U.S. Private Wealth Management
U.S. Bank

IRC § 678 and the Beneficiary Deemed Owner Trust ("BDOT"):

Understanding the Asset Protection, Estate/Gift and Income Tax Ramifications of Powers of Withdrawal and General Powers of Appointment and Their Lapses

Making trusts simpler and more income tax efficient.

Investment products and services are:
NOT A DEPOSIT • NOT FDIC INSURED • MAY LOSE VALUE •
NOT BANK GUARANTEED • NOT INSURED BY ANY FEDERAL GOVERNMENT AGENCY

Speaker

Edwin P. Morrow III, J.D., LL.M. (Tax), MBA, CFP®, CM&AA®
Wealth Strategist, Eastern U.S.
U.S. Bank Private Wealth Management
OSBA Board Certified Specialist in Estate Planning and Trust
Fellow, American College of Trust and Estate Counsel

U.S. Bank Building
425 Walnut St, 7th Floor
Cincinnati, OH 45202
(513) 632-4350
Edwin.morrow@usbank.com or edwin.morrow3@gmail.com

Course Theme

"We hold these truths to be self-evident: that all trusts are *not* created equal, that they are endowed by their Creator with certain *alienable* rights, that among these are the power to defer, avoid or shift taxation and shelter assets from creditors - That to secure these rights, attorneys are endowed with certain powers to arrange such trusts as necessary for the public good."

Article Related to Presentation

This CLE will cover the recent LISI article:

Section 678 and the Beneficiary Deemed Owner Trust (BDOT), LISI Estate Planning Newsletter #2577 (Sept 5, 2017), which is in your material, but with minor updates (e.g. tax reform) and in a more organized format from the article. See www.ssrn.com for later updates (search under my name or the article name).

You will not need to refer to the outline to follow the presentation. "BDOT" refers to a trust that is deemed to be owned by the beneficiary for income tax purposes, but not for estate/gift/asset protection purposes.

Agenda for CLE

I. Background of Fiduciary Income Taxation
II. Basics of IRC § 678
III. Understanding Varying Definitions of "Income" in Subchapter J
IV. IRC §671 and the "Portion" Rules
V. Comparisons of non-grantor trust v. grantor trust scheme; incl. §199A
VI. Effect of Current, Lapsed Withdrawal Powers for
    a) estate/gift tax under IRC §2041/2514;
    b) spousal elective share; asset protection; bankruptcy
VII. Techniques to improve asset protection
VIII. Income Tax Effect of Lapse - "partial release" for IRC §678(a)(2)?
IX. Contrasting with BDITs (beneficiary defective inheritor's trusts)
X. Contrasting with *Crummey* Powers and IRC §2503 "present interest"
XI. Tax effect of amendments, reformation, decanting to add §678 powers
XII. Summary: Superior Protection with Greater Tax Simplicity

I. Income Tax Planning for Estates?

- With the federal estate tax exclusion after tax reform $11.18 million indexed for 2018-2025 ($11.4 million in 2019), plus double for married couples with portability, and considering many taxpayers with estates above those levels leave a portion to charity or private foundations, the number of estates paying estate tax is far, far less than 1% of the population, (and per Trump advisor Cohn, those are "only morons"). Even with a reversion to approximately $6 million in 2026, it is still probably not a major concern. For the 99.9%, the income tax is more concerning!
- *You're an income tax planner, whether you know it or not*! How you structure trusts has a huge impact on beneficiary income tax and proactive planning can save a bundle.

I. Three INCOME Tax Problems of Trusts

1. Lack of 2nd basis "step up" that a simple "I love you will" or even intestacy would probably provide at 2nd death (not discussed today, see separate outline on the *Optimal Basis Increase Trust,* available at www.ssrn.com)

2. Higher compressed trust income tax rates

3. Certain assets receive worse tax treatment in trust, see the recently proposed §199A regulations' anti-trust bent

The goal of this CLE is to address points #2 and #3 – **turn these negatives into POSITIVES**

I. Income Taxation of Trusts and Estates

- Subchapter J of the Internal Revenue Code (26 U.S.C.)

  - Part I - Subpart A - §§ 641-646 - General Rules
    - Subpart B - §§ 651-652 - Simple Trusts
    - Subpart C - §§ 661-664 - Complex Trusts and CRTs
    - Subpart D - §§ 665-668 - Accumulation Distributions [Foreign]
    - **Subpart E - §§ 671-679 - Grantor Trusts**
    - Subpart F - §§ 681-685 - Misc. Rules
  - Part II - §§ 691-692 - Income in Respect of a Decedent

I. Fundamental Concepts and Tax Rates

- Trusts and estates are separate taxable entities (except grantor trusts §671-679), with income divided between the trust/estate and beneficiary (unlike pass through business entities under Subchapters S or K)

- Taxable income is computed in same manner as individuals (§641(b)), "except as otherwise provided" – if you are unsure whether something is income, or deductible to a trust, first ask, "would it be income or deduction to an individual?" Then, is there an exception? Sometimes trust/estates have better tax treatment (above the line deduction for some unique expenses), but ***usually individual taxpayers fare much better***.

I. Fundamental Concepts, Compressed Tax Rates

TABLE 5 - Section 1(e) – Estates and Trusts, contrasting 2017 and 2018

2017 - If Taxable Income Is:	The Tax Is:
Not over $2,550	15% of the taxable income
Over $2,550 but not over $6,000	$382.50 plus 25% of the excess over $2,550
Over $6,000 but not over $9,150	$1,245 plus 28% of the excess over $6,000
Over $9,150 but not over $12,500	$2,127 plus 33% of the excess over $9,150
Over $12,500	**$3,232.50 plus 39.6% of the excess over $12,500**

2018 - If taxable income is:	**The tax is:**
Not over $2,550	10% of taxable income.
Over $2,550 but not over $9,150	$255, plus 24% of the excess over $2,550.
Over $9,150 but not over $12,500	$1,839, plus 35% of the excess over $9,150.
Over $12,500	**$3,011.50, plus 37% of excess over $12,500.**

[omits AMT, 3.8% NIIT, special rates for LTCG, QD, Collectibles, Section 1250 gain]

I. Fundamental Concepts: Compressed Surtax, AMT Rates

- If the trust or estate has net investment income, the 3.8% net investment income tax applies to individuals with modified adjusted gross income of $200,000 (single) or $250,000 (married filing jointly), but for trusts and estates, the same top bracket noted on last slide, is used as the threshold:
- Thus, if a trust and estate has $20,000 of net investment income in 2017 and does not make any distributions to beneficiaries, $7,500 (ignoring deductions) will be subject to 3.8% surtax (either 23.8% total rate if long-term capital gains/qualified dividends, 31.8% if collectibles, 28.8% Section 1250 gain, 43.4% if ordinary income/short term capital gains). In 2018, the same, but top rate is only 37%+3.8% = 40.8% (plus any state income tax).
- AMT exemptions (2017) are Married Filing Jointly: $84,500; Single: $54,300; **Trusts and Estates: $24,100. Tax reform increased the AMT exemption for 2018-2025 and phase out for individuals ($109,400 (MFJ)/$70,300 (single)), but NOT for trusts and estates.**

I. Income Tax Categories of Trusts

- **Grantor** (All Income is Reported on Grantor/Bene’s Form 1040, No Income is “Trapped” or Taxed to Trust as separate taxpayer)

- **Non-Grantor** (traditional trust and estate income taxation, files Form 1041, governed by Subchapter J, Parts A-D), These in turn might be labeled “simple” or “complex”, but few differences.

- **Part Grantor, Part Non-Grantor, divided under Treas. Reg. §1.671-2 portion rules** and allocated and divided as either a fractional share (e.g. 95%/5% for trust w/”five and five”), per asset or based on accounting income/principal, depending on the language of the document that creates

I. Grantor Trust Provisions

- Grantor (or spouse via §672) has one or more “powers” described in IRC §673-679 or beneficiary has power of withdrawal of income or corpus under IRC §678 (which I will not call a grantor trust, but a “beneficiary deemed owner trust” (BDOT), since the beneficiary did not contribute to the trust).

- All income, expenses and credits “flow through” and are taxed to the grantor or beneficiary, *regardless of whether any distributions are made*. Treas. Reg. §1.671-1

- Subpart A-D, Subchapter J (separate entity tax rules for taxation of trusts and estates) do **not** apply to fully grantor trusts, but a trustee may have simplified filing requirement (there is a box on Form 1041 for grantor trusts, but there are alternative filing options).

I. Grantor Trust – Common Examples

- Revocable living trust, GRAT, SLAT, QPRT, IGTs etc. where grantor retains power to revoke, substitute property, rights to distributions from income/corpus for self or spouse, etc.
- If beneficiary has right to amend, revoke or withdraw corpus (e.g. *Crummey* trusts, certain marital trusts, BDITs), *beneficiary* is taxed under IRC §678(a), but if grantor is living, any grantor/spouse's §673-677 power trumps §678, pursuant to §678(b). Thus a SLAT or ILIT, even w/Crummey powers, is typically a grantor trust as to the settlor.
- If you would prefer a SLAT or intervivos QTIP to be taxed as a separate *non-grantor* trust taxpayer (sometimes preferable for high bracket taxpayers), see this article:

http://leimbergservices.com/all/LISIMorrowPDF4_23_2018.pdf

II. Basics of Section 678

- **IRC §678: "a)** General rule

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

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

  (2) **"***

II. Basics of Section 678

- **Let's tackle a power of corpus first:**

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

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

  Example: John Doe dies and leaves assets to wife in a marital trust that grants her the power to withdraw corpus

  Example 2: John Doe dies and leaves assets in trust for son and daughter until age 30, 35, 40 when they can withdraw 1/3, 1/2 and 100% respectively, but they're ages 49, 51 now

II. Basics of Section 678

- **Now let's tackle a power over income:**

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

  (1) such person has a power ***exercisable solely by himself*** to vest the ******income [from the corpus] in himself***,"

  Example: John Doe dies and leaves assets to wife in a marital trust that grants her the power to withdraw annual **income (not entire corpus)**

  Example 2: John Doe dies and leaves assets in trust for son and daughter allowing them to withdraw all income annually (not entire corpus)

  But, how is "income" defined?

III. Understanding Definitions of "Income"

- "Income" has different meanings in Subchapter J, Subpart E (grantor trust rules, including IRC §678) v. Subparts A-D (non-grantor trusts):
- Treas. Reg. §1.671-2(b) Applicable Principals: "(b) Since the principle underlying subpart E (section 671 and following), part I, subchapter J, chapter 1 of the Code, is in general that income of a trust over which the grantor or another person has retained substantial dominion or control should be taxed to the grantor or other person rather than to the trust which receives the income or to the beneficiary to whom the income may be distributed, **it is ordinarily immaterial whether the income involved constitutes income or corpus for trust accounting purposes. Accordingly, when it is stated in the regulations under subpart E that "income" is attributed to the grantor *or another person*, the reference, unless specifically limited, is to *income* determined for tax purposes and not to income for trust accounting purposes"**

III. Taxable Income

- Thus the definition of “income” throughout Subpart E (grantor trust provisions) is more what lay people without so much over-education about trusts think about income.
- Simpler for lay people to understand: “Is it something I have to pay tax on?” Is there a 1099, 1099-R, K-1? No different from individual taxation
- But the trust document might be referring to a different concept….

III. Trust Accounting Income (TAI)

- Somewhat anachronistic since many modern trusts use unitrust or discretionary standards for distributions, but still an important concept for non-grantor trust taxation (not necessarily for BDOT).
- Trustee allocates receipts/disbursements between *accounting* income and principal, determined by governing instrument or, if instrument silent, by state law (Uniform Principal and Income Act)
- Accounting income can be taxable or non-taxable (e.g. muni bond interest, Roth IRA account distribution)
- Receipts allocable to principal may be taxable although they are not accounting income (e.g. portion of any traditional IRA/qualified plan distribution, deferred comp, capital gains)
- This is the default definition of "income" in trusts, and what that term means for *non-grantor* trust taxation

III. Definition of Income Applied to Section 678

- **Recall the language of §678(a): "**A person other than the grantor shall be treated as the owner of ***any portion*** of a trust with respect to which:

  (1) such person has a power ***exercisable solely by himself*** to vest the ******income [from the corpus] in himself***,"

  Example: John Doe dies and leaves assets to wife in a marital trust that grants her the power to *withdraw all income*

  Example 2: John Doe dies and leaves assets in trust for son and daughter allowing them to *withdrawal all income* annually

  If "income" means accounting income, then 678 only applies to a "portion" of the trust (the accounting income, not the taxable income, thus leaving the taxable income allocable to principal to be taxed under non-grantor trust rules).

  However, if "income" is defined in the trust's withdrawal power as all taxable income from the trust corpus, then 678 applies to **all** taxable income – the "portion" is 100%. **I refer to such a trust as a "Beneficiary Deemed Owner Trust"**

III. Definition of "Income" Applied to Section 678

- **Case law History:** That the power to withdraw income is tantamount to owning the income has been a tenet of tax law for nearly as long as the income tax, culminating in *Mallinckrodt v. Nunan*, 146 F.2d 1 (8th Cir. 1945) that was cited by Congress in passing Section 678 in 1954. In this case, dad had established trust for son and his wife. The wife got the first $10,000 of income and the son could withdraw any remaining income (not all corpus), but he did not.
- Held: son must be taxed on the trust income above $10,000, *because he could withdraw it*.

III. Definition of "Income" Applied to Section 678

- **Case law History:** Long case history aside from *Mallinkrodt*. To quote the Supreme Court, "the power to dispose of income is the equivalent of ownership of it." *Harrison v. Schaffner*, 312 U.S. 579 (U.S. Mar. 31, 1941), quoted by the *Mallinkrodt* case.

III. Definition of “Income” Applied to Section 678

- **Post-678 Case Law History:** While *Mallinkrodt* appeared to apply to capital gains or other income as well as accounting income, the case did not mention the distinction at all, but *Campbell v. Commissioner*, T.C. Memo 1979-495, did. There, the beneficiaries had the power to withdraw income, specifically including capital gains. Held: *the beneficiary must report the capital gains withdrawable under Section 678 regardless of whether he withdrew it*. It is not optional.

III. Definition of Income Applied to Section 678

- **Recent PLR:** While PLRs are not citable as precedent they can be used as rationale for avoiding penalties and are still useful to gauge IRS thinking. PLR 2016-33021 involved a non-grantor trust (#1) funding a second trust (#2), with the second trust granting the first trust the power to withdraw the taxable income (*but **not** the power to withdraw corpus beyond that*) with the power lapsing on the last day of the calendar year.
- Held: the first trust must report the taxable income, including capital gains, withdrawable under Section 678 regardless of whether the first trust withdraws it.
- Note: while I don't think there is anything debatable about the ruling, I would not copy the exact language from the PLR, for reasons cited in the material.

IV. IRC Section 671 and the “Portion” Rules

Treas. Reg. §1.671-3 provides three main ways that a trust’s income might be divided between a grantor (or deemed owner per §678) and the trust as a separate taxpayer:

1. Divided based on a **fraction** (Johnny can withdrawal half the income, or half the corpus)

2. Divided based on access to **specific assets** or income therefrom (e.g. Johnny has the power to withdraw XYZ Co. stock or the income such as dividends and capital gains therefrom)

3. Divided based on differing powers/rights having to do with “**ordinary**” income and “income **allocable to corpus**” (e.g. Johnny has the right to withdraw accounting income, not capital gains).

IV. Portion Rules: Partial Grantor, Non-Grantor Trust

- Trusts may be part grantor, part non-grantor if the beneficiary retains a power to withdraw something less than all of the taxable income of a trust such as the *Mallinkrodt* case. E.g. my spouse may withdraw all taxable income that is not appointed to charity and trust has $100,000 of income, family appoints or trustee distributes $10,000 to donor advised fund. Voila! Trust has $10,000 of income but gets $10,000 above the line 642c deduction, $90,000 taxed to spouse at lower bracket and the charitable tax deduction is saved for the middle class).

- A portion of the income, expenses and credits "flow through" and are taxed to the grantor or beneficiary deemed owner and a portion are taxed to the trust under Subpart A-D, Subchapter J.

- Also possible to have multiple parties deemed owners: if son has power to withdraw 50% of income, and granddaughter 25%, and grandson 25%, then we have "beneficiaries deemed owners.

IV. Portion Rules: Partial Grantor, Non-Grantor Trust

Examples:

- Grantor dies. Beneficiary has power to withdraw 4% of corpus annually. Beneficiary is taxed on 4% of income/capital gains whether beneficiary exercises the power or not. Similar 5/5 power.

- Grantor dies. Beneficiary has *power to withdraw* net accounting income (a QTIP might be drafted this way). Beneficiary is taxed on net accounting income, whether actually distributed or not. This was *Goldsby v. Commissioner*, T.C. Memo 2006-274. Income attributable to principal (extraordinary dividend, often 90% of IRA RMD plus any additional distribution beyond RMD, etc., plus usually capital gains), is taxed pursuant to non-grantor trust rules to either trust or beneficiary.

V. Contrasting Grantor, Non-Grantor Trust Taxation

Principal differences:

1) Filing more complicated IRS Form 1041
2) The trust is usually in a much higher tax bracket than beneficiary for ordinary income, capital gains, NIIT, AMT.
3) The default rule is to tax most capital gains in the trust (IRC §643), although the trust agreement, if administered in the most tax advantageous way, can justify in many cases passing capital gains out on a K-1 to the beneficiary pursuant to exceptions noted in Treas. Reg. §1.643(a)-3(b)

See page 180-186 of “OBIT” white paper/CLE outline

4) However, exploiting the above rule requires distributions out of the trust, making it extremely “leaky” from an asset protection and estate tax leveraging standpoint. ***With ordinary trusts, more has to leave the trust to be taxed at the lower beneficiary tax rate!***
5) Some tax deductions/benefits are lost by trust taxpayer status
6) Some planning techniques are lost by separate trust tax status

V. Deduction/Exclusions Denied to Trusts and Estates

- Certain code sections grant deductions or exclusions to *individual taxpayers only*, ***not*** to non-grantor trusts or estates, principally:
- IRC §179(d) election to expense $1,000,000 depreciable property (increased from $500,000 w/tax reform for 2018). This one is the **most common and easy to miss** – many taxpayers/trusts own portions of LLC/LP/S corps that may pass through this deduction.
- IRC §121 $250,000/$500,000 capital gains tax exclusion for principal residence – huge for middle class
- IRC §170 charitable deduction disallowed, must qualify as §642(c) deduction, which is limited based on instrument, traced to gross income, UBTI reduction, no carryforward

V. Deduction/Exclusions Denied to Trusts – §199A

- The new §199A 20% qualified business income deduction prop. regs are more anti-trust than most expected:
- Example: I gift some of my LLC interests, a specified service business, to my daughter in trust. Trust makes $250,000 gross, distributes $100,000 to daughter. The taxable income is $150,000 but deemed to be $250,000 for 199A purposes. Deduction denied! (due to exceeding $157,500-$207,500 threshold). For an ESBT, it would also be denied to daughter's $100k since she has no K-1.
- "Anti-abuse" regs could deny deduction for "trusts formed or funded with a significant purpose of receiving a deduction under section 199A". Who wants to guarantee their non-grantor trust will pass this gauntlet?
- However, grantor trusts are treated very favorably.

V. Other Advantages of Grantor Trusts

- S Corporation qualification under IRC §1361(c)(2)(A) without the negatives and compliance of QSST/ESBT election (you could as "belt and suspenders" make an ESBT election for a grantor trust that is ignored until grantor trust status terminates).
- Transfer for Value rules for life insurance favorable to beneficiary deemed owner trusts per Rev. Rul. 2007-13
- If beneficiary is active in the business, BDOT clearly avoids 3.8% surtax, whereas, even if a non-grantor trust hires a trustee/agent active in the business, and even in spite of *Frank Aragona* and *Mattie Carter* taxpayer victories, such a trust may still owe tax. The IRS is still extremely stringent in its interpretation of these rules and may issue regulations or eventually prevail in court. That may be expensive.

V. Other Advantages of Grantor Trusts – State Tax

- BDOTs may avoid single, double or more state income taxation and/or compressed state tax rates. With a BDOT, state income tax is based on the residency of the beneficiary; with a non-grantor trust, the state of the settlor, the state of the beneficiary, the state of the trustee, the state of the directed trustee or other fiduciary may all cause multi-state taxation that credits may not 100% offset. A trust may "reside" in multiple states.
- For example, a Maine resident who establishes a trust with one child or friend as trustee in Oregon and another as beneficiary in California. Top income tax rates of Maine, California and Oregon are 10.15%, 13.3% and 9.9% respectively. Idaho 7.4% has 3 of 5 factor test for trusts.

V. Other Advantages of Grantor Trusts - QTIPs

- QTIPs, and perhaps even more compelling, Reverse QTIPs can be BDOTs, which allows more funds to stay in the GST exempt portion, allowing the reverse QTIP to be more efficient and less "leaky", which could mean millions more GST exempt depending on the overlife of the surviving spouse. QTIPs are an interesting animal – for blended families where grantor wants to grow corpus and doesn't want surviving spouse to get anything beyond net accounting income, a BDOT clause does *not* fit, but for many situations other than this, where someone trusts the surviving spouse and would not mind their taking all the taxable income, it's a no brainer, because it opens up more planning and allows more growth/exploiting GST.

V. Other Advantages of Grantor Trusts – GST Ex. QTIP

- Simple contrast: John leaves his $10 million estate to his wife Jane in a QTIP, for which a reverse QTIP election will be made to use John's $11.18 million GST exemption. Jane has a $10 million estate of her own.
- Scenario #1 (regular planning): John's QTIP generates 4% income a year and 3% unrealized growth. Jane takes out the 4% annually because 1) it was **required** to take the net accounting income and 2) her advisory team told her to take the capital gains and other income as well to shift it to her lower tax bracket and save money. Result over 10 years @3% (simple growth, ignoring compounding) – trust grows 30% to **$13 million**.
- Scenario #2 (BDOT): Jane does not need to take 4% to shift income, GST exempt QTIP grows @7%, 70% to **$17 million**. Jane's own assets would decrease by $4 million, but GST used!

V. Other Advantages of Grantor Trusts

- Installment sales, swaps are tax-free per Rev. Rul. 85-13
- Jane inherits $10 million in BDOT.
- Jane sells a portion of her $80 million company to her BDOT on installment sale. This works similar to an installment sale to an IGT, but Jane still has the power over taxable income, which cannot be kept in an IGT, all while keeping the funds outside of her estate. Works similar to installment sale to BDIT, but less risky since more than $5,000 is in the trust, so it's not on the IRS transaction of interest list.
- Moreover, on her deathbed, Jane *swaps* out assets, ensuring that the lowest basis assets are included in her estate and the higher basis assets are in her BDOT which is excluded from her estate unless a formula general power of appointment were added.

V. Pros/Cons - Losses Trapped Until Termination

- Net Capital *Losses*

• If a trust has a massive net capital *loss*, it may be near useless and trapped in a long-term trust if it can't be soaked up by capital gains, which might be an additional reason to terminate a trust early, if it can otherwise be justified, since the beneficiaries may thereafter be able to use it to offset their capital gains (and $3000/yr of ordinary income).

- Net Passive *Losses - similar*
- *Net Operating Losses (NOL) - similar*
- *Current year excess deductions expenses (when lines 10 - 15b exceed total income on line 9) - does not carry forward to future tax years of entity – it's a "use it or lose it" (e.g. $600/$300/$100)*
- *Worse, charitable contributions in excess of or not traceable to gross income are wasted,* ***even in year of termination***

V. Distributions in Kind and *Kenan* Gain Dangers

- In kind distributions have a dark side if the distribution is going towards fulfilling an obligation to fund a pecuniary amount. For example:
  - Trust mandates payment of $50,000 a year, plus more at trustee's discretion. Trust pays $20,000 cash, $30,000 appreciated property w/basis of $15,000. $15,000 capital gains income incurred. Rev. Rul. 68-392. Similar result if the trust mandated all net income which was $50,000. Reg. §1.651(a)-2(d), §1.661 (a)-2(f)
  - Trust mandates Junior receive $1 million specific bequest. Trustee pays $200,000 in cash, $800,000 appreciated property w/basis of $700,000. $100,000 of capital gains incurred to trust on funding.
  - Trust mandates $5.49 million by formula into bypass trust (or excess by pecuniary to marital trust, or GST pecuniary), and $1 million cash, $2 million IRA is moved to bypass. $2 million income tax triggered!
  - Trust with $6 million mandates half be distributed to Junior on his 35th birthday, valued at that date. This may also trigger gain on distribution.

  See Treas. Reg. §1.1014-4(a)(3), IRS CCM 2006-44020, *Kenan v. Comm.*, 114 F. 2d 217 (2d Cir. 1940). **Most dangerous for inherited IRAs**! Easily missed!

VI. Effect of Current, Lapsed Withdrawal Powers for Estate/Gift Tax, Asset Protection and Bankruptcy

- **Estate/Gift Tax** – Powers of withdrawal are presently exercisable general powers of appointment, governed by IRC §§2041, 2514.
- If someone releases (nonqualified disclaimer) a general power of appointment (withdrawal power), it is a taxable gift per §2514 of the value.
- If someone allows such a power to lapse, there is protection from being considered a release (which would be a gift) under §2514(e) "to the extent that the property which could have been appointed by exercise of such lapsed powers exceeds in value the greater of the following amounts:

  (1) $5,000, or

  (2) 5 percent of the aggregate value of the assets out of which, or the proceeds of which, the exercise of the lapsed powers could be satisfied"
- Treas. Reg. §25.2514-3(c)(4):"For example, if an individual has a noncumulative right to withdraw $10,000 a year from the principal of a trust fund, the failure to exercise this right of withdrawal in a particular year will not constitute a gift if the fund at the end of the year equals or exceeds $200,000. If, however, at the end of the particular year the fund should be worth only $100,000, the failure to exercise the power will be considered a gift to the extent of $5,000, the excess of $10,000 over 5 percent of a fund of $100,000."
- Add a "0" to make realistic: $2,000,000 trust, power to withdrawal taxable income of less than $100,000. If this lapses, it is within regulation above.

VI. Effect of Current, Lapsed Withdrawal Powers for Estate/Gift Tax, Asset Protection and Bankruptcy

- Estate tax of general powers under IRC §2041:
- Value is included in estate, even if it's a "five and five" power. Causing estate inclusion, new basis. E.g. 5% power might increase or decrease basis pro rata to date of death by 5% stock w/$100 basis, $1000 FMV now $145 (95% or $95 carries over and 5% or $50 is stepped up from $5 to $50, total $145).
- This could be avoided if the power were not effective as of the date of death, e.g. if there were a precondition not satisfied, such as a power effective only at the end of the year, etc.

VI. Effect of Current, Lapsed Withdrawal Powers for Estate/Gift Tax, Asset Protection and Bankruptcy

- **State law asset protection** – for residents of about half the states, the 5/5 lapse rules are important to know even for taxpayers who are completely unaffected and unphased by estate/gift tax, because the creditor protection for trusts post-lapse references 2514 of the code: AL, DC, FL, ID, IL, KS, ME, MO, MT, NE, NV, NJ, NM, ND, OH, OR, PA, TN, TX, UT (probably), VT, VA, WV, WI – these states do not protect unlimited amounts post-lapse, but tie the protection to 2514 and 2503 (annual exclusion), with some, such as Ohio, doubling the annual exclusion if the settlor/donor was married. Many such as Ohio could also use their DAPT statute.
- For a surprising number (most of the remaining states), *the entire amount* of any lapse is still protected and it is not considered a self-settled trust.

Let's compare and contrast.

- John has the power to withdrawal all net taxable income from a $4 million trust and it was a great year, $400,000 of realized income (10%). In the first category of states, if John "lets it ride" and takes nothing and the power lapses, he is considered a settlor as to $200,000 of the corpus after lapse. In the second category of states, he is not.
- If John simply takes half the income to pay his tax, fund a SLAT/ILIT, spend in Vegas, whatever, and only half his withdrawal right lapses, it is within 5% and probably not a problem in the vast majority of states

VI. Effect of Current, Lapsed Withdrawal Powers for Estate/Gift Tax, Asset Protection and Bankruptcy

- For those in the states with only 5/5 lapse protection for debtor/creditor law, solutions to protect a trust in the event taxable income exceeds 5% include:
- Select an appropriate trustee and use DAPT statute
- Cap the power. E.g. if the trust is $1 million, taxable income $60,000, cap the withdrawal right of all income up to 5% ($50,000). This would mean, however, that $10,000 is taxable under non-grantor trust rules for that year. Not a horrible result, since in most years it would be under this and allow more to stay protected. It is balancing grantor trust status w/asset protection and tilting towards asset protection if taxable income exceeds 5%.
- ***Use the power if income exceeds 5%***: in above example, the beneficiary simply takes at least $10,000 (which would be extremely common anyway)! It could be put into IGT, SLAT, LLC, 529, life insurance, TbyE, DAPT, etc…if appointed to a trust, it would likely be a grantor trust as to powerholder!
- Add a hanging power, that would likely be absorbed in the following year. E.g. in above example $10,000 above “hangs” and when the next year’s income is only $40,000, the hang will lapse.

VI. Effect of Current, Lapsed Withdrawal Powers for Estate/Gift Tax, Asset Protection and Bankruptcy

- Bankruptcy law, 11 USC §541, brings in any *presently exercisable* power a debtor may exercise for their own benefit, such as a *Crummey* or other withdrawal power (techniques to remove them are noted on next slide).
- Thus, even in a state that protects presently exercisable powers from creditors, the bankruptcy trustee might be able to attach. It cannot exercise testamentary powers i.e., powers for others.
- Under 11 USC §541(c)(2) state law spendthrift protections in third party created trusts are honored and excluded from the bankruptcy estate.
- Thus, if there is no *current* power, look to state trust law as to whether a trust or any portion thereof is included in bankruptcy estate. In our previous example, John's presently exercisable power would be included regardless of state, but excluded if the power had lapsed.
- For more on potential exceptions piercing third party created trusts, see *Ed Morrow: Asset Protection Dangers When a Beneficiary Is Sole Trustee and Piercing the Third Party, Beneficiary-Controlled, Irrevocable Trust*, LISI Asset Protection Newsletter # 339 (March 9, 2017)

VII. Techniques to exploit asset protection and estate tax exposure

- Powers that create a BDOT can be removed (unless it's a QTIP, in which case it can only be removed as to the income allocable to principal, which can be terminated, and not the ordinary (accounting) income, which cannot be)
- Why remove them? Perhaps the beneficiary is now in the highest tax bracket, high tax state, where non-grantor trust status might save state income tax, or might get slightly better deductions for charitable donations. Perhaps the beneficiary or beneficiary's spouse are planning to file for divorce and the applicable state law makes a withdrawal power a liability (think about the *Ferri v. Powell-Ferri* case)
- Perhaps the beneficiary just got hit with a lawsuit/judgment and is filing bankruptcy. Cessor (a.k.a. forfeiture, protective trust, shifting executory interests) clauses are generally upheld in bankruptcy (see *Bank One Trust Co. v. United States*, 80 F.3d 173 (6th Cir. 1996), *Safanda v. Castellano*, 2015 WL 1911130 (N.D. Ill. 2015). Such clauses remove mandatory payment or withdrawal provisions and convert the trust to a discretionary one, or even remove the beneficiary, replace the beneficiary (perhaps with conditions on revesting), or accelerate remaindermen into current spray beneficiaries. Cessor clauses will **not** get around federal tax or restitution liens, unless they are drafted so as to apply prior to the lien taking effect. See recent article on Harris case: https://www.linkedin.com/pulse/9th-circuit-attaches-third-party-discretionary-trust-lien-morrow

VII. Techniques to exploit asset protection and estate tax exposure

- Every speaker/author (OK, maybe even me ☺) on asset protection touts a wholly discretionary third party created trust with an independent trustee as the Holy Grail of asset protection. Mandatory rights are bush league! But asset protection doesn't matter year by year, it only matters when the s___ hits the fan!

Let's contrast:

- Joan is primary beneficiary of a *discretionary* trust funded with $2 million from late mother. Every year, it grows 4% unrealized gain, 4% realized taxable income. The trustee naturally, taking her tax advisor's sage advice to reduce income tax, distributes the income every year for 20 years. Her trust, ignoring compound growth, now is worth 80% more, let's say $3.6 million. Her outside attachable assets, meanwhile, grew by the $1.6 million distributed over time (minus tax).
- Counterfactual: Same amounts, but Jane has a *BDOT* provision and simply let it ride and paid tax on the trust's income. The trust grew to $5.2 million and her outside attachable assets, meanwhile, depleted by the tax paid on $1.6 million.
- Joan is now sued, files bankruptcy, and her withdrawal rights are eliminated. **Which situation is more protective in the long run?**
- **Moreover, if Joan had a taxable estate, which situation saves more estate tax?**

VIII. Income Tax Effect of Lapse - "partial release" for IRC §678(a)(2)?

- What if a powerholder were to simply let the power to withdrawal the income lapse and it stays in the trust, and the powerholder retains a lifetime limited power of appointment and status as beneficiary eligible to receive distributions of income or corpus from the trustee?
- This is very similar at this point to the core strategy of the BDIT, discussed on the next slide. IRC §678(a)(2)'s terms deem a beneficiary to be the owner if their power is "partially released or otherwise modified". A lapse is not the same as a release for estate, gift and state law creditor protection purposes. However, in at least 30 or so PLRs the IRS has equated the two, so many people feel comfortable that they're substantially the same for §678 purposes and that the IRS would unlikely back down from dozens and decades of PLRs.
- The key would be to keep some kind of limited power so that it's "partially" rather than completely released, and to keep some power/right that still triggers §673-677, the easiest being §677 rights to income for self or spouse.
- One contrast between BDITs/BDOTs on this point: BDITs the withdrawal expires forever, whereas w/BDOTs it would typically only expire for the year's income and resurrect each year unless a trust protector/cessor clause provides otherwise.

IX. Contrasting with BDITs (beneficiary defective inheritor's trusts)

- Much of the BDIT rests on the same principles we've discussed for BDOTs: §678 deems the beneficiary the owner for income tax purposes, which can include installment sales between the beneficiary and BDIT/BDOTs. If a BDIT enters into a transaction with a beneficiary while the power is current over the entire corpus, the tax law is similar.
- Contrasts: often any transactions are after a BDIT beneficiary's current power has lapsed. It is the lapse that has an uncertain tax effect, as discussed in prior slide. While the IRS has indicated it will no longer rule on BDIT transactions, it does not appear to be §678 that they are concerned with, but the size of the transactions dwarfing the original gift. There is a good argument that the size of the seed gift for an installment sale is not as important as the practical economics, most especially who and what is guaranteeing the loan – things that banks and lenders pay attention to in the real world.

IX. Contrasting with BDITs (beneficiary defective inheritor's trusts)

- Often BDITs are funded starting with only $5,000 but even these can be worth it if the investment takes off – look at the *Kloiber* case (in spite of the divorce blowing up). Loan guarantees from remainder beneficiaries and guarantee fees certainly complicate the transaction. Some feel BDITs have more risk in the follow through and administration of the installment loan, step transaction risk, risk of recharacterizing the sale as a transfer with retained interest.
- BDOTs have no limit; However, state law regarding lapses should be considered since income might exceed some states' lapse protection if they use 5/5.
- Contrast though, assuming a BDIT holds up as a "partial release" and §678(a)(2) applies, it is now a discretionary trust for life taxed to beneficiary, whereas a BDOT would convert to a non-grantor trust if a trustee/trust protector or cessor clause eliminated the withdrawal right. Usually this is not a big deal, but it would make it important to monitor any substantial installment sales with a beneficiary or the effect of a conversion on pass through entities w/ debt>basis (*Madorin*).
- BDOTs, however, seem to make toggling easier.
- In short, while related in exploiting §678, they are really two different tools.

X. Contrasting with *Crummey* Powers and IRC §2503 "present interest"

- We tend to think of *Crummey* powers as 678 powers and vice versa. They overlap, but are not the same. IRC §2503 requires a present interest – the right for the beneficiary to access some economic benefit at the time of the gift – hence the 30 day window to access cash, the put rights included in LLC/LPs after *Fisher, Price, Hackl* cases denied annual exclusion gifts for LLC/LP interests with significant restrictions on accessing economic benefit.
- By contrast, §678 has no requirement for immediate access upon funding or even the beginning of the year, merely unfettered access to the taxable income or the corpus at some point. Thus, in contrast to *Crummey* powers, the right to the income or corpus might be subject to a precondition (as long as it is later met) or a window in time at the end of the year - as long as the beneficiary at the end of the day has the unfettered right to access the taxable income or corpus, they must be taxed on the taxable income.
- For intervivos BDOTs, you can get an annual exclusion for large gift where someone has right to income only, but only for actuarial value of interest, and any forfeiture clause could jeopardize that, so don't count on it.

XI. Tax Effect of Amendments, Reformation, Decanting to Add Powers

- What if you wanted to transition an existing irrevocable trust into a BDOT?
- Do parties agree? Generally, lots of flexibility in UTC, state law, decanting or even trustee/trust protector amendment provisions
- What's the tax effect? See Part VII of Optimal Basis Increase Trust white paper at www.ssrn.com. Nutshell – don't try to make it retroactive. Unless there is truly an ambiguity, scrivner's error etc. requiring construction (and even then, maybe not), IRS not bound by state court determination after taxable event. However, if the trust terms are prospectively changed pursuant to the instrument/state law, it should have prospective effect for tax. For simplicity, accounting (especially business owning trusts), use next January 1 effective date.
- If parties consent and are giving up an economic benefit, consent to an amendment could be a taxable gift. In many cases, such as parties agreeing to convert an "all net income"/HEMS to a BDOT, it's hard to see much of a gift at all. Regardless, some may not care about nominal gift, and decanting that does not involve beneficiary consent is much less likely to be a gift at all. Many decanting statutes expressly permit the granting of a general power of appointment, e.g. AK, CO, DE, IL, KY, MI, MN, NV, NH, NM, NY, NC, OH, SC, SD, TN, TX, VA, WI.

XII. Summary

- A trust is a separate taxable entity, unless grantor trust rules apply to the entire trust. After settlor's death, always, absent §678.
- Income is taxed to either estate/trust or beneficiary and a withdrawal power can ensure the beneficiary is taxed on 100%.
- Be careful that the withdrawal power apply to phantom income as well (probably even muni bond income, since that could be taxed for state) and no clauses "fetter" the right (no ability to retroactively eliminate). Remember, the proceeds need not (should not) be traced – where any funds or assets for the actual distribution comes from is irrelevant.
- Withdrawal powers (and post-lapse) have strong unlimited protection in many states, but many (UTC, ID, TX) are limited to 5/5 + annual exclusion. There are many solutions to protect assets when (if) income exceeds 5%.
- **Where is the harm in permitting a trustee or trust protector to grant (or remove) such a power if circumstances warrant?**
- **Over the long run, asset protection for such trusts is much *stronger*, rather than weaker, because the taxable income can be taxed at lower rates *without* forcing distributions and valuable corpus out from the protective trust structure as**

Disclosures

U.S. Bank does not provide legal advice. This report provides educational information specific to your tax and personal planning. You should review all personal planning with your own advisors.

U.S. Bank serves as trustee for trusts in Ohio and has trust offices in states such as Delaware, Nevada and South Dakota that are discussed in this outline.

This piece is not intended to provide specific tax or legal advice; you should consult with your own advisors about your particular situation.

Circular 230 Disclosure – To ensure compliance with requirements imposed by the IRS, we inform you that, unless expressly stated otherwise, any U.S. Federal tax advice contained in this communication (including any attachments) is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties under Internal Revenue Code or (ii) promoting, marketing or recommending to another party any transaction or matter addressed herein.

Final Note on Later Supplements

- For a white paper discussing the optimal basis increase trust, optimal basis increase LLC and using formula general powers of appointment, the Delaware Tax Trap, and various techniques to improve income tax basis and shifting in trust design and administration, there is material online at http://ssrn.com/abstract=2436964. This has not been fully updated for tax reform.
- Regarding Section 678, however, your material is more recent than the white paper's section on 678.

Email: edwin.morrow@usbank.com or edwin.morrow3@gmail.com

Questions?