



June 26, 2012

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Re: Comments on [Notice 2011-101](#) regarding Transfers by a Trustee From an Irrevocable Trust to Another Irrevocable Trust (“Decanting”); Requests for Comments (12/27/2011)

Dear Messrs. Shulman, Wilkins, Van Hove, and Wilson:

The American Institute of Certified Public Accountants (AICPA) submits the below comments in response to Notice 2011-101, regarding transfers by a trustee from an irrevocable trust to another irrevocable trust (often referred to as “decanting”).

The AICPA is the national professional organization of certified public accountants comprised of more than 377,000 members. Our members advise clients on federal, state and international tax matters and prepare income and other tax returns for millions of Americans. Our members provide services to individuals, not-for-profit organizations, small and medium-sized businesses, as well as America’s largest businesses.

Background

The Notice requests comments 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”) that have the effect of changing the beneficial interests of the property held in trust should be treated as having no income, gift, estate, and/or generation-skipping transfer (GST) tax consequences.

Although apparently not defined by any state statute, the term “decanting” is often used to refer to the trustee’s exercise of discretion, granted by the governing instrument or state statute, to transfer some or all of the trust property from the distributing trust to a receiving trust whose provisions in some way differ

The Honorable Douglas H. Shulman
The Honorable William J. Wilkins
Mr. Jeffrey Van Hove
Mr. Curtis G. Wilson
June 26, 2012
Page 2 of 17

from the original distributing trust. The underlying rationale of decanting is that if a trustee has the discretionary power to transfer property to or for the benefit of one or more trust beneficiaries, then the trustee, in effect, has a power similar to a limited power of appointment, although exercisable in fiduciary capacity.

Trustees have expressed a variety of non-tax and tax-related objectives for decanting, including, but not limited to, the following:

- Changing administrative provisions, such as those related to investment policy, powers to sell trust property, or powers to borrow;
- Changing trusteeship provisions, including compensation, indemnification, designation of successor trustees, and removal provisions;
- Changing a trust's situs or governing law;
- Merging or dividing trust property to create separate trusts;
- Adding a spendthrift provision;
- Correcting errors or ambiguities in trust drafting;
- Modernizing a trust to address changes in federal or state law;
- Adding language to qualify a trust for tax purposes, such as to hold S-Corporation stock or to qualify it as a "designated beneficiary" for retirement plans;
- Converting a trust to a "special needs trust" in order for a disabled beneficiary to continue to receive federal or state aid;
- Severing a trust for GST tax purposes, into trusts with inclusion ratios of one and zero.

As of the date of our response, we understand that a number of states have enacted decanting statutes. Our comments do not compare or contrast the respective state decanting statutes, nor do they address the effect of state law or the absence of state law as it relates to a decanting action. Instead, our comments address what we believe to be the relevant federal income tax, gift tax, estate tax, and GST tax issues, as well as certain foreign trust aspects, of decanting as requested in the Notice.

Income Tax

Grantor Trusts

If a trust is treated as owned by the grantor or another (deemed owner) under subpart E, part I, subchapter J, chapter 1 of the Code (a grantor trust), the deemed owner is treated as the owner of the assets in the trust for federal income tax purposes. See Rev. Rul. 85-13, 1985-1 C.B. 184. If a wholly-owned grantor trust is decanted into another wholly-owned grantor trust with the same deemed owner, the deemed owner is treated as owning the trust assets before and after the decanting. Nothing has happened for federal income tax purposes.

The Honorable Douglas H. Shulman
The Honorable William J. Wilkins
Mr. Jeffrey Van Hove
Mr. Curtis G. Wilson
June 26, 2012
Page 3 of 17

If a grantor trust is decanted into a trust which is not a grantor trust, then for federal income tax purposes the deemed owner of the old trust is treated as transferring the assets in that trust to the new trust. One possible income tax consequence of such a transaction arises if an asset transferred is subject to a liability in excess of the deemed owner's basis in that asset. The grantor would have to recognize gain if the liability from which the deemed owner is discharged upon the transfer exceeds the deemed owner's basis in the asset subject to the liability. Treas. Reg. § 1.1001-2(c), *Example 5*.

Non-grantor Trusts

The rest of the income tax discussion focuses on situations in which a non-grantor trust is decanted under a state statute. We have addressed herein two potential income tax issues that may arise. One issue is whether the receiving trust is a new trust or a continuation of the distributing trust. The other issue is whether there are any income tax consequences to any of the beneficiaries as a result of a decanting.

1. Status of Decanting Trust

Division of Trust - If a trust is merely dividing into separate shares or separate trusts under the terms of the trust agreement, then we believe the receiving trusts are a continuation of the distributing trust. For example, if a trust for the benefit of the grantor's child divides, upon the child's death, into separate trusts for the benefit of the grantor's grandchildren, all the grandchildren's trusts are, collectively, a continuation of the child's trust. Of necessity, only one of the receiving trusts can retain the distributing trust's taxpayer identification number (TIN), while the others will receive new TINs. Nevertheless, the division should not be treated as a distribution by the distributing trust subject to the provisions of sections 661 and 662. Each of the new trusts will take its pro-rata portion of all the tax attributes of the distributing trust. In addition, if (1) the decanting under a state statute involves transferring part of the assets of the distributing trust to a receiving trust for one or more beneficiaries, (2) those beneficiaries are no longer potential beneficiaries of the distributing trust, and (3) the terms of the distributing trust and the receiving trust remain the same with the exception of the identity of the trust beneficiaries, then we believe this transaction is a division of the old trust, which is not subject to the provisions of sections 661 and 662. As a result, the tax attributes of the old trust will be divided pro-rata between the old trust and the new trust.

Receiving Trust - If the decanting under a state statute involves transferring *all* of the distributing trust to an existing receiving trust (with non-identical terms), or a transfer of a portion of the distributing trust to an existing receiving trust, we believe that the distributing trust is making a distribution to the receiving trust subject to the provisions of sections 661 and 662. For example, if a trust for the benefit of the grantor's spouse terminates upon the spouse's death and all the assets are distributed to the existing family trust, the spouse's trust is making a distribution to the family trust for purposes of sections 661 and 662. If the decanting involves transferring *all* of the assets of the distributing trust in a series of distributions to a new receiving trust (not all within a single calendar year), we believe the distributing trust is making distributions to the new receiving trust subject to the provisions of sections 661 and 662. The distributing trust will terminate upon the last distribution of assets to the receiving trust. If the decanting involves transferring a *portion* of the assets of the distributing trust to a receiving trust without

The Honorable Douglas H. Shulman
The Honorable William J. Wilkins
Mr. Jeffrey Van Hove
Mr. Curtis G. Wilson
June 26, 2012
Page 4 of 17

changing the terms of the distributing trust or to a receiving trust with different terms, we believe the distributing trust is making a distribution to the receiving trust subject to the provisions of sections 661 and 662. For example, if pursuant to the trustee's discretionary authority to distribute principal to or for the benefit of the grantor's children, the trustee transfers some of the assets to a new trust for the benefit of one child, without otherwise changing the terms of the distributing trust so that the child remains a potential beneficiary of the old trust, the transfer is a distribution subject to the provisions of section 661 and 662. The distributing trust will terminate upon the last distribution of assets to the new receiving trust. Similarly, if a *portion* of the assets of the distributing trust are transferred to a receiving trust for one or more beneficiaries, those beneficiaries no longer are potential beneficiaries of the distributing trust, but the terms of the receiving trust are different from terms of the distributing trust (in addition to differences in the identity of the trust beneficiaries), the transfer is a distribution subject to the provisions of sections 661 and 662.

Transfer(s) Within Single Year - If the distributing trust is transferring all its assets in one transfer to a new receiving trust (or in a series of distributions all occurring within a single calendar year), then we believe the new receiving trust is a continuation of the distributing trust and the provisions of sections 661 and 662 do not come into play. For example, if the trustee exercises its discretionary authority to make distributions to or for the benefit of the grantor's child by distributing all the property in the trust to a new trust for the benefit of that child, the new trust should be treated as a continuation of the distributing trust. In some situations it may not matter whether the new receiving trust is treated as a continuation of the distributing trust or the distributing trust is treated as terminating and distributing all its assets to the new receiving trust.

2. *Income Tax Consequences*

If the distributing trust is treated as terminating, then the distributable net income (DNI) of the distributing trust will include capital gains in the final year. The distributing trust will receive a deduction for the amount of DNI and the receiving trust will include the same amount in income. Any net operating loss carryovers under section 172, any capital loss carryovers under section 1212 and any deductions in excess of gross income will carry over to the receiving trust as a beneficiary succeeding to the property of the distributing trust under section 642(h). Thus, it would have the same effect as if the distributing trust continued and was taxed on its capital gain and retained its tax attributes.

Section 642(h) - So far it would appear that the tax results are the same irrespective of whether or not the receiving trust is treated as a continuation of the distributing trust. There are, however, several differences. First, the excess deduction that the receiving trust is entitled to under section 642(h) is deductible only in computing taxable income, not adjusted gross income. Therefore, the deduction is subject to the 2 percent income floor in the hands of the new trust under Treas. Reg. § 1.642(h)-2(a).

Second, not all tax attributes of the distributing trust carry out to a receiving trust under section 642(h). Any charitable deduction in the distributing trust's final year is not carried over but is wasted

The Honorable Douglas H. Shulman
The Honorable William J. Wilkins
Mr. Jeffrey Van Hove
Mr. Curtis G. Wilson
June 26, 2012
Page 5 of 17

under Treas. Reg. § 1.642(h)-2(a). Passive activity losses suspended under section 469 are also not included in the items distributed to the receiving trust under section 642(h). Rather, the suspended passive activity losses are added to the basis of the distributed activity in accordance with section 469(j)(6). As a result, the basis adjustment would increase the depreciable basis of an asset owned directly by the receiving trust and the trust's outside basis of a partnership interest. The basis increase is for the entire amount of suspended passive activity losses and is not limited to the activity's fair market value on the date of distribution.

Third, section 642(h) does not include unused tax credits as items that may be carried over from a terminating distributing trust to the receiving trust. These credits could include the foreign tax credit, the AMT credit, general business credits, and special credits.

Liabilities in Excess of Basis - The possibility also arises that the distributing trust may have to recognize gain if property it transfers is subject to a liability that exceeds the trust's basis in the property. We believe that section 643(e), which provides in general that the fiduciary's basis in property distributed in kind carries over to the beneficiary, addresses this issue.

Recommendations

We believe that decanting (when all the assets of the distributing trust are transferred at the same time to one or more receiving trusts) should be viewed as a continuation of the distributing trust, rather than the termination of the distributing trust. Such a position would be the simplest from an administration perspective and is consistent with existing law. Unless there is a gift or estate tax consequence as a result of the decanting, the grantor of the distributing trust will remain the grantor of the receiving trust for federal income tax purposes. Treas. Reg. § 1.671-2(c)(5) provides that if a trust makes a gratuitous transfer of property to another trust, the grantor of the transferor trust generally will be treated as the grantor of the transferee trust.

One of the only IRS pronouncements on the tax effects of decanting is Priv. Ltr. Rul. 2007-36-002 (May 22, 2007). In that case, pursuant to a court order, the assets in an existing trust will be divided pro-rata among three successor trusts with substantially the same terms as the original trust. The ruling concludes that because the creation of the successor trusts is a modification of the original trust for federal income tax purposes, the successor trusts are treated as a continuation of the original trust and the transfer of assets from the original trust to the successor trusts will not be treated as a distribution or termination under Section 661 and will not result in the realization by the original trust, the successor trusts, or by any beneficiary of the original trust or the successor trusts of any income, gain, or loss.

Treating the receiving trust as a continuation of the distributing trust eliminates the need to obtain a new EIN (unless there is more than one receiving trust), to file two tax returns for one year, and to complete Form 1041, Schedule K-1 to transfer tax attributes from the distributing trust to the receiving

The Honorable Douglas H. Shulman
The Honorable William J. Wilkins
Mr. Jeffrey Van Hove
Mr. Curtis G. Wilson
June 26, 2012
Page 6 of 17

trust. In addition, such an approach avoids the potential issues discussed above that would be present if the distributing trust is treated as terminating and distributing all its assets to the receiving trust.

Income Tax Consequences to Beneficiaries

Another potential income tax issue of decanting is whether any of the beneficiaries have any income tax consequences as a result of decanting. Section 61(a)(3) provides that gross income includes gains derived from dealings in property and, under section 61(a)(15), from an interest in a trust. Section 1001(a) provides that the gain from the sale or other disposition of property is the excess of the amount realized over the adjusted basis provided in section 1011 for determining gain, and the loss is the excess of the adjusted basis provided in section 1011 for determining loss over the amount realized. Under Section 1001(c), the entire amount of gain or loss must be recognized, except as otherwise provided. Treas. Reg. § 1.1001-1(a) provides that, except as otherwise provided in subtitle A (relating to income tax), the gain or loss realized from the exchange of property for other property differing materially either in kind or in extent is treated as income or as loss sustained.

Under *Cottage Savings Association v. Commissioner*, 499 U.S. 554 (1991), an exchange of property results in the realization of gain or loss under section 1001 if the properties exchanged are materially different. Properties exchanged are materially different if the properties embody legal entitlements different in kind or extent or if the properties confer different rights and powers. In defining what constitutes a material difference for purposes of section 1001(a), the Court stated that properties are different in the sense that is material to the Code so long as their respective possessors enjoy legal entitlements that are different in kind or extent.

Private letter rulings that analyze *Cottage Savings* in the context of a trust merger or modification apply a two part test to determine whether a sale or exchange has occurred: (1) there must be a sale, exchange, or other disposition; and (2) if an exchange, it must result in the receipt of property that is materially different from the relinquished property. If the transaction is the result of the trustee merely exercising its existing authority under the governing instrument to exercise any additional powers conferred as a result of the change to state law, the private letter rulings conclude that the beneficiaries do not acquire their interests in trust as a result of an exchange and because there is no exchange, there is no receipt of property that is materially different in legal entitlements from the relinquished property. See, for example, Priv. Ltr. Rul. 2011-34-017 (May 26, 2011), Priv. Ltr. Rul. 2006-08-007 (Nov. 16, 2005), Priv. Ltr. Rul. 2005-39-001 (June 24, 2005). Accordingly, the private letter rulings conclude that the transfer of assets from one trust to another will not result in realization of gain or loss under section 61 or section 1001 by either trust or by any beneficiary.

In accordance with the private letter rulings cited above, we believe that if a trustee is permitted to decant a trust under a state statute without the consent of the beneficiaries, there is no exchange for purposes of section 1001 and no income tax consequences to either trust or to any beneficiaries. If the beneficiaries are *required* to consent to the trustee's actions, then the beneficiaries are participating in the decision to

The Honorable Douglas H. Shulman
The Honorable William J. Wilkins
Mr. Jeffrey Van Hove
Mr. Curtis G. Wilson
June 26, 2012
Page 7 of 17

decant. As a result, the facts must be analyzed to determine whether the beneficiaries' interests before and after the decanting are materially different. If their interests are not materially different, there are no income tax consequences. This would always be the case if the beneficiary is a purely discretionary beneficiary both before and after the decanting. If a beneficiary had a vested interest in the original trust and that interest was changed either by increasing it or decreasing it upon the decanting, the beneficiary could have a recognized gain or loss as a result of agreeing to the decanting.

Gift Tax

Section 2501 imposes a gift tax on any transfer of property by gift. Under Treas. Reg. § 25.2511-1(a), the gift tax applies to gifts that are indirectly made. Any transaction in which an interest in property is gratuitously passed or conferred upon another, regardless of the means or device employed, constitutes a gift subject to tax.

Under the decanting statutes, the trustee has the ability under certain circumstances to transfer assets from one trust to another trust. The terms of the new trust may change ministerial provisions, timing provisions, or perhaps beneficial interests. If the trustee is not a beneficiary of the trust, one issue is whether the trustee can act on its own in decanting the trust or is required to obtain the consent of the beneficiaries in order to take the proposed action. If the trustee is required to obtain the consent of the beneficiaries, then consideration must be given to whether the beneficiaries have vested interests in the trust or whether they are merely potential recipients of distributions from a purely discretionary trust.

Beneficiaries With Vested Interests Required to Consent

If the beneficiaries are required to give consent to the proposed action *and* if they have vested interests in the trust, then it appears that they could be making a gift subject to gift tax if, as a result of the decanting, the interests of some beneficiaries have been reduced. A decanting resulting in purely administrative changes should not change the vested interests of any of the beneficiaries and, thus, should not result in a transfer for gift tax purposes. However, there may be a different result if the beneficial interests are changed as a result of the decanting. *Example 6* in Treas. Reg. § 25.2511-1(h) provides that, if an individual has a vested remainder interest in property, subject to being divested only in the event the individual fails to survive another individual, an irrevocable assignment of all or any part of that interest results in a transfer subject to gift tax. Consenting to a decanting that reduces a beneficiary's vested interest in trust property may be viewed as analogous to this example and could result in a taxable gift by the beneficiary.

Other Situations

We believe that the same rule should apply to other categories of situations in which the beneficial interests in the trust may change as a result of the decanting. In one category, the beneficiaries do not have vested interests and may or may not be required to consent to the decanting. In another category, the

The Honorable Douglas H. Shulman
The Honorable William J. Wilkins
Mr. Jeffrey Van Hove
Mr. Curtis G. Wilson
June 26, 2012
Page 8 of 17

beneficiaries may or may not have vested interests, but the trustee is permitted to act on its own without their consent. In a final category, the beneficiaries may or may not have vested interests and the trustee is permitted to act on its own without their consent but chooses to seek their consent. In none of these situations has the beneficiary voluntarily surrendered any interest in the trust.

If the beneficiary has no vested interest in the trust, the beneficiary is entitled to nothing from the trust unless and until the trustee decides to make a distribution to the beneficiary. Any change in the terms of the trust upon decanting cannot result in a transfer by the beneficiary because the beneficiary had no rights in the trust before the decanting. This is true even if all the discretionary beneficiaries are required to consent to the decanting.

If the trustee can act on its own without the consent of the beneficiaries, the beneficiaries have no say in the action and cannot be considered to make a transfer subject to gift tax based on an action that is totally beyond their control. A transfer by gift must involve a voluntary action on the part of the person making the gift. An action by another party should not equate to a taxable transfer by someone who was not a party to the action. Concluding that the beneficiaries have not made a gift when the trustee can act on its own is the proper result even if the beneficiaries have vested interests in the trust. This is also the proper result even if the trustee requests the beneficiaries' consent even though it could act on its own.

Trustee/Beneficiary

If a beneficiary is a trustee or one of the trustees, there may be gift tax consequences to decanting. An individual acting in these dual roles could be treated as having a general power of appointment if the trustee has the ability under the terms of the trust to appoint property to himself or herself. A decanting that results in changing beneficial interests may be considered an exercise of the general power of appointment within the meaning of Sections 2514 and 2041 and subject the trustee/beneficiary to gift tax on the transaction.

It would be unusual for a beneficiary to be the trustee of a discretionary trust without either the terms of the trust or applicable state law limiting the trustee's ability to make distributions to himself or herself to, at most, an ascertainable standard of health, education, maintenance and support within the meaning of section 2041(b)(2). In such a situation, the actions of the trustee/beneficiary should have no different gift tax consequences than those discussed above for situations in which the trustee is not a beneficiary.

Delaware Tax Trap

Section 2514(d) treats the exercise of a special power of appointment as a transfer for gift tax purposes if the power holder exercises a granted power to create another power of appointment and, under applicable local law, the new power of appointment can be validly exercised to postpone the vesting of any estate or interest in the property which was subject to the first power, or suspend the absolute ownership or power of alienation of such property, for a period ascertainable without regard to the date of the creation of the

The Honorable Douglas H. Shulman
The Honorable William J. Wilkins
Mr. Jeffrey Van Hove
Mr. Curtis G. Wilson
June 26, 2012
Page 9 of 17

first power. Thus, if a beneficiary exercises a power of appointment by creating another power of appointment, the beneficiary has made a taxable gift if the vesting of the property under the second power could be extended beyond the appropriate period based upon the date the first power was created.

The ability of a trustee to decant a trust under the terms of the applicable state statute should not be considered a power of appointment. If the trustee is a beneficiary, then it could be argued that the trustee/beneficiary's action in decanting under the state statute and extending the potential vesting of interests beyond the appropriate period with reference to the date the original trust was created may be a transaction within the purview of section 2514(d). However, a trustee, who is not also a beneficiary, is merely exercising a fiduciary power granted to the trustee under the applicable state statute to deal with the trust property for the benefit of the beneficiaries of the trust. We believe this action should not be treated as the exercise of a power of appointment because the trustee has a fiduciary responsibility to take into consideration the interests of all the current and future beneficiaries of the trust and to take actions with regard to the trust only in a fiduciary capacity.

Estate Tax

As a general rule, there should be no adverse estate tax consequences to a decanting. However, every situation involving a decanting will need to be evaluated based upon the facts and circumstances at hand. The comments below are organized on a situational basis.

Living Settlor/Grantor with Estate Inclusion of Original Trust Prior to Decanting

Where, prior to decanting, the assets of the distributing trust would have been includible in the gross estate of a settlor/grantor, the assets of the receiving trust in the decanting would also typically be includible in the gross estate of the same individual, unless the terms of the new trust are changed in a way that eliminate the powers or interests that resulted in estate tax inclusion of the distributing trust. Note though, that if the "strings" that would have resulted in inclusion are eliminated, gift tax consequences may arise and the three-year estate tax inclusion period of section 2035 may be invoked.

Living Settlor/Grantor with No Estate Tax Inclusion of Distributing Trust Prior to Decanting

Where the assets of the distributing trust would not be includible in the estate of the settlor/grantor, decanting the assets to a receiving trust would not normally change that result, unless:

- a. The terms of the receiving trust provide the settlor/grantor or the spouse of the settlor/grantor with powers or an interest in the trust, which either: (1) result in inclusion under sections 2036 through 2038; (2) allow the creditors of the settlor/grantor to access the assets of the trust, or (3) the settlor/grantor acquires the right to remove trustees and appointment him/herself or a subordinate/subservient person as trustee.

The Honorable Douglas H. Shulman
The Honorable William J. Wilkins
Mr. Jeffrey Van Hove
Mr. Curtis G. Wilson
June 26, 2012
Page 10 of 17

- b. If the settlor/grantor were to be required to consent to the decanting (or even be asked to consent to the decanting by a trustee as a precautionary measure) the settlor/grantor could potentially be viewed as having a prohibited control (even if just implied) over the beneficial enjoyment of the assets of the trust that could potentially cause estate tax inclusion under sections 2036 or 2038.

Non-Beneficiary Trustee/Administrator/Protector

If the assets of the distributing trust are includible in the gross estate of the non-beneficiary trustee under section 2041, the receiving trust would similarly be includible unless the prohibited general power of appointment is effectively released (*i.e.*, eliminated from the terms of the receiving trust). The release of a general power of appointment can result in gift tax consequences as well as an extended estate tax inclusion period under section 2035.

That said, if the assets of the distributing trust would not be included in the gross estate of the trustee under Section 2041, there should be no impact on estate tax inclusion for the trustee unless the provisions of the receiving trust create a general power of appointment in the trustee.

A trustee's decision to decant a trust—pursuant to either a power of invasion or a decanting power (under state law or the trust instrument)—should generally be viewed as similar to the exercise of a limited power of appointment and would not alone impact the estate tax inclusion of the trust assets (unless a general power is created or released as a consequence of the decanting). Further to that point, a decanting that triggers the Delaware Tax Trap (as defined earlier) pursuant to section 2041(a)(3) can also cause estate tax inclusion for a trustee.

Non-Settlor/Grantor Beneficiary

Where the assets of a trust are not includible in the estate of a beneficiary, decanting would have no impact on estate tax inclusion, unless one or more of the following is true:

- a. The receiving trust provides a beneficiary with a general power of appointment;
- b. The beneficiary is given the right to remove a trustee responsible for making discretionary distributions to him/her and replace with a related or subordinate party (to the extent equivalent to a general power of appointment);
- c. The decanting results in a completed gift by the beneficiary, who also retains powers in the receiving trust which are taxable under the estate tax “string provisions” under any of sections 2035, 2036, 2037, 2038, or 2042, or

The Honorable Douglas H. Shulman
The Honorable William J. Wilkins
Mr. Jeffrey Van Hove
Mr. Curtis G. Wilson
June 26, 2012
Page 11 of 17

- d. The decanting results in an incomplete gift by the beneficiary that becomes complete at the beneficiary's death and is includible under section 2036(a)(2) and/or section 2038.

Where a trust's assets are includible in a beneficiary's estate prior to decanting, decanting the trust could potentially impact estate inclusion if the result is a release of a general power of appointment or if "strings" resulting in estate tax inclusion are removed, in which case gift tax consequences may result.

Generation-Skipping Transfer Tax

Chapter 13 of the Internal Revenue Code imposes an additional tax equal to the highest estate tax rate on certain generation-skipping transfers. The purpose of Chapter 13 of the Code is to ensure that property is subject to transfer tax (*i.e.*, gift or estate tax) at each generational level.

The GST tax applies to three types of generation-skipping transfers: direct skips, taxable terminations, and taxable distributions. The amount of GST tax due on the transfer, the person liable for the tax, the allocation of GST exemption and the method by which it is allocated, all depend on the classification of the taxable transfer.

Section 2612(a) provides that the term "taxable termination" means a termination (by death, lapse of time, release of a power, or otherwise) of an interest in property held in a trust unless: (a) immediately after such termination, a non-skip person has an interest in such property; or (b) at no time after such termination may a distribution (including distributions on termination) be made from such trust to a skip person. Section 2612(b) provides that the term "taxable distribution" means any distribution from a trust to a skip person (other than a taxable termination or a direct skip). Section 2612(c) provides that the term "direct skip" is a transfer subject to federal estate or gift tax of an interest in property to a skip person.

Grandfathered Trusts

Certain trusts are grandfathered and, therefore, not subject to Chapter 13. Under section 1433(a) of the Tax Reform Act of 1986 (the "Act") and Treas. Reg. § 26.2601-1(a), the GST tax is generally applicable to generation-skipping transfers made after October 22, 1986. However, under section 1433(b)(2)(A) of the Act and Treas. Reg. § 26.2601-1(b)(1)(i), the GST tax does not apply to a transfer under a trust that was irrevocable on September 25, 1985, but only to the extent that such transfer is not made out of corpus added to the trust after September 25, 1985 (or out of income attributable to corpus so added). Under Treas. Reg. § 26.2601-1(b)(1)(ii), any trust in existence on September 25, 1985, will be considered irrevocable unless the settlor had a power that would have caused inclusion of the trust in his or her gross estate under Section 2038 or 2042, if the settlor had died on September 25, 1985. Barring additional transfers to an irrevocable trust created before September 25, 1985, such trust is not subject to GST tax. These trusts are commonly referred to as "grandfathered trusts."

The Honorable Douglas H. Shulman
The Honorable William J. Wilkins
Mr. Jeffrey Van Hove
Mr. Curtis G. Wilson
June 26, 2012
Page 12 of 17

When a grandfathered trust is modified by the action of a trustee, beneficiary or grantor of a trust, there is a concern that the grandfathered status of the trust may be lost. The IRS has given numerous private letter rulings regarding the effect of a trust modification on the grandfathered status of a trust. The IRS issued so many private letter rulings that on December 20, 2000, the IRS issued final regulations (T.D. 8912, 65 Fed. Reg. 79735) regarding the type of trust modifications that will not affect the GST tax-exempt status of a grandfathered trust. The regulations group trust modifications into four categories: (1) exercise of discretionary powers by fiduciaries; (2) court-approved settlements; (3) judicial construction of a trust's governing instrument and (4) other changes that do not fit within the first three categories. In general, the power of a trustee to appoint trust assets under a decanting statute should be considered the exercise of a discretionary power by a trustee to distribute assets to a new or existing trust, falling into the first category.

Treas. Reg. § 26.2601-1(b)(4)(i)(A) provides that the exercise of a discretionary power to distribute trust principal from an exempt trust to a new trust or retention of trust principal in a continuing trust will not cause the new or continuing trust to be subject to GST tax if: (1) either: (i) the terms of the governing instrument of the exempt trust authorize distributions to the new trust or the retention of trust principal in a continuing trust, without the consent or approval of any beneficiary or court; or (ii) at the time the exempt trust became irrevocable, state law authorized distributions to the new trust or retention of principal in the continuing trust, without the consent or approval of any beneficiary or court; and (2) the terms of the governing instrument of the new or continuing trust do not extend the time for vesting of any beneficial interest in the trust in a manner that may postpone or suspend the vesting, absolute ownership, or power of alienation of an interest in property for a period, measured from the date the original trust became irrevocable, extending beyond any life in being at the date the original trust became irrevocable plus a period of 21 years, plus if necessary, a reasonable period of gestation. The exercise of a trustee's distributive power that postpones or suspends the vesting, absolute ownership, or power of alienation of an interest in property for a term that will not exceed 90 years (measured from the date of the original trust) will not be considered an exercise that postpones or suspends vesting, absolute ownership, or the power alienation beyond the perpetuities period.

We submit that a decanting of a grandfathered trust should be judged by the criteria in Treas. Reg. § 26.2601-1(b)(4)(i)(A). This would be true regardless of whether the receiving trust into which part or all of the assets of the grandfathered trust were appointed is an irrevocable trust created before or after September 25, 1985.

If the assets of a grandfathered trust are distributed to a receiving trust that has assets contributed to it after September 25, 1985, we submit that rules similar to the rules in Treas. Reg. § 26.2601-1(b)(1)(iv) should apply to the trust. Under this regulation section, if an addition is made to a grandfathered trust after September 25, 1985, a pro rata portion of subsequent distributions from (and terminations of interests in property held in) the trust is subject to the provisions of chapter 13. If an addition is made, the trust is thereafter deemed to consist of two portions, a grandfathered portion and a non-grandfathered portion. The grandfathered portion would represent the value of the assets transferred to the trust by the

The Honorable Douglas H. Shulman
The Honorable William J. Wilkins
Mr. Jeffrey Van Hove
Mr. Curtis G. Wilson
June 26, 2012
Page 13 of 17

grandfathered trust. The applicable fraction for the grandfathered portion is deemed to be 1 and the inclusion ratio for such portion is 0. The value of the non-grandfathered portion is the value of the trust consisting of all additions made to the trust after September 25, 1985. The inclusion ratio of the non-grandfathered portion is determined under Section 2642. In the event a trust has multiple grantors (regardless of when a transfer was made to the trust), rules similar to those contained in Section 2654(b)(2) and Treas. Reg. § 26.2654-1(a)(2) (creating separate trusts for multiple grantors for GST tax purposes) should apply.

Non-Grandfathered Trusts

Trusts created after September 25, 1985, are subject to Chapter 13. Transfers to these trusts are subject to GST tax if a potential beneficiary of the trust is a skip person. For purposes of this discussion, we have assumed that a decanting will not result in gift or estate tax to the trustee or to any beneficiary.

Section 2613(a)(1) defines “skip person” as all natural persons two or more generations younger than the transferor. Section 2652(a) defines the “transferor” as: (a) in the case of a transfer subject to estate tax, the decedent and (b) in the case of a transfer subject to gift tax, the donor. Treas. Reg. § 26.2652-1(a) provides that the individual with respect to whom property was most recently subject to gift or estate tax is the transferor for GST tax purposes. Unless a person makes a transfer to a trust to which gift or estate tax is applicable, a GST tax cannot be assessed. The one exception to this general statement is the exercise, release or lapse of a general power of appointment under section 2041 or section 2514.

Less often than in the case of a grandfathered trusts, the IRS has ruled on the GST tax consequences of a modification of a trust in which the trust has an inclusion ratio of zero (*i.e.*, a GST-exempt trust). In those rulings the IRS notes that no guidance has been issued concerning modifications that may affect the status of trusts that are exempt from GST tax because sufficient GST exemption has been allocated to the transfers to result in an inclusion ratio of zero. However, the IRS concludes that at a minimum, a modification that would not affect the GST status of a grandfathered trust should similarly not affect the GST tax-exempt status of a trust with a zero inclusion ratio. See, for example, Priv. Ltr. Rul. 2012-10-002 (Nov. 4, 2011), Priv. Ltr. Rul. 2012-04-005 (Sept. 30, 2011), and Priv. Ltr. Rul. 2011-48-001 (Aug. 1, 2011).

We submit that this is not the proper criterion of whether a modification of a trust has GST tax consequences. The focus should be on whether the modification results in a transfer for gift or estate tax purposes. If there has been no such transfer, a GST tax event cannot occur. Thus, we believe that a non-grandfathered trust may be modified in any manner with no GST tax consequences, provided the modification does not result in a taxable event for gift or estate tax purposes. We further submit that a trustee, acting in a fiduciary capacity, cannot make a transfer for gift tax or estate tax purposes. Thus, unless a decanting results in a transfer for gift tax or estate tax purposes, such a decanting should not have GST tax consequences. This is true regardless of whether the trust has an inclusion ratio of zero, one or somewhere in-between. If a transfer for gift or estate tax does occur with regard to a decanting, the

The Honorable Douglas H. Shulman
The Honorable William J. Wilkins
Mr. Jeffrey Van Hove
Mr. Curtis G. Wilson
June 26, 2012
Page 14 of 17

decanting results in a “new transferor” for GST tax purposes – which may result in GST tax consequences.

Foreign Trusts

The earlier discussion of Income Tax focused on decanting of domestic trusts. When the decanting involves a foreign trust, additional tax issues may apply, based upon special rules regarding inbound and outbound transfers in trust. Specifically, in the case of an outbound transfer (*i.e.*, a transfer from a domestic trust to a foreign trust), section 684 may apply to trigger gain recognition. In the case of an inbound transfer (*i.e.*, a transfer from a foreign trust to a domestic trust), an additional tax and interest charge may be assessed.

Outbound transfers (Decanting a domestic trust to a foreign trust)

If a domestic trust is decanted to a foreign trust, section 684 will require the recognition of gain on any appreciated assets of the trust, unless the decanting qualifies for an exception as described in Treas. Reg. § 1.684-3. The most commonly seen exception to section 684 is when any person is treated as the owner of the trust under the grantor trust rules.

As a practical matter, if the trust was established by a U.S. grantor who is still alive at the time of the decanting, section 679 will likely delay the application of section 684. In such a scenario, section 679 will apply to treat the U.S. grantor as the owner of the trust unless i) under the terms of the trust, no part of the income or corpus of the trust may be paid or accumulated during the taxable year to or for the benefit of a U.S. person; and ii) where the trust terminated at any time during the taxable year, no part of the income or corpus of such trust could be paid to or for the benefit of a U.S. person.

If the foreign trust is treated as owned by a U.S. person under section 679 or another grantor trust provision, Section 684 will then generally apply when grantor trust status terminates, unless the criteria for another exception in Treas. Reg. § 1.684-3 are satisfied (*e.g.*, assets of the trust are included in the grantor’s gross estate).

Similarly, if the foreign trust is not a grantor trust to a U.S. person, section 684 will generally apply at the time of the decanting unless the criteria for another exception in Treas. Reg. § 1.684-3 are satisfied.

Inbound transfers (Decanting a foreign trust to a domestic trust)

If a foreign nongrantor trust is decanted to a domestic trust, the key issue is the application of special income tax rules in Subpart D (Sections 665-668) regarding excess distributions. These rules may impose an additional tax (commonly referred to as a “throwback tax”) and a related interest charge in the event distributions from a trust exceed certain parameters. Specifically, the throwback tax and interest charge may apply in the event of an accumulation distribution, which is a distribution exceeding a threshold

The Honorable Douglas H. Shulman
The Honorable William J. Wilkins
Mr. Jeffrey Van Hove
Mr. Curtis G. Wilson
June 26, 2012
Page 15 of 17

amount, *i.e.*, the greater of trust accounting income or DNI, less amounts required to be distributed currently (this threshold amount will be referred to in this discussion as “current year income”).

With respect to a decanting from a foreign nongrantor trust to a domestic trust in an amount *not exceeding current year income*, section 665(b) provides that such a distribution is not an accumulation distribution, so neither the throwback tax nor the interest charge will be imposed. This conclusion applies irrespective of whether such a decanting is made to an existing domestic trust or a new domestic trust. The domestic trust would have gross income based upon the amount and character of the foreign trust’s DNI.

In the case of a decanting from a foreign nongrantor trust to a domestic trust in amounts *exceeding current year income*, the application of the throwback tax and interest charge will depend upon whether the trust to which property has been appointed is viewed as a continuation of the distributing trust or, instead, as a distribution to a receiving trust.

If the distributing trust is viewed as continuing, the throwback tax and interest charge will not be imposed at the time of the decanting. All of the attributes of the distributing trust will retain their character as DNI or undistributed net income (UNI) in the hands of the domestic trust, which will be carried out upon distribution to a U.S. beneficiary of the receiving trust. Thus, the U.S. beneficiaries of the domestic trust will be subject to throwback tax on any future accumulation distributions, and the IRS’ official position (as stated Rev. Rul. 91-6, 1991-1 C.B. 89) is that the interest charge will apply as well.

If, in the alternative, the decanting is viewed as a distribution to a receiving trust, the foreign trust will have a distribution deduction and the domestic trust will have gross income based upon the amount and character of the foreign trust’s DNI. The domestic trust will also be subject to throwback tax and interest charge based upon any distribution of UNI of the foreign trust.

To the extent a foreign trust which is a grantor trust to a U.S. person is decanted to a domestic trust, the domestic trust will not be a grantor trust under section 679, but it may otherwise be a grantor trust under Sections 671-678. If the domestic trust is somehow not a grantor trust, the income tax consequences should be those that would normally apply to a transfer by a U.S. person (*i.e.*, the U.S. grantor of the foreign trust) to a domestic trust.

Lateral transfers (Decanting from one foreign trust to another)

If a foreign trust which is a grantor trust to a U.S. person is decanted to another foreign trust, section 679 will likely apply to make the receiving trust a grantor trust if it applied to the distributing trust. In that event, section 679 would be inapplicable only if the receiving trust has a more limited class of beneficiaries that meets the standard of section 679(c)(1). If a provision other than section 679 applied to the distributing trust, the receiving trust should nevertheless be a grantor trust as long as the relevant conditions which made the distributing trust a grantor trust under sections 671-678 are also applicable to the receiving trust.

The Honorable Douglas H. Shulman
The Honorable William J. Wilkins
Mr. Jeffrey Van Hove
Mr. Curtis G. Wilson
June 26, 2012
Page 16 of 17

In the case of a decanting from one foreign nongrantor trust to another, the federal income tax treatment will depend upon whether the receiving trust is viewed as a continuation of the distributing trust or, instead, as a distribution to a receiving trust.

If the distributing trust is viewed as continuing, the throwback tax and interest charge will not be imposed at the time of the decanting. All of the attributes of the distributing trust will retain their character as DNI or UNI, which will be carried out upon distribution to a U.S. beneficiary of the receiving trust.

If, in the alternative, the decanting is viewed as a distribution to a receiving trust, the receiving trust is subject to tax on any U.S.-source income of the distributing trust. The distributing trust could typically have investment income under section 871(a)(1)(A), the liability for which would be satisfied through withholding on fixed or determinable annual or periodical (“FDAP”) income pursuant to section 1441. Typically, any foreign-source income would not be subject to tax in the hands of the distributing trust or the receiving trust (with the exception of income under section 864(c)(4)(B)). The character of the U.S.-source income (as effectively connected income (ECI) or FDAP) is retained through the distribution. US-source income or ECI earned by the distributing trust would be subject to an income distribution deduction and would flow to the receiving trust. The receiving trust should be able to use any withholding credits passed through from the distributing trust.

Because the receiving trust is foreign, the throwback tax and interest charge would only be triggered to the extent of US-source income or ECI included in UNI. The receiving trust should be considered to have the UNI of the distributing trust, to the extent of the distribution.

Conclusion

In summary, we urge the Service to consider our comments and recommendations regarding the relevant federal income tax, gift tax, estate tax, and GST tax issues, as well as certain foreign trust aspects, of decanting as requested in the Notice.

We welcome the opportunity to discuss these comments or to answer any questions that you may have. I can be reached at (401) 699-0206, or patt@pgco.com; or you may contact Frances Schafer, Chair, AICPA Trust, Estate, and Gift Tax Technical Resource Panel, at (202) 521-1511, or fran.schafer@us.gt.com; F. Eric L. Johnson, Chair, AICPA Decanting Task Force, at (312) 486-4442 or ericljohnson@deloitte.com; or Eileen Sherr, AICPA Senior Technical Manager, at 202-434-9256, or esherr@aicpa.org.

Sincerely,


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Chair, Tax Executive Committee

The Honorable Douglas H. Shulman
The Honorable William J. Wilkins
Mr. Jeffrey Van Hove
Mr. Curtis G. Wilson
June 26, 2012
Page 17 of 17

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