax sensitive powers that could be exercised for the trustee's individual benefit);
- Revising trustee compensation provisions to be consistent with the trustee's current published compensation guidelines (including the compensation guidelines for special types of investments);
- Changing the trustee to one located in a different state in order to accomplish *state* income tax savings; and
- Dividing a trust so that there are separate Receiving Trusts for respective beneficiaries, which may be helpful in a variety of situations, including using different investment philosophies for each beneficiary if that is appropriate, achieving local tax savings in a foreign country if some but not all beneficiaries live in such foreign country, or domesticating portions of a foreign trust where some but not all beneficiaries live in foreign countries.

None of these administrative changes are abusive of the federal transfer and income tax systems. Bessemer Trust urges Treasury and the IRS to adopt rules that will not restrict trustees from having the flexibility to utilize decanting transactions authorized under trust instruments or state law in a wide variety of ways to adapt to changing circumstances in a manner that does not abuse the federal transfer and income tax systems.

C. GST Tax Issues

Decanting can be useful for clients who wish to engage in appropriate GST tax planning. For instance, the granting of a power of appointment in a Receiving Trust may allow for the postponement or avoidance of GST tax because the powerholder may add non-skip person beneficiaries.¹⁸ Furthermore, subject to certain requirements discussed below, a trustee of a Distributing Trust that is grandfathered for GST tax purposes and is therefore exempt from GST tax may be able to decant the trust property to a Receiving Trust whose governing instrument

¹⁸ Tractenberg, *Decanting From Irrevocable Trusts*, TRUSTS & ESTATES (July 2011).

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provides that the trust property will remain in trust for generations beyond those provided for under the governing instrument of the Distributing Trust.¹⁹

1. Trusts Exempt From Application of GST Tax

Property that is exempt from GST tax because it is held in a trust governed by an instrument that was irrevocable on September 25, 1985 (a "grandfathered" trust) will maintain its exemption from GST tax in a decanting transaction by meeting the requirements of one of two "safe harbors" under Treas. Reg. § 26.2601-1(b)(4)(i). (That regulation provides four safe harbors, but only two of them are relevant to decanting transactions.)

Under the first safe harbor (the "(A) safe harbor"), a decanting will not affect the GST-exempt status of a grandfathered trust as long as: (a) the governing instrument or applicable state law at the time the trust became irrevocable authorizes the decanting to the Receiving Trust without the consent or approval of any beneficiary or court; and (b) the terms of the governing instrument of the Receiving Trust will not extend the time for vesting, absolute ownership or power of alienation of an interest in property beyond the longer of: (i) the life of any person in being at the date the Distributing Trust became irrevocable plus a period of 21 years; or (ii) a ninety-year period beginning on the date of the creation of the Distributing Trust.²⁰ Because the consent or approval of any beneficiary or court is not required under any state decanting statute, meeting the requirements of this first safe harbor should help avoid adverse gift and estate tax consequences arising from a decanting.

Regarding the first requirement of the (A) safe harbor, a trust must have been irrevocable on September 25, 1985 to be grandfathered from GST tax. Since there was no decanting statute in effect in any state on September 25, 1985, the trustee must show instead that the decanting was made pursuant to the terms of the trust instrument or under state common law. Reported decisions regarding decanting decided before September 25, 1985 are very limited; one such pre-existing reported case is *Phipps v. Palm Beach Trust Company*.²¹ However, the lack of any reported decision specifically addressing decanting in a state prior to September 25, 1985 does not mean that the common law of that state did not permit decanting (following reasoning similar to that of the *Phipps* case) on that date. There may have been no reported decision or statute in a

¹⁹ U.S. Trust, Bank of America Private Wealth Management, *State Decanting Statutes*, PRACTICAL DRAFTING (January 2008).

²⁰ Treas. Reg. §§ 26.2601-1(b)(4)(i)(A); 26.2601-1(b)(4)(i)(E), Ex. 1 (a discretionary trust for a child and the child's issue that will terminate upon the child's death will not lose grandfathered status if, pursuant to the trust terms, property is distributed to another trust for the benefit of the child's issue if such trust terminates 21 years after the death of the survivor of the child's issue living on the date the original trust was established). See also the discussion *supra*, note 3, regarding the consequences, or lack thereof, of a beneficiary granting consent where none is necessary.

²¹ 196 So. 299 (Fla. 1940) (the Supreme Court of Florida approved a decanting in which the Receiving Trust had the same beneficiaries as the Distributing Trust and the Receiving Trust granted a new limited power of appointment to one of the beneficiaries). See also *Wiedenmayer v. Johnson*, 106 N.J. Super. 161, 254 A.2d 534 (N.J. Super. Ct. App. Div. 1969), *aff'd*, 55 N.J. 81, 259 A.2d 465 (N.J. 1969), in which the court approved a distribution to the beneficiary conditioned upon the beneficiary's agreement to use the distribution to create a new trust.

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given state on September 25, 1985 that specifically authorized a trustee to lend funds to beneficiaries, to guaranty debts of a beneficiary or to distribute funds for the direct benefit of a beneficiary rather than making a distribution directly to the beneficiary, but that does not mean the state's common law did not allow such actions.

Indeed, states' decanting statutes may specifically acknowledge that the provisions are reflective of prior common law in the state, and that the statute merely codifies that result.²²

If the state law that governs the administration of the trust at the time of a decanting transaction permitted decanting on September 25, 1985, the provisions of the (A) safe harbor should apply. Furthermore, if a state court construes the terms of a trust to permit making distributions for the benefit of a beneficiary including in a further trust, and if the state court provides that such construction is consistent with state common law that existed on September 25, 1985, and if such state court action becomes binding on all parties, the trustee should *subsequently* be able to exercise the decanting power consistent with the provisions of the (A) safe harbor.²³ A private letter ruling confirmed that the (A) safe harbor would apply in a case in which a state court confirmed that a trustee's authority to distribute "to or for the benefit of" a beneficiary permitted a distribution to another trust for the same beneficiary.²⁴

Therefore, the clearest manner in which to decant without losing grandfathered status under the first safe harbor is to rely on the terms of the trust instrument, if any, that allow a decanting;²⁵ but the common law of states other than Florida may also have permitted decanting with respect to trusts that became irrevocable before September 25, 1985.

Under the second safe harbor (the "(D) safe harbor"), decanting will not affect the grandfathered status of a trust that does not meet the requirements of the (A) safe harbor as long as: (a) the decanting does not shift a beneficial interest in the trust to a beneficiary who occupies a lower generation (as defined in IRC § 2651) than the persons who held the beneficial interest under the Distributing Trust prior to the decanting; and (b) the decanting does not extend the time for vesting of any beneficial interest in the trust beyond the period provided in the original trust.²⁶ A decanting of a grandfathered trust pursuant to a statute enacted after the trust became irrevocable should not lose its GST exempt status if the requirements of the (D) safe harbor are met.

If a decanting of a trust that is grandfathered from GST tax results in a change in trust situs from a jurisdiction with the traditional rule against perpetuities (*i.e.*, requiring the trust to terminate

²²Such provisions in trust legislation are not uncommon. See *e.g.*, TEX. H.B. 1190 §5 (2005) (effective date provision states that "Section 5 of this Act is intended to clarify existing law, but only as expressly provided by that section. An inference may not be drawn from the amendments made by that section for situations not specifically described by that section."); Section 456.4-419, RSMo. ("[t]his section is intended to codify and, from and after enactment, to provide certain limitations to the common law of this state,...").

²³ See Rev. Rul. 73-142, 1973-1 C.B. 205. Revenue Ruling 73-142 is discussed above in Item B.2.

²⁴ Priv. Ltr. Rul. 200530012 (March 24, 2005).

²⁵ Culp & Mellen, *supra*, note 15, at 19-20.

²⁶ Treas. Reg. § 26.2601-1(b)(4)(i)(D), -1(b)(4)(i)(E), Ex. 2.

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upon the death of designated lives in being at the creation of the trust plus 21 years) to a jurisdiction that allows a longer term to apply to the decanted trust, the grandfathered status of the trust, under either safe harbor, will be lost²⁷ (unless, in accordance with the (A) safe harbor: (a) under the trust's governing instrument or the law governing administration of the trust when it became irrevocable, decanting was authorized; and (b) the terms of the governing instrument of the Receiving Trust will not extend the time for vesting, absolute ownership or power of alienation of an interest in property beyond the longer of: (i) the life of any person in being at the date the Distributing Trust became irrevocable plus a period of 21 years; or (ii) a ninety-year period beginning on the date of the creation of the Distributing Trust).

Under the (D) safe harbor, for example, if property is held in a grandfathered trust for the grantor and the grantor's children and succeeding interests are held by the grantor's grandchildren, the trust property could be decanted to a new trust that includes legally adopted grandchildren of the grantor without losing the trust's GST exemption. The shift in beneficial interests in this case would not be to a lower generation, and the time for vesting of any interest will not be delayed. However, the original beneficiaries of the trust may be deemed to have made a gift to the new beneficiaries, as discussed above.²⁸

If such a decanting indirectly increases the amount transferable to beneficiaries by, for example, lowering administrative costs or decreasing taxes, the IRS should not consider such decanting as an impermissible shift in beneficial interests under the (D) safe harbor.²⁹

The rules that apply to trusts that are exempt from GST tax by reason of grandfathering should also apply to trusts that are exempt from GST tax by reason of allocation of the GST exemption.³⁰ Specifically, a trust exempt from GST tax due to allocation of GST exemption should be able to be decanted without losing its GST exempt status if the requirements of one of the above safe harbors is met.³¹

2. Trust Severances

In a decanting transaction, a Distributing Trust could divide into two separate Receiving Trusts, and such division could be structured as a "qualified severance."³² If the Distributing Trust has an inclusion ratio of either one or zero, each trust resulting from the qualified severance will have an inclusion ratio equal to that of the Distributing Trust.³³ If the Distributing Trust has an inclusion ratio of greater than zero and less than one, the severance will be a qualified severance only if the Distributing Trust is divided on a fractional share basis, and one

²⁷ See Culp & Mellen, *supra*, note 15, at 20.

²⁸ See *id.*; Treas. Reg. § 26.2601-1(b)(1)(v)(D), Ex. 4.

²⁹ Treas. Reg. § 26.2601-1(b)(4)(i)(E), Ex. 10; see Culp & Mellen, *supra*, note 15, at 20-21.

³⁰ IRC § 2631; Levin & Flubacher, *Put Decanting to Work to Give Breath to Trust Purpose*, ESTATE PLANNING (January 2011); see e.g., I.R.S. Priv. Ltr. Ruls. 200919008 (May 8, 2009); 200743028 (May 29, 2007).

³¹ See Culp & Mellen, *supra*, note 15, at 23-26.

³² See IRC § 2642(a)(3)(B)(i).

³³ Treas. Reg. § 26.2642-6(d)(6).

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Receiving Trust has an inclusion ratio of zero, and the other Receiving Trust has an inclusion ratio of one.³⁴

If a decanting results in a taxable termination as to a portion of the Distributing Trust, the taxable termination should be deemed to occur only with regard to that particular portion.³⁵

3. Identity of the Transferor

In a decanting transaction, the identity of the transferor (within the meaning of IRC § 2652(a)(1)) of the Receiving Trust should usually be the same as the identity of the transferor of Distributing Trust. If, however, estate or gift tax consequences, as discussed above, arise under IRC §§ 2514 or 2041 due to a decanting, the person who incurred such consequences should be considered the transferor of the Receiving Trust.

D. Income Tax Issues

1. Grantor Trust Status

The decanting of trust property from one grantor trust to a new grantor trust should not give rise to income tax consequences for the grantor. Similarly, decanting from a non-grantor trust to a grantor trust³⁶ or from a grantor trust to a non-grantor trust³⁷ should not give rise to income tax consequences for the grantor. In all of these situations, the Receiving Trust should have a carryover basis in all the property received from the Distributing Trust.

2. Identity of the Grantor

Treasury regulations provide that if a trust transfers property to another trust, the grantor of the transferor trust generally will be treated as the grantor of the transferee trust.³⁸ However, if a person with a general power of appointment with respect to the transferor trust exercises that power in favor of another trust, such person will be treated as the grantor of the transferee trust,

³⁴ See IRC § 2642(a)(3)(B)(ii); Treas. Reg. § 26.2642-6(d)(7). See also Treas. Reg. § 26.2642-6(h) (treatment of trusts resulting from a severance that is not qualified).

³⁵ Zeydel & Blattmachr, *Tax Effects of Decanting -- Obtaining and Preserving the Benefits*, 111 J. TAX'N (November 2009).

³⁶ Rev. Rul. 85-13, 1985-1 C.B. 184 (conversion of nongrantor trust to grantor trust [by reason of trust's purchase of assets from the grantor for a note, which constituted an indirect borrowing by the grantor] did not result in taxable income to grantor); Chief Counsel Advice 200923024.

³⁷ Rev. Rul. 77-402, 1977-2 C.B. 222, found that a transfer of trust property consisting of certain partnership interests from a grantor trust to non-grantor trust can cause the grantor to recognize income. However, this ruling should not be extended to a decanting to the extent the decanting involves the transfer of non-partnership property because the conclusion of Rev. Rul. 77-402 was based on a particular rule of partnership taxation, IRC § 752(d), which requires a realization of income if a partner's share of partnership liabilities is reduced or eliminated by reason of a transfer or deemed transfer of a partnership interest. An ordinary decanting, not involving partnership interests, from a grantor trust to a non-grantor trust should have no tax consequences in the same way as any other change in grantor trust status.

³⁸ Treas. Reg. § 1.671-2(e)(5), (e)(6), Ex. 8-9.

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even if the transferor trust is a grantor trust with respect to the grantor. These same rules should apply to a transfer of property from a Distributing Trust to a Receiving Trust through a decanting (regardless of whether the decanting is implemented by a trustee who is also the holder of a general power of appointment).

In addition, if the Receiving Trust is an established trust, the grantor of the Distributing Trust should be the grantor of the Receiving Trust only as to the property that is the subject of the decanting.

3. Distributable Net Income

Regarding complex trusts, in general, a decanting should carry out the Distributing Trust's distributable net income ("DNI") as defined in IRC §§ 661 & 662.³⁹ Thus, the Receiving Trust would receive taxable income and the Distributing Trust would have a corresponding deduction under IRC § 661(a).⁴⁰ If all of the Distributing Trust's property is subject to the decanting, all of the Distributing Trust's DNI would be shifted to the Receiving Trust. In this situation, the DNI would include capital gain because the Distributing Trust would be, in effect, making a termination distribution.⁴¹

4. Tax Consequences to a Beneficiary

A beneficiary could conceivably be deemed to have recognized income due to a decanting that changed the beneficiary's interest. Under *Cottage Savings Association v. Commissioner*,⁴² this income might be recognized were the IRS to determine that the beneficiary's interest under the Receiving Trust is "materially different" from the beneficiary's interest under the Distributing Trust. Beneficial interests are materially different if their respective possessors enjoy legal entitlements that are different in kind or extent.⁴³ However, even if a beneficiary's interests under the Distributing Trust and the Receiving Trust are materially different, if such beneficiary did not participate (as a trustee) in the subject decanting transaction, no taxable income should be realized by the beneficiary regardless of whether his or her beneficial interest in the Receiving Trust is materially different.⁴⁴ Similarly, a decanting by a non-beneficiary trustee that effects a conversion of such beneficiary's interest from an income

³⁹ See Zeydel & Blattmachr, *supra*, note 34 ("A distribution by the trustee, pursuant to a decanting statute, of less than the entire corpus of the trust seems, as indicated above, to be the equivalent of a discretionary distribution by the trustee to a beneficiary. Presumably, it will be deemed to consist of DNI although special rules may limit the amount of DNI that is shifted from the trust to the beneficiary.").

⁴⁰ See Culp & Mellen, *supra*, note 15, at 35.

⁴¹ IRC § 642(h); Treas. Reg. § 1.643(a)-3(e), Ex. 7.

⁴² 499 U.S. 554 (1991).

⁴³ *Id.* at 564-565.

⁴⁴ Even if the beneficiary affirmatively consents to the decanting, the giving of consent should not result in adverse income tax consequences to the beneficiary because a beneficiary's consent to a decanting is *never* required under the law of any state. See the discussion *supra*, note 3, regarding the GST tax consequences, or lack thereof, of a beneficiary granting consent to a decanting transaction where consent is not necessary.

interest to a unitrust interest under Treas. Reg. § 1.643(b)-1 should not give rise to tax consequences to such beneficiary.

5. Severance

Under Treas. Reg. § 1.1001-1(h), a severance of a trust would not constitute an exchange of property for other property differing materially either in kind or extent if applicable state law or the governing instrument allows the severance of the trust and the non-pro-rata funding of the trusts.⁴⁵ This same rule should also apply to a decanting that is permitted under a trust's governing instrument or applicable state law. However, if: (a) neither the terms of the trust nor state law authorizes the decanting or a non-pro-rata division of trust property; and (b) a beneficiary acquiesces or consents to the decanting on a non-pro-rata basis, a taxable exchange could result.⁴⁶

6. Trusts Holding Retirement Assets

It is common for an owner of retirement assets (*e.g.*, pension plans, IRAs, IRC § 401(k) plans and profit-sharing plans) to name a trust as the recipient of such retirement assets upon the owner's death. After the owner's death, most retirement assets are subject to minimum required distribution rules under IRC § 401(a)(9) that mandate distributions of a certain amount each year from the retirement asset and the recognition of such distributions as taxable income as and when received by the beneficiary. These minimum required distributions may be reduced, and taxable income deferred, if a trust that is the beneficiary of a retirement asset meets certain requirements. One of these requirements is that the beneficiaries of the trust all qualify as "designated beneficiaries."⁴⁷ Individuals are considered designated beneficiaries for purposes of these rules, while beneficiaries such as estates, partnerships and charities are not considered designated beneficiaries.

If a trust that holds retirement assets has a beneficiary who is not a "designated beneficiary" and if such beneficiary is removed or eliminated as a beneficiary by September 30th of the year following the year of the death of the retirement asset owner, the trust will qualify as a "designated beneficiary" and required retirement asset distributions can be minimized.⁴⁸ Even if all the beneficiaries of the trust qualify as designated beneficiaries, income tax deferral can be maximized if certain older designated beneficiaries are removed before that date because

⁴⁵ See Rev. Rul. 69-486, 1969-2 C.B. 159 (implication that non-pro-rata distribution from estate is not a taxable exchange by beneficiaries if the executor has the authority to make a non-pro rata distribution under the trust instrument or state law); Pvt. Ltr. Rul. 200010037 (March 13, 2000) (no sale or exchange occurs due to partition of trusts, which did not arise from an exchange of trust interests by beneficiaries but rather from authority granted in the trust instrument).

⁴⁶ See Culp & Mellen, *supra*, note 15, at 33; Zeydel & Blattmachr *supra*, note 34.

⁴⁷ Treas. Reg. § 1.401(a)(9)-4.

⁴⁸ See Treas. Reg. § 1.401(a)(9)-4, A-4(a) (participant's designated beneficiary "will be determined based on the beneficiaries designated as of the date of death who remain beneficiaries as of September 30 of the calendar year following the calendar year of the employee's death").

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minimum required distributions are calculated based on the life expectancy of the oldest trust beneficiary.⁴⁹

A decanting should qualify as an effective method to remove a trust beneficiary who is not a "designated beneficiary" within the meaning of IRC § 401(a)(9). The decanting could move the retirement asset to another trust the beneficiaries of which will all qualify as designated beneficiaries. The minimum required distributions from the retirement asset to the trust will then be minimized and income tax can be deferred.

7. Tax Identification Number

If all of the property of the Distributing Trust is transferred to the Receiving Trust through a decanting, the Receiving Trust should be able to use the same tax identification number used by the Distributing Trust, or the trust could elect to obtain a new tax identification number. Either approach should be satisfactory.

* * *

We very much appreciate your consideration of our comments in response to Notice 2011-101 and would be pleased to provide further perspectives about our comments.

Respectfully submitted,



Stephen Akers
Fiduciary Counsel – Southwest Region
(214) 981-9407
akers@bessemer.com



James Kronenberg
Chief Fiduciary Counsel
(212) 708-9311
kronenberg@bessemer.com

⁴⁹ Treas. Reg. § 1.401(a)(9)-5, A-5(a)(1), A-7(a)(1).