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Estate Planning with Section 678
of the Internal Revenue Code

Explanation and
Sample Forms

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# Background

When I was a child, I remember being taught that, win or lose, after every baseball or soccer game we were to cheer for the opposing team: "2-4-6-8, who do we appreciate?" And then we would fill in the cheer with the opponent's team name. Today, *only a few years later*, I am now most often heard to cheer: "Who do we appreciate? It's Congress and the Internal Revenue Code, Section 678!"

Why is IRC Section 678 so important in estate planning? The story actually beings in the year 1993, when Congress saw fit to lower the amount at which trusts are taxed at the highest federal income tax rate to only $7,500 (inflation adjusted to $13,451, today). Thus, a trust established for the benefit of a decedent's minor child or children is taxed at the maximum federal income tax rate at only $13,451 of taxable income, and is entitled to only a $100 exemption for standard "complex trusts."

By comparison purposes, a single individual would need to have taxable income in excess of $539,000 before he or she would be in the maximum federal income tax bracket, after a standard deduction of $12,950. Added together, this means that an individual would need to have almost 41 times as much income as a trust, before he or she would be taxed in the same tax bracket.

Just three years later, in 1996, Congress decided it would tax S corporation interests held in so-called "Electing Small Business Trusts" ("ESBTs," for short) even less favorably than trusts for minor children, by imposing the maximum federal

income tax rate on the trust's portion of the S corporation's income, regardless of the income level of the trust.

Finally, in 2019, Congress passed the SECURE Act, which Act generally accelerates the income taxation on IRA and 401k plan benefits payable to trusts or individuals other than the surviving spouse, from a period formerly equal to the lifetime of the individual or trust income beneficiary, to a compressed period of only 10 years. Combined with the 1993 severe compression of trust income tax brackets when compared to individual income tax brackets, at first blush Congress in 2019 essentially eliminated the payment of IRA and 401k plan proceeds to trusts as an estate planning technique.

Even in high net worth situations, without additional planning it would make little sense today to pay IRA and 401k plan benefits to trusts, at least trusts which are designed to be exempt from transfer tax at the beneficiary's death, because the value of the transfer-tax-exempt trust would be reduced by the significant income tax burden on the IRA and 401k plan benefits.

Similar larger tax gaps between trusts and individuals exist in the case of the 15% and 20% capital gain rates, the latter coming into play at taxable income of as little as $13,451 for a trust (in 2022), while the 2022 comparable level for unmarried individuals is $459,750. Trusts also pay the 3.8% net investment income tax on the lesser of undistributed net investment income or adjusted gross income in excess of$13,451 (for 2022), whereas an unmarried individual needs to have net investment income or modified adjusted gross income in excess of $200,000 before he or she will need to pay the 3.8% tax.

In summary, over the last 30 years Congress has taken a variety of steps which, whether intended or not, appear to dampen enthusiasm for using trusts in estate planning, trusts which would

otherwise help minimize transfer taxes when the life beneficiary passes, protect the lifetime beneficiary in cases of minority, incapacity or immaturity, and insulate the trust assets from claims against the beneficiary by creditors or a divorced spouse.

# I

# How Can Section 678 Help?

It would be a simple matter to distribute all of the current income of the trust to the trust beneficiaries, in order to avoid the compressed trust income tax rates. In limited circumstances (e.g., by allocating capital gains to trust accounting income in the trust document), it might also be possible to distribute the trust's capital gains to the beneficiaries, in order to avoid the higher capital gains rates typically applicable to trusts, as well as the 3.8% net investment income tax.

The problem is that few clients want these automatic trust distributions to their children or other heirs to occur. For the parents of minors and other young children and adults, the issue is obvious. Parents of young children and adults do not want significant automatic annual distributions to the children, or to the guardian or conservator for the children, to be made. Parents of older children are more concerned with issues of divorce protection, creditor protection, and estate tax minimization (including state death taxes) for their children.

The automatic distribution of trust income and capital gains to the children ignores this legitimate parental concern. Parents of special needs children also obviously do not want the trust income to be paid to the children.

**Drafting Solutions**

Here are some planning thoughts which the attorney or other advisor may wish to consider to assist clients in responding

to their predicament - the challenge of achieving significant income tax savings while also preserving the non-tax purposes of the trust.

**Use of §678 Withdrawal Power Over Trust Income**

For new trusts, drafting an IRC Section 678(a)(1) withdrawal power over trust accounting income into the trust (other than a simple trust), in order to tax the trust beneficiary on all trust taxable income, is not only permissible in the tax law, but, for all the income-tax-saving reasons outlined above, is usually advisable. [See Regs. §§1.678(a)-1, 1.671-3(c), 1.677(a)-1(g), Ex. 2.]

This withdrawal power should be coupled with a power in the trustee to allocate capital gains and IRA, etc. receipts to trust accounting income pursuant to a reasonable and impartial (i.e., with respect to current and remainder beneficiaries, including permissible appointees and takers in default of appointment) exercise of a discretionary power in the governing instrument, factoring in tax consequences to the trust and its beneficiaries. [*See* Regs. §1.643(b)-1] Inclusion of the "reasonable and impartial" standard (which is actually already a part of most states' "duty of impartiality" for trustees) should forestall an IRS argument that a trustee-beneficiary possesses a general power of appointment over the entirety of the IRA, etc. accounts and the appreciation portion of the securities as a result of the withdrawal power over trust accounting income.

The withdrawal power should also include a power in the trustee to fully or partially suspend the beneficiary's future withdrawal power in appropriate situations, e.g., immature or unwise use of withdrawn funds by the beneficiary, lawsuits, divorce, college financial aid qualification reasons, or, as discussed below, for the purpose of minimizing overall income

taxes to the trust and its beneficiaries.

Except in the case where IRAs, etc., are distributable to the trust (which situation is discussed in the next chapter), it may even be possible, and make sense in some circumstances, to add a Section 678 withdrawal power to a "special" or "supplemental" needs trust, e.g., by giving the withdrawal power to a sibling or siblings in a modest income tax bracket. If so, the sibling's withdrawal power would again want to be coupled with an ability in the trustee to suspend the same, if the sibling is not acting in the special needs child's best interests. (See the additional discussion on trustee suspension powers, below.)

Note that if the withdrawal power holder needs funds to pay the income tax attributable to his or withdrawal right, he or she merely may exercise the withdrawal power to the extent so necessary. An alternative would be to allow an independent trustee to pay these taxes, either directly or indirectly by reimbursing the beneficiary.

Some may argue that a minor's legal guardian has a fiduciary duty to exercise the Section 678 withdrawal power on behalf of the ward/beneficiary, and that therefore employment of the power of withdrawal in the case of minor beneficiaries could turn out to defeat the parents' desire that their children do not receive substantial sums at age 18. Is this a sound argument? Would a legal guardian, knowing that any amounts not withdrawn on the beneficiary's behalf will remain in a creditor-protected trust held exclusively for the ward's benefit, and that the ward will eventually control this trust at a designated age, be acting in the ward's best interest if he or she chose to exercise the withdrawal power and deposit the withdrawn funds in an unprotected guardianship or conservatorship account for the ward?

Assume the ward is later involved in a major car accident, and the guardianship or conservatorship estate is exhausted to satisfy a claim against the ward. Could the guardian then be surcharged for foolishly and needlessly withdrawing the funds from the protected trust? The point is self-evident. Regardless, as discussed in the immediately below section titled “Use of Trustee Suspension Power,” the trustee could merely threaten to suspend the beneficiary’s withdrawal power should the trustee determine the exercise of the same by a guardian acting on behalf of a minor would needlessly expose the protected trust assets to lawsuits.

Some may also argue that, under IRC Section 678(a)(2) and IRS private letter rulings, when the beneficiary’s withdrawal power lapses each year, the beneficiary continues to be taxed on an ever-increasing portion of the trust’s income, including capital gains. The problem with this argument (aside from the fact that it is really just an argument in favor of lower income taxes, in most instances) is that it flies in the face of the Internal Revenue Code itself, as the withdrawal power holder has not “partially released or otherwise modified” the power. The power lapses by the terms of the trust, not by any affirmative “release” or “modification” on the part of the beneficiary withdrawal power holder, which is what Section 678(a)(2) requires. In any event, because it is now normally desired that all of the trust’s taxable income be taxable to the current beneficiary anyway, this debate is now largely of no consequence.

Because the beneficiary’s withdrawal right is designed to fully or partially (i.e., subject to a “hanging power”) lapse at the end of each year, i.e., to the extent of 5% of the value of the trust each year, in order to avoid annual taxable gifts under IRC Section 2514(e), will the lapsed amount be accessible to the beneficiary’s future creditors? In most states, and under the Uniform Trust Code, the beneficiary’s annual withdrawal power

(including, presumably, any "hanging power") is not protected, but the annual lapses of the withdrawal rights, are. [The American College of Trust & Estate Counsel, or ACTEC, has an excellent web link on this topic.] In the balance of the states which do not protect the annual lapse of the withdrawal right from the beneficiary's creditors the question must be asked: Who is the real "creditor" here, when the alternative to "Section 678 planning" is to pay much higher income taxes to the IRS?

While the beneficiaries of a trust can protect themselves against many types of potential future lawsuits with umbrella liability insurance, these policies will obviously be ineffective as against the excessive income taxes the trust will most certainly owe the IRS.

**Use of Trustee Suspension Power**

With the current and future uncertainty in the tax law, with the uncertainty in the trust's and beneficiary's respective tax situations, and with the above-described varied treatment of the Section 678 withdrawal power for creditor rights purposes, the Section 678 power needs to be drafted in a flexible fashion, so that it can adapt to various and changing circumstances. One way of accomplishing this is to allow an independent trustee the opportunity to annually suspend (and restore) future withdrawal powers, in whole or in part, prior to January 1 of the next tax year.

Another reason for the needed flexibility is the manner in which certain trust expenses are treated for trust versus individual income tax purposes. The unbundled portion of trustee fees not attributable to investment advisory services, for example, may be deductible for trust income tax purposes, under the current tax law, but not deductible for individual income tax purposes. Under the IRS Regulations, an allocable portion of these types of fees would be applied to the beneficiary of the Section 678 withdrawal

power, and as a consequence would no longer be deductible. [*See* Regs. §§1.678(a)-1, 1.671-3(c), 1.677(a)-1(g), Ex. 2.] The trustee may thus find itself in a situation where the federal marginal income tax rate applicable to the individual beneficiary is much lower than the federal marginal income tax rate applicable to the trust, but making use of the individual's income tax rate would eliminate a potentially significant annual income tax deduction.

Take, for example, a $2 million trust with a 1% annual trustee fee on the first $1 million of assets and a 0.75% fee on the next million. The total annual trustee fee would be $17,500. Assume also that no portion of this fee is allocable to tax-exempt income. If the deduction for this fee is lost by allocating it to the individual beneficiary under a Section 678 power, the negative annual income tax effect could be as much as $6,500. If the individual beneficiary is at least that much ahead by having the trust income and capital gains taxed to him or her, versus the trust, this may be fine; but if the overall savings is less than this, suspension of the beneficiary's Section 678 withdrawal power by an independent trustee may be in order. In many cases this will be easy enough to do, because the trust would likely already have an independent trustee in place. Note also that, after the suspension, the independent trustee will still retain the power to make IRC Sections 661/662 distributions to the individual beneficiary with the "after tax deduction income," the negative, of course, being the loss of the non-tax advantages for retaining assets in trust.

Suspension of the individual beneficiary's future withdrawal powers may likewise be advantageous when the trust would otherwise be entitled to a significant tax deduction for state taxes paid (if state capital gains taxes would otherwise be payable by the trust as a result of a large capital gain inside the trust), at a time when the individual beneficiary is already benefitting from a similar state tax deduction. Suspending the individual beneficiary's future Section 678 withdrawal power may make it

possible to, in effect, "double up" on the current $10,000 annual ceiling on the state income tax deduction and achieve an aggregate deduction of as much as $20,000. As in the case of the trustee fee deduction, this technique could then be coupled with an IRC Sections 661/662 distribution to the individual beneficiary of the "after tax deduction income." Again, the aggregate tax savings of using the suspension power in this situation should be balanced against the non-tax reasons for retaining the income in the trust. Note too that, under the trustee standard for determining trust accounting income described at page 5, the trustee need not allocate all capital gains and IRA, etc. receipts to withdrawable trust accounting income, thus leaving some of this gross income in the trust to absorb "trust only" deductions. Under either planning technique, remember that the grantor trust "portion rules" under Section 1.671-3 of the Regulations do not allow for a dollar-for-dollar tax deduction by the trust; a portion of the deductions will be allocated to the beneficiary and not be deductible on the trust tax return, in any event.

Suspension of the individual beneficiary's future Section 678 withdrawal power may also make sense if the individual beneficiary is already in a high tax bracket, or if the individual beneficiary is subject to the so-called "Kiddie Tax" in a particular year. However, before making this decision, the independent trustee should bear in mind that this type of individual beneficiary might also be benefiting on the estate tax side, by personally paying the income taxes attributable to an estate or generation-skipping transfer tax exempt trust's income. If the decision to suspend is made here, remember that the independent trustee can always restore the beneficiary's withdrawal power in the future, in full or in part, if and when changed circumstances dictate.

In certain situations it may make sense for an independent trustee to only partially suspend a beneficiary's future Section 678

withdrawal power. For example, if the trust does not have any significant tax deductions which would be lost, it might be beneficial to suspend the beneficiary's withdrawal power only over an amount equal to the level at which the trust reaches the maximum income tax bracket (e.g., $13,451 in 2022), or to some other lower tax bracket level. In so doing, the trustee may also elect to limit the suspension to income items other than qualified dividends and capital gains, first, so that the beneficiary may avail himself or herself of the significantly larger 0% tax bracket amount for these items, while also avoiding the 3.8% tax on net investment income.

Bear in mind, however, that the tax benefits of this "partial" suspension will be limited by the fact that the general effective tax rate on the compressed lower brackets of the trust is over 24%, a rate which does not kick in for single individuals until income levels of almost $102,026 (in 2022, including the $12,950 standard deduction). [The married couple numbers are twice these figures.] The next tax bracket of 32% is not reached until the single individual has over $183,000 in income, including the $12,950 standard deduction. [Again, the married couple numbers are twice these figures.] Thus, unless the beneficiary has a significant taxable income, utilizing this partial suspension technique will normally be tax neutral, at best. In fact, and as alluded to above, subject to the potential application of the Kiddie Tax rules, if the beneficiary has little or no separate income, utilizing the suspension technique may effectively cause some loss of the 0% tax rate on qualified dividends and capital gains to a single beneficiary with income (including the $12,950 standard deduction) of $54,625 or less, in 2022.

As alluded to above, perhaps the most important reason for including a trustee suspension power in the trust is that it allows the trustee to maintain some control over the beneficiary's "non-tax situation." This is what concerns parents the most. As just

some of the potential examples, the trustee might suspend the beneficiary's future withdrawal power (i) because of the immature or unwise use of funds the beneficiary is withdrawing from the trust, (ii) to motivate the beneficiary to take a particular action (e.g., go to college, or get a job), (iii) because the beneficiary is getting a divorce, (iv) because the beneficiary is involved in a lawsuit, or (v) because the beneficiary is attempting to qualify for college financial aid and a withdrawal right would hinder these efforts.

Due to the multitude and potential complexity of the issues involved, the trust document should exonerate the independent trustee for any decision or non-decision relative to the trustee's suspension power. The trustee should also be reminded that, in order to clearly comply with the IRC Section 678(a)(1) requirements, the suspension power may only be exercised effective January 1 of the following tax year. This will typically require some level of annual dialogue between or among the trust's CPA, attorney, trustee and/or investment advisor.

**Trust Income Which Exceeds the §2514(e) Limitation**

Assume that a significant portion of the trust accounting income (including capital gains and IRA, etc., receipts allocated to trust accounting income) would exceed the Section 2514(e) 5% limitation. Is there a solution to this problem which will cause the beneficiary to be taxed on the income, but without the potential of causing a taxable lapse under either IRC Section 2041(b)(2) or 2514(e)?

There is a 9th Circuit Court of Appeals decision, *Fish v. United States*, 432 F.2d 1278 (9th Cir. 1970), which, although incorrectly decided, nevertheless stands for the proposition that the "5 and 5" limitation in the case of a beneficiary's withdrawal power over income can only be based on the current income of

the trust as the denominator. It cannot be based on the entire value of the trust, even if the trustee is expressly granted the power, under the trust instrument, to use any assets of the trust in order to satisfy the beneficiary's exercise of the withdrawal power. The court's theory was that, because the beneficiary possessed no withdrawal power over trust principal, the latter could not be included in the "5% denominator," despite the clear language of the Internal Revenue Code to the contrary if the trustee was permitted to use any asset of the trust to satisfy the exercise of the beneficiary's withdrawal power.

Therefore, if we wish to avoid the 9th Circuit's holding in *Fish*, and simultaneously cause all of the trust's current income (including capital gains and IRA, etc., distributions) to be taxed to the trust's beneficiary, and not to the trust, we need to utilize the following three-step process:

**Step 1:** Provide in the trust document that the trust's current beneficiary has a right to withdraw all of the "current income" of the trust, including, as defined in the trust document, all or a portion of the trust's capital gains and IRA, etc., distributions.

**Step 2:** Provide in the trust document that the beneficiary's withdrawal power over this trust income lapses at the end of each year, but only to the extent it will not constitute a release under either IRC Section 2041(b)(2) or 2514(e), and make clear in the trust document that the trustee can use any of the trust's assets, whether current income or principal, to satisfy the exercise of the withdrawal power by the beneficiary, including assets which may be payable to the trust over time, such as IRAs. [Note that the "deemed release" amount will therefore vary, depending on whether or not you choose to follow the 9th Circuit's decision in *Fish*.] Because of the hanging power, even

if *Fish* applied there would be no IRC Section 2041(b)(2) or 2514(e) lapse issue.

**Step 3:** The current income not withdrawn by the beneficiary during the calendar year is added to the principal of the trust, and the current beneficiary retains an annual power to withdraw from the principal of the trust an amount equal to the trust's previous current income in which the beneficiary's withdrawal power did not lapse at the end of any previous calendar year pursuant to Step 2. This subsequent power of withdrawal over principal will thereupon lapse at the end of each succeeding calendar year, but again only to the extent it will not constitute a release under either IRC Section 2041(b)(2) or 2514(e). The trustee is given the power to use all or any portion of the trust's assets to satisfy the exercise of the withdrawal power by the beneficiary under this Step 3, other than current trust accounting income, including assets which may be payable to the trust over time, such as IRAs. Because the trust document now clearly bestows upon the beneficiary a right to withdraw trust principal in Step 3, the basis of the 9th Circuit's decision in *Fish* no longer exists.

If the beneficiary desires to accelerate the lapsing process under this 3-step plan, but without adding to the value of the beneficiary's assets, the beneficiary need merely exercise the beneficiary's power of withdrawal to pay the income taxes attributable to the Section 678 power and/or to pay other living expenses.

**Sample Form**

Here is a sample form which implements these "Section 678" drafting recommendations:

**Section 1. Distribution of Income and Principal During Lifetime of Beneficiary**

1.1 Subject to the remaining provisions of this subsection 1.1, during the beneficiary's lifetime the beneficiary (including any legal representative acting on behalf of the beneficiary if the beneficiary is under a legal incapacity) shall have the annual noncumulative power to withdraw all or any portion of the trust accounting income on or before December 31 of the calendar year (or on the date of the beneficiary's death, if earlier); PROVIDED, HOWEVER, that (i) the foregoing power of withdrawal shall not extend to the portion of the trust accounting income which, for the calendar year, would be exempt from federal income tax, and (ii) if Section 2041(b)(2) and/or 2514(e) of the Internal Revenue Code, or any successor sections thereto, is/are in effect during the calendar year, the beneficiary's power of withdrawal under this subsection 1.1 shall lapse at the end of the calendar year (or on the date of the beneficiary's death, if earlier) to the extent the same shall not constitute a release of a general power of appointment by the beneficiary pursuant to the provisions of either or both Section 2041(b)(2) and/or 2514(e) of the Internal Revenue Code, or any successor sections thereto in effect at the time of the lapse, after factoring in all other lapsed powers of withdrawal of the beneficiary other than pursuant to the provisions of subsection 1.2, below. The portion of the trust accounting income for the calendar year subject to the beneficiary's foregoing power of withdrawal which is not withdrawn by the beneficiary (including by any legal representative acting on behalf of the beneficiary if the beneficiary is under a legal incapacity) during the calendar year and in which the beneficiary's withdrawal power has not lapsed pursuant to the foregoing provisions of this subsection 1.1 shall accumulate and continue to be subject to a power of withdrawal in the beneficiary (including any legal representative acting on behalf of the beneficiary if the beneficiary is under a legal

incapacity) pursuant to the provisions of subsection 1.2, below. Any such withdrawable trust accounting income which is not withdrawn by the beneficiary (or by a legal representative acting on behalf of the beneficiary if the beneficiary is under a legal disability) by the end of any calendar year (or by the time of the beneficiary's death, if earlier) shall be added to the principal of the trust estate. [ATTORNEY DRAFTING NOTE: MAY NOT WANT TO USE BENEFICIARY INCOME WITHDRAWAL RIGHTS WHEN: (1) SECOND SPOUSE, OR (2) HIGH NET WORTH CLIENT AND NO TAX BENEFIT FOR SUCH POWER OVER NON-GST TAX-EXEMPT TRUST.]

1.2 Subject to the remaining provisions of this subsection 1.2, during the beneficiary's lifetime the beneficiary (including any legal representative acting on behalf of the beneficiary if the beneficiary is under a legal incapacity) shall have the annual power to withdraw from the principal of the trust estate an amount equal to all or any portion of the trust accounting income for all previous years of the trust which has not previously been withdrawn by the beneficiary (either pursuant to the provisions of subsection 1.1, above, or this subsection 1.2) and over which the beneficiary's withdrawal power has not previously lapsed either pursuant to the provisions of subsection 1.1, above, or this subsection 1.2. The beneficiary's power of withdrawal under this subsection 1.2 shall lapse at the end of the calendar year (or on the date of the beneficiary's death, if earlier) to the extent the same shall not constitute a release of a general power of appointment by the beneficiary pursuant to the provisions of either or both Section 2041(b)(2) and/or 2514(e) of the Internal Revenue Code, or any successor sections thereto in effect at the time of the lapse, after factoring in all other lapsed powers of withdrawal of the beneficiary during the same calendar year pursuant to the provisions of either or both Section 2041(b)(2) and/or 2514(e) of the Internal Revenue Code, or any successor sections thereto in effect at the time of the lapse, including any

lapse pursuant to the provisions of subsection 1.1, above. The portion of the beneficiary's withdrawal power under this subsection 1.2 which is not exercised by the beneficiary during the calendar year and which has not lapsed during the calendar year pursuant to the foregoing provisions of this subsection 1.2 shall continue to be withdrawable by the beneficiary (including any legal representative acting on behalf of the beneficiary if the beneficiary is under a legal incapacity) pursuant to the provisions of this subsection 1.2.

1.3 Satisfactions of any right of withdrawal of the beneficiary pursuant to the provisions of this subsection 1.1 and 1.2, above, must be made in cash, although the trustee may liquidate any asset of the trust (including but not limited to by withdrawing retirement assets [as defined in ARTICLE __, below] and other assets which are payable to the trust over time and not yet paid to the trust) in order to generate said cash; PROVIDED, HOWEVER, that the trustee may not utilize current trust accounting income to satisfy the beneficiary's right of withdrawal under subsection 1.2, above. The trustee other than a trustee having any beneficial interest in the trust (other than solely as a contingent taker under ARTICLE __, below) may, in the sole and absolute discretion of said trustee, suspend the beneficiary's withdrawal power under subsection 1.1 and/or 1.2, above, in whole or in part, by instrument in writing executed by said trustee before January 1 of the calendar year in which such withdrawal power would otherwise exist. Reasons for such suspension may include, but shall not be limited to, overall tax savings for the trust and its beneficiaries (including remainder beneficiaries), creditor protection for the beneficiary, and unwise or immature use of withdrawn funds by the beneficiary. In the event the beneficiary shall have the beneficiary's aforesaid power of withdrawal suspended, in whole or in part, the trustee other than a trustee having any beneficial interest in the trust (other than solely as a contingent taker under ARTICLE __, below) may also,

in the sole and absolute discretion of said trustee, restore the beneficiary's withdrawal power under subsection 1.1 and/or 1.2, above, in whole or in part, at any time, by instrument in writing executed by said trustee. The trustee shall be exonerated from any liability for any decision or non-decision under this subsection.

1.4 The trustee may, in the trustee's sole discretion, distribute, use or apply so much of the income and principal of the trust estate (which is not withdrawable by the beneficiary or by the beneficiary's legal representative pursuant to the provisions of subsection 1.1 or 1.2, above) as the trustee may deem necessary to provide for the maintenance, support, health care and education of the beneficiary, in the beneficiary's accustomed manner of living. In addition, the trustee may, in the trustee's sole discretion, distribute, use or apply the income and principal of the trust estate (which is not withdrawable by the beneficiary or by the beneficiary's legal representative pursuant to the provisions of subsection 1.1 or 1.2, above) as the trustee may deem necessary for the maintenance, support, health care and education of any descendant of the beneficiary; PROVIDED, HOWEVER, that (i) the needs of the beneficiary as specified above shall be the primary concern of the trustee, and (ii) neither the income nor principal of the trust may be used to limit, relieve or otherwise discharge, in whole or in part, the legal obligation of any individual to support and maintain any other individual. In determining the amounts to be distributed, used or applied for the beneficiary's descendants, the trustee shall not be required to treat each of such persons equally but shall be governed more by the particular needs and interests of each of them. The trustee other than the beneficiary and other than a trustee designated by the beneficiary who is "related or subordinate" to the beneficiary within the meaning of current Section 672(c) of the Internal Revenue Code, or any successor section thereto (substituting "the beneficiary" for "the grantor" in said Section), may, in such trustee's sole and absolute discretion, utilize the income and

principal of the trust estate (which is not withdrawable by the beneficiary or by the beneficiary's legal representative pursuant to the provisions of subsection 1.1 or 1.2, above) for the purpose of purpose of paying all or any portion of the beneficiary's income taxes, directly, or indirectly by reimbursing the beneficiary for any income taxes paid by the beneficiary, including but not limited to income tax liability accruing to the beneficiary as a result of the beneficiary's power of withdrawal under subsection 1.1 or 1.2, above; PROVIDED, HOWEVER, that the trustee shall not possess the discretionary power described in this sentence if, as a consequence of possessing said power, the beneficiary is deemed to possess the same power for federal or state estate tax, gift tax, generation-skipping transfer tax, inheritance tax or other transfer tax purposes.

1.5 The trustee shall be entitled to rely on the advice of legal counsel with respect to any matter under this Section 1; PROVIDED, HOWEVER, that if said legal counsel's opinion is subsequently determined to be invalid as applied to this subsection, either as a result of a subsequently passed federal or state law, or a subsequently promulgated regulation or published ruling, or as a result of judicial decision, the matter shall be determined based on such subsequent development and not in accordance with said legal counsel's opinion.

The following additional clauses are designed to achieve income tax basis step-up on the remaining assets of the trust at the death of the beneficiary, while also minimizing estate and generation-skipping transfer taxes:

**Section 2. Additional Testamentary Power of Appointment**

2.1 In addition, except as otherwise provided herein in ARTICLE __ hereof [SPECIAL PROVISIONS IF

RETIREMENT ASSETS ARE PAYABLE TO THE TRUST - SEE PARAGRAPH 1 OF SAMPLE FORM AT PAGE 29], if the beneficiary is not survived by a surviving spouse (as that term is defined for purposes of Section 2056 of the Internal Revenue Code, or any successor section thereto, or for purposes of the law of the state or other jurisdiction in which the beneficiary was domiciled at the time of his or her death, if said state or other jurisdiction has an estate or inheritance tax in effect at the time of the beneficiary's death), then to the extent it will not result in (i) the beneficiary's estate being liable for any federal or state estate or inheritance taxes (assuming no alternate valuation date or similar elections, qualified disclaimers, or deductible administration expenses), (ii) the beneficiary's estate being liable to reimburse any government for any assistance or other benefits provided the beneficiary during the beneficiary's lifetime, (iii) the beneficiary's estate or the trust being automatically subject to income tax on any gain attributable to any portion of the remaining trust assets, or (iv) a reduction in the federal income tax basis of any asset over its historical federal income tax basis, the beneficiary shall have the power to appoint those remaining trust assets, if any, beginning with the asset or assets having the greatest amount of built-in appreciation (calculated by subtracting the trust's income tax basis from the fair market value on the date of death of the beneficiary), as a percentage of the fair market value of such asset or assets on the date of death of the beneficiary, to the creditors of the beneficiary's estate (or to or among the beneficiary's estate and any one or more individuals and/or entities, including a trust or trusts, if the power to distribute such assets to the creditors of the beneficiary's estate is not sufficient to cause a federal income tax basis adjustment under IRC Section 1014, or any successor section thereto, at the beneficiary's death), utilizing the same appointment procedure described in subsection __, above; PROVIDED, HOWEVER, that if this trust has been or will be divided into two separate trusts for federal generation-skipping transfer tax purposes, the

beneficiary's foregoing additional power of appointment shall apply (i) first to the trust having an inclusion ratio, as defined in Section 2642(a) of the Internal Revenue Code, or any successor section thereto, of other than zero, but only to the extent such trust is not otherwise already includible in the beneficiary's estate for federal estate tax purposes, pursuant to the other provisions of this trust instrument, and (ii) next to the trust having an inclusion ratio, as defined in Section 2642(a) of the Internal Revenue Code, or any successor section thereto, of zero; PROVIDED FURTHER, HOWEVER, that if the beneficiary is the beneficiary of more than one trust which includes a provision similar to this sentence, under no circumstance shall the beneficiary's estate be liable for any federal or state estate or inheritance tax as a consequence of the beneficiary's foregoing additional power of appointment, and if necessary to carry out this intent, the extent of the beneficiary's foregoing additional power of appointment shall be reduced in proportion to the value of all other trust assets subject to a similar additional power of appointment, or by a greater amount, if further necessary.

2.2 If the beneficiary is survived by a surviving spouse (as that term is defined for purposes of Section 2056 of the Internal Revenue Code, or any successor section thereto, or for purposes of the law of the state or other jurisdiction in which the beneficiary was domiciled at the time of his or her death, if said state or other jurisdiction has an estate or inheritance tax in effect at the time of the beneficiary's death), the beneficiary shall only possess the beneficiary's foregoing additional power of appointment to the same or lesser extent that the trustee (other than the beneficiary and other than a trustee who is "related or subordinate" to the beneficiary within the meaning of current Section 672(c) of the Internal Revenue Code (substituting "the beneficiary" for "the grantor" in said Section)) shall direct by instrument in writing filed with the trust during the beneficiary's lifetime and not revoked by said trustee prior to the beneficiary's

death; PROVIDED, HOWEVER, that the trustee shall not possess the foregoing power to direct if the beneficiary appointed the trustee who or which possesses the foregoing power to direct, and if as a consequence the beneficiary is deemed to possess the foregoing power to direct for federal or state estate tax or inheritance tax purposes. In exercising said trustee's broad discretionary power in determining whether and to what extent the beneficiary shall possess the beneficiary's foregoing power of appointment if the beneficiary is survived by a surviving spouse, said trustee shall be primarily concerned with minimizing overall income and transfer taxes to the beneficiary's estate, to the beneficiary's surviving spouse's estate, and to recipients of the trust assets after the beneficiary's death, and with minimizing the liability of the beneficiary's estate to reimburse any government for any assistance or other benefits provided the beneficiary during the beneficiary's lifetime. The trustee shall be entitled to rely on the advice of legal counsel with respect to any matter under this subsection 2.2; PROVIDED, HOWEVER, that if said legal counsel's opinion is subsequently determined to be invalid as applied to this subsection, either as a result of a subsequently passed federal or state law, or a subsequently promulgated regulation or published ruling, or as a result of judicial decision, the matter shall be determined based on such subsequent development and not in accordance with said legal counsel's opinion.

If no action is taken by an independent trustee pursuant to the immediately above subsection 2.2, it may still be possible for the beneficiary to create an optimum level of income tax basis step-up at the beneficiary's death by intentionally triggering the so-called Delaware Tax Trap. [See the discussion at pages 33-37.]

In attempting to achieve an optimum income tax basis step-up level when the beneficiary has a spouse, the independent

trustee or testator must first recognize that, to the extent the independent trustee adds a general testamentary power of appointment to, or the testator triggers the Delaware Tax Trap over, an accumulation trust having a zero inclusion ratio, and as a result assets are appointed in favor of the testator's descendants and/or a bypass trust for the benefit of the testator's surviving spouse and/or descendants (i.e., rather than to the surviving spouse and/or a QTIP Trust for the benefit of the surviving spouse where the QTIP election is made), this action will reduce the availability of the portability election to the surviving spouse.

Thus, should the surviving spouse have a significant estate of his or her own, including property which was acquired from the testator and property which was jointly-owned with the testator, federal and state estate taxes may be owed by the surviving spouse's estate which would not have been owed had the portability election been preserved by not intentionally causing estate tax inclusion solely for income tax basis purposes. Appointing the trust assets to the surviving spouse and/or to a QTIP trust for the surviving spouse will create income tax basis without disturbing the availability of the portability election, but of course at the expense of increasing the size of the surviving spouse's taxable estate.

Note, however, that in the case of a bypass trust, including one which receives IRA or qualified retirement plan benefits, the drafting attorney may want to consider placing a limit on the surviving spouse's conditional testamentary general power of appointment if generation-skipping planning is involved. This is because the deceased spouse's generation-skipping transfer tax exemption is not portable. Thus, for example, if (i) the estate tax exemption available to the surviving spouse is $12 million, as a result of combining $6 million of estate tax exemption from the deceased spouse, but the surviving spouse's generation-skipping transfer tax exemption is only $6 million, (ii) the bypass trust

assets are worth $6 million, and (iii) the bypass trust includes generation-skipping provisions, would it make sense to grant the surviving spouse a conditional general testamentary power of appointment over the bypass trust assets, in order to achieve income tax basis step-up at the surviving spouse's death, but in the process eliminate the GST-exempt nature of the bypass trust assets? Some may argue that the answer is no, despite the income tax basis step-up potential, especially if it is anticipated that the trustee of the bypass trust will trade regularly.

# II

# Impact of the SECURE Act

Does it still make sense after the SECURE Act to pay funds from IRAs or 401Ks to trusts designed to protect the money for the beneficiary? (Traditionally, this has been done for protection against immaturity, lawsuits, divorce and estate taxes.) Many will argue it doesn't make sense anymore, because of the high income tax rates on trusts. The "trust tax rate penalty" would become even greater if the Build Back Better Act, which imposes a 5% surtax on taxable income over $200,000 and 8% on taxable income over $500,000, eventually becomes law. [Compare to taxable income levels of $10 million and $25 million for individuals.] As discussed in chapter I, however, you can handle those higher rates by judiciously using Section 678 of the Internal Revenue Code in the drafting of the trust. This allows the income of the trust to be taxed at the beneficiary's income tax rates, not the trust's rates.

Thus far we have been discussing tax saving strategies applicable to so-called "accumulation trusts." These same strategies will not work in the case of so-called "conduit trusts," because conduit trusts mandate that all IRA and plan distributions paid to the trust in turn be paid out to the designated beneficiary of the trust, upon receipt. Conduit trusts obviously solve the high trust tax rate issues associated with the compressed 10-year deferral period, but at the expense of obviating the reasons estate planning attorneys use trusts in the first place, e.g., asset protection, estate tax protection and divorce protection, along with general protection for young and/or spendthrift children.

Existing trust documents which establish accumulation trusts may need to be modified in order to ensure the 10-year deferral period for payments to a "designated beneficiary" is achieved over the 50% shorter 5-year default period. If the shorter 5-year default period is imposed, it will be almost impossible to navigate the high income tax rates on trusts, even utilizing the combination of the IRC Section 678 and other tax savings strategies discussed above. This is because the IRA, etc., payments will be 20% or more per year, under the 5-year default rule. It is thus incumbent on the drafting attorney to ensure that the trust qualifies under the 10-year alternate period in the case of payments to a "designated beneficiary" as defined in new IRC Section 401(a)(9)(E)(i). See IRC Section 401(a)(9)(H)(I).

Even though life expectancy is irrelevant to the new 10-year rule, there remains a concern that provisions like this one found in current Section 1.401(a)(9)-4, A-1 of the Regulations, may nevertheless still apply:

"A designated beneficiary need not be specified by name in the plan or by the employee to the plan in order to be a designated beneficiary so long as the individual who is to be the beneficiary is identifiable under the plan. The members of a class of beneficiaries capable of expansion or contraction will be treated as being identifiable if it possible to identify the class member with the shortest life expectancy."

Unless and until these regulations are revised, if the trust includes a testamentary limited power of appointment to the surviving spouse of the beneficiary, or automatically continues the trust for the surviving spouse after the death of the beneficiary, with no age limit being placed on the surviving spouse, the trust may not qualify for 10-year deferral because it is impossible to identify the class member with the shortest life

expectancy. If the goal is to achieve a 10-year deferral rather than the default 5-year, there should therefore be some age limit imposed on the potential surviving spouse, e.g., no more than 100 years older than the grantor of the trust.

Similarly, the trust document should be prepared to ensure that any contingent gift cannot pass to an individual more than a designated number of years older than the grantor of the trust and, of course, that adopted descendants of the grantor can only consist of individuals younger than the descendant doing the adopting. Finally, charities and other non-individual beneficiaries and appointees, including the beneficiary's estate or the creditors of the beneficiary's estate, will not qualify as designated beneficiaries, because they are not individuals. IRC Section 401(a)(9)(E)(I).

Compare the situation which existed prior to 2020, where not only was it necessary to determine the class member with the shortest life expectancy, but the life expectancy of this person was the determining factor in discerning the maximum IRA, etc., payout period. To qualify for the new 10-year deferral period, it is only necessary to place some limit on the age of the class members.

If a charity (i.e., with no life expectancy) is a potential remainderman under a trust, or if, for the purpose of obtaining income tax basis step-up at the death of the beneficiary, the beneficiary is given a testamentary general power of appointment to the beneficiary's estate or to the creditors of the beneficiary's estate (each of which also has no life expectancy), the attorney drafter will need to divide the trust for the beneficiary into two shares, and ensure that in the "IRA share" it is possible to identify the individual class member with the shortest life expectancy, and that it is impossible for a non-individual to take.

Set forth below is some sample language which can be employed to accomplish the above objectives, while still ensuring that estate and generation-skipping transfer taxes are minimized at the beneficiary's death. Note the blank near the end of the first paragraph. This allows the drafting attorney to insert a minimum designated dollar amount for the trust's share of IRAs and 401Ks below which the attorney has determined that lower current income taxes and the separate share approach is not necessary, with simplicity and basis step-up for the entire trust (assuming the entire IRA/401K has been paid out over 10 years) being more desirable.

Paragraph 3 includes a special priority distribution out of Share B. This is designed to accomplish the grantor's dispositive and income tax basis step-up objectives to the maximum extent possible, while still achieving the 10-year deferral for the IRA and 401K benefits made payable to the trust.

Finally, paragraph 4 of the form has been specially designed to create an estate taxable general power of appointment in Share A of a trust which has an inclusion ratio of other than zero, without destroying the ability of the trust to defer income taxation of IRAs and 401Ks over 10 years. [As discussed at pages 33-37, in may also be possible to create an estate taxable general power of appointment which is more sensitive to potential unusual state transfer tax issues, by utilizing a "Delaware Tax Trap" triggering device.]

**Separate Accounting for Retirement Assets.** If (A) one or more charitable organizations is a potential beneficiary under ARTICLE __ hereof and/or if one or more charitable organizations, the estate of the primary current beneficiary of the trust (as defined in ARTICLE __ hereof, and hereinafter referred to as "the beneficiary"), the beneficiary's creditors and/or the creditors of the beneficiary's estate is or are a potential

beneficiary or potential beneficiaries, either during the beneficiary's lifetime or upon the beneficiary's death, or is or are a potential appointee or potential appointees of the remaining trust assets at the beneficiary's death, and (B) (i) any retirement assets (as defined in paragraph 6, below) shall become payable to any trust hereunder as a result of the grantor's death, whether immediately or over time, and (ii) the aggregate present fair market value (as of the date of the grantor's death, and as determined for federal estate tax purposes, if the federal estate tax is in existence at the time of the grantor's death, otherwise as determined by the trustee, in the trustee's sole discretion) of all of said retirement assets (as so defined) payable to the trust, shall exceed $________, then (C) the trustee shall set aside and maintain as a separate share (hereinafter referred to as "Share A") from the remainder of the assets of each trust established hereunder (hereinafter referred to as "Share B"), said trust's right to receive all retirement assets (as so defined), together with the proceeds from the same, and with respect to any such separate shares created hereunder, the following rules shall apply notwithstanding any other provision of this instrument to the contrary:

1. No portion of the income or principal of Share A may be distributed to a charitable organization or to the beneficiary's estate, the beneficiary's creditors, or the creditors of the beneficiary's estate, and no testamentary power of appointment in Share A may be exercised in favor of any charitable organization or in favor of the beneficiary's estate, the beneficiary's creditors or the creditors of the beneficiary's estate.

2. For purposes of construing the provisions of the "CONTINGENT REMAINDER INTERESTS" under ARTICLE __ hereof which will potentially apply at the termination of Share A, all charitable organization takers shall be deemed to be not then in existence.

3. If, as a result of the application of paragraphs 1 and 2, immediately above, a non-individual or non-individuals which would have otherwise received a portion of Share A, either as a result of the death of the beneficiary or as a contingent taker or takers under ARTICLE hereof, is or are deemed to be not then in existence, only these non-individual(s) shall be deemed to be designated as beneficiary or beneficiaries of Share B for purposes of determining the takers upon the death of the beneficiary and/or as contingent takers of Share B under said ARTICLE ___ hereof, until such time as said non-individual(s) receive the same share(s) in Share B which it or they would have received in Share A had it or they not been deemed to be then in existence pursuant to the application of the immediately preceding paragraphs 1 and 2, after which point the provisions applicable at the death of the beneficiary and under said ARTICLE ___ hereof shall apply normally to the balance of Share B.

4. If the trust has an inclusion ratio, as defined in Section 2642(a) of the Internal Revenue Code or in any successor section thereto, of other than zero, and if, assuming the primary current beneficiary of the trust died immediately, a "taxable termination" as defined in Section 2612(a) of the Internal Revenue Code or in any successor section thereto, would occur, then the primary current beneficiary of the trust shall have the power to withdraw all of the income and principal of Share A of the trust, but only with the consent of the then acting trustee or co-trustees of the trust (other than the primary current beneficiary of the trust or any institution in which the primary current beneficiary of the trust owns any interest) who and/or which is/are not adverse to the exercise by the primary current beneficiary of the trust of the aforesaid power of withdrawal (within the meaning of Internal Revenue Code Section 2041(b)(1)(C)(ii), or any successor section thereto, and Section 20.2041-3(c)(2) of the Treasury Regulations, or any successor section(s) thereto), or if all of the then acting trustees (other than the primary current beneficiary of the trust

or any institution in which the primary current beneficiary of the trust owns any interest) are adverse to said exercise, then only with the consent of a nonadverse individual or institution (other than the primary current beneficiary of the trust or any institution in which the primary current beneficiary of the trust owns any interest) designated by the then acting trustee or co-trustees of the trust (other than the primary current beneficiary of the trust or any institution in which the primary current beneficiary of the trust owns any interest), or, if no such nonadverse individual or institution has been designated, only with the consent of the institution (or its successor) designated herein as the sole ultimate successor institutional trustee of the trust. (The previous provisions of this paragraph 4 shall not be construed as a limitation on any trust beneficiary who is already entitled to receive all of the income of the trust currently, pursuant to the terms of the trust, or who already possesses a current right to withdraw all or any portion of the trust income or principal, pursuant to the terms of the trust.)

5. If the foregoing provisions of this Section apply to the trust, said provisions shall continue to apply to any other trust which is subsequently funded utilizing assets of the original trust, in whole or in part.

6. The term "retirement assets" shall mean any asset classified as part of a qualified plan pursuant to Section 401 of the Internal Revenue Code, or any successor section thereto, as part of an annuity payable under Section 403(a) or 403(b) of the Internal Revenue Code, or any successor sections thereto, as part of an individual retirement account (including a simplified employee pension) pursuant to Section 408 of the Internal Revenue Code, or any successor section thereto, as part of a ROTH IRA pursuant to Section 408A of the Internal Revenue Code, or any successor section thereto, as part of an inherited IRA established by the trustee pursuant to Section 402(c)(11) of the

Internal Revenue Code, or any successor section thereto, as part of a retirement plan pursuant to Section 457 of the Internal Revenue Code, or any successor section thereto, or as part of any similar qualified retirement arrangement under the Internal Revenue Code.

**The “Current Income Taxation” vs “Income Tax Basis Step-Up" Tradeoff**

Except in the case of a trust having an inclusion ratio of other than zero, where full federal estate tax inclusion is achieved under paragraph 4 of the above form by granting the beneficiary a lifetime general power of withdrawal over the trust income and principal (subject to the consent of a nonadverse trustee in order to preserve asset protection for the trust corpus), income tax basis step-up will not be available for the “IRA portion” of the trust. This situation arises for two reasons. First, a testamentary power to appoint to the beneficiary’s estate or to the creditors of the beneficiary’s estate, even when limited so that it will not cause the beneficiary's estate to be liable to pay federal or state estate or inheritance taxes, would cause the loss of the 10-year deferral for IRA, etc. receipts payable to the trust. Second, granting the beneficiary the full lifetime power to withdraw the income and principal of a trust having an inclusion ratio of zero, even if limited by requiring the approval of a nonadverse trustee, would automatically cause the *entire* trust (i.e., not just the portion which will not cause estate tax) to be included in the beneficiary's taxable estate.

Unfortunately, therefore, in an effort to achieve 10-year versus the default 5-year deferral for the “IRA portion” of a trust having a zero inclusion ratio, in the long run this drafting may necessarily cost the remainder persons of the trust significant capital gain tax dollars, because *no* income tax basis step-up would be available for the “IRA portion” of the trust at the death

of the life beneficiary of the trust.

An alternative approach to creating income tax basis step-up, worth considering in certain situations, is for the Share A beneficiary of the zero inclusion ratio trust to exercise a limited testamentary power of appointment over the Share A assets at the beneficiary's death in a fashion which intentionally violates IRC Section 2041(a)(3), sometimes referred to as "triggering the Delaware Tax Trap." Although an exhaustive discussion of the subject matter is beyond the scope of this handbook, it should be noted that commentators differ whether this strategy will always be successful. Whether this approach to intentionally causing full or partial federal estate tax inclusion for a zero inclusion ratio trust should be utilized over other approaches to achieving income tax basis step-up, as well as the effectiveness of this strategy generally, will depend on all the facts and circumstances, including: (a) applicable state law, (b) the manner in which the instrument creating the limited power of appointment is crafted, and (c) the manner in which the instrument exercising the power is drafted.

Section 20.2041-3(e) of the Regulations, set out here, which is intended as an interpretation of IRC Section 2041(a)(3), is significant because it can provide the drafting attorney with a valuable roadmap for intentionally triggering the Delaware Tax Trap, in whole or in part. In studying the regulation note in particular the language which the author has bolded, which language is not part of the Internal Revenue Code language itself, or part of IRC Section 2041(a)(3)'s legislative history.

> **(e) Successive powers.**
>
> (1) Property subject to a power of appointment created after October 21, 1942, which is not a general power, is includable in the gross estate of the holder of the power

under section 2041(a)(3) if the power is exercised, and if both of the following conditions are met:

(i) If the exercise is (a) by will, or (b) by a disposition which is of such nature that if it were a transfer of property owned by the decedent, the property would be includable in the decedent's gross estate under sections 2035 through 2037; and

(ii) If the power is exercised by creating another power of appointment which, **under the terms of the instruments creating and exercising the first power** and under applicable local law, can be validly exercised so as to (a) postpone the vesting of any estate or interest in the property for a period ascertainable without regard to the date of the creation of the first power, or (b) (if the applicable rule against perpetuities is stated in terms of suspension of ownership or of the power of alienation, rather than of vesting) suspend the absolute ownership or the power of alienation of the property for a period ascertainable without regard to the date of the creation of the first power.

The Regulation infers that the greatest chance of success for intentionally triggering the Delaware Tax Trap will lie in states which have an unlimited rule against perpetuities, and where *both* (1) the trust instrument which *creates* the first power of appointment ("the first power") *and* (2) the will or trust instrument which *exercises* the first power, allow for the valid exercise of a new power ("the second power") in a manner which can postpone or suspend the vesting or ownership of any estate or interest in the property subject to the second power for a period ascertainable without regard to the date of the creation of the first power. **[This Regulation also infers to the author that, in crafting any power of appointment, especially after the**

**general repeal of the Rule Against Perpetuities, there should be included a clear and bold warning to the donee of the power to be cognizant of IRC Section 2041(a)(3) in exercising the power, so as to not inadvertently trigger the Delaware Tax Trap, and to employ the assistance of estate planning counsel prior to exercising the power of appointment. The drafting attorney should not assume he or she will be representing the donee of the power of appointment, in other words. This same warning can then also be used to make the donee aware that he or she may choose to utilize IRC Section 2041(a)(3) in an effort to create income tax basis step-up at his or her death, but again only with the assistance of estate planning counsel.]**

Thus, for example, if a person who creates a limited testamentary power of appointment (the "first power") in a spouse or child resides in a state which has completely repealed the common law Rule Against Perpetuities (i.e., has not replaced it with, say, a 360-year rule),without placing any duration restraints on the spouse's or child's exercise of the first power, and if the spouse or child in turn exercises the first power by creating a new power (the "second power") in, e.g., a grandchild, which second power can be validly exercised by the grandchild so as to postpone the vesting of any estate or interest in the property for a period ascertainable without regard to the date of the creation of the first power (presumably the date of death of the grandparent), the spouse's or child's exercise of the first power should cause the trust assets subject to the first power to be includible in the spouse's or child's gross estate under Section 2041, and therefore also entitled to income tax basis step-up.

Of course, any intentional triggering of the Delaware Tax Trap must be carefully formulated so as to not cause the first power holder's estate to be liable for any federal or state estate

or inheritance taxes (unless, as described in the next section of this chapter, this is desirable in order to avoid a higher generation-skipping transfer tax), as well as to cause the greatest basis step-up possible. The triggering should therefore be accomplished in a two-part exercise of the testamentary limited power of appointment, part 1 being to a trust containing an additional ("second") power of appointment violative of ("triggering") IRC Section 2041(a)(3), and part 2 being to a trust which does not include an additional power of appointment which violates IRC Section 2041(a)(3).

Here is one sample form:

1. To the extent it will not result in (i) my estate being liable for any federal or state estate or inheritance taxes (assuming no alternate valuation date or similar elections, qualified disclaimers, or deductible administration expenses), (ii) my estate being liable to reimburse any government for any assistance or other benefits provided me during my lifetime, (iii) the Trust being automatically subject to income tax on any gain attributable to any portion of the remaining trust assets, or (iv) a reduction in the federal income tax basis of any asset of the Trust over its historical federal income tax basis, I hereby appoint those remaining assets of the trust under ARTICLE __ of the JOHN DOE LIVING TRUST (herein "the Trust"), if any, over which I possess a testamentary power of appointment, beginning with the asset or assets having the greatest amount of built-in appreciation (calculated by subtracting the trust's income tax basis from the fair market value on the date of my death), as a percentage of the fair market value of such asset or assets on the date of my death, to the trust under ARTICLE __ of my Revocable Trust; PROVIDED, HOWEVER, that if the Trust has been or will be divided into two separate trusts for federal generation-skipping transfer tax purposes, this appointment shall apply (i) first to the trust having an inclusion ratio, as defined in

Section 2642(a) of the Internal Revenue Code, or an successor section thereto, of other than zero, but only to the extent such trust is not otherwise already includible in my estate for federal estate tax purposes, pursuant to the other provisions of the JOHN DOE LIVING TRUST, and (ii) next to the trust having an inclusion ratio, as defined in Section 2642(a) of the Internal Revenue Code, or any successor section thereto, of zero.

2. I hereby appoint the balance of the assets of the Trust, if any, over which I possess a testamentary power of appointment, to the trust under ARTICLE of my Revocable Trust.

Finally, note that in some situations triggering of the Delaware Tax Trap in the manner described above, in an effort to create income tax basis step-up at the beneficiary's death, may be the only viable alternative to creating income tax basis which is available to the beneficiary. In these situations it would normally seem that there would be nothing to lose by proceeding down this planning path.

**The “Current Income Taxation” vs “Transfer Taxation” Tradeoff**

There may also be a "tax tradeoff" decision to be made between potentially reducing income taxes on IRA and 401K receipts, on the one hand, and the payment of additional federal and state transfer taxes at the beneficiary’s death, on the other. Set forth below is some optional conditional testamentary general power of appointment language the attorney may choose to employ when drafting a trust which will otherwise be subject to federal (and, in some situation, state) generation-skipping transfer taxes at the beneficiary’s death, i.e., trusts with an inclusion ratio of other than zero. The purpose of this optional language is to minimize ***overall*** federal and state estate, inheritance and generation-skipping transfer taxes payable at the

beneficiary's death by utilizing a formula conditional testamentary general power of appointment which considers all such taxes as well as the domicile of the beneficiary at the time of his or her death.

In order to enable 10-year deferral rather than five-year deferral, the first clause of the form excepts from its scope Share A situations where the trust has an inclusion ratio of other than zero and also establishes a Share A/B arrangement (the "Separate Accounting for Retirement Arrangements" clause set forth at page 28, above, which includes its own taxable general power of appointment in paragraph 4).

Note also the language throughout the paragraph which creates a formula designed to minimize overall federal and state estate, inheritance and transfer taxes at the beneficiary's death, including federal and state generation-skipping transfer taxes.

**Conditional Testamentary Power of Appointment.** Any other provision in this instrument notwithstanding (other than the "Separate Accounting for Retirement Assets" provision of Section __ of this ARTICLE), if a separate trust hereunder has an inclusion ratio (as defined in Section 2642(a) of the Internal Revenue Code or in any successor section thereto) of other than zero, such property may also be distributed at the primary current income beneficiary of the trust's (as defined in ARTICLE __ hereof, and hereinafter in this paragraph referred to simply as "the beneficiary") death to such of the creditors of the beneficiary's estate (or to the beneficiary's estate if the power to distribute such amounts to the creditors of the beneficiary's estate is insufficient to include such property in the beneficiary's estate for federal estate tax purposes) as shall be designated by a provision in the beneficiary's last will and testament, signed after the grantor's death, making specific reference to this paragraph. Any such

property with respect to which the beneficiary fails to effectively exercise this power of appointment shall be distributed as though this paragraph were not contained in this instrument; PROVIDED, HOWEVER, that unless the beneficiary specifies otherwise in a last will and testament or trust instrument, the trustee shall pay from such separate trust all estate, inheritance and other transfer taxes (including interest and penalties) imposed by reason of the beneficiary's death which would not have been imposed were it not for the inclusion of such property in the beneficiary's estate for estate, inheritance or other transfer tax purposes. Notwithstanding the preceding provisions of this paragraph to the contrary, however, this power of appointment shall not be applicable to a particular trust if, absent this power of appointment, no distribution from the trust at the beneficiary's death would be subject to a federal or state generation-skipping transfer or other transfer tax, and this power of appointment shall only be applicable (i) to the extent it maximizes a reduction of the aggregate federal and state estate, inheritance, generation-skipping transfer and other transfer tax liability otherwise applicable to the assets of the trust as a result of the beneficiary's death or (ii) in the event this power of appointment has no effect upon said aggregate tax liability, in either case assuming no alternate valuation date or similar elections, qualified disclaimers, or deductible administration expenses. For purposes of this paragraph it shall be assumed [except to the extent the trustee (other than the beneficiary and other than a trustee who is "related or subordinate" to the beneficiary of the trust within the meaning of current Section 672(c) of the Internal Revenue Code (substituting "the beneficiary" for "the grantor" in said Section)) shall direct by instrument in writing filed with the trust during the beneficiary's lifetime and not revoked by said trustee prior to the beneficiary's death] that all available federal and state qualified terminable interest property elections or similar marital deduction elections are made in the beneficiary's estate only to the extent they have the effect of minimizing all federal and state estate and

inheritance taxes applicable to the beneficiary's estate at the beneficiary's death. In the event the foregoing power of appointment shall only be applicable to a portion of the property held in said separate trust, the power of appointment shall extend first to those trust asset(s) having the greatest amount of built-in appreciation (calculated by subtracting the trust's income tax basis from the fair market value on the date of death of the beneficiary), as a percentage of the fair market value of such asset or assets on the date of death of the beneficiary. In the event the foregoing power of appointment shall have no effect upon the aggregate federal and state estate, inheritance, generation-skipping transfer and other transfer tax liability applicable to the assets of the trust as a result of the beneficiary's death, trust assets which would have a lower federal income tax basis if subject to the foregoing power of appointment shall be excluded from the same.

In the case of a trust having an inclusion ratio of other than zero, the aforesaid attempt to achieve the "optimum" estate and transfer tax level at the beneficiary's death will be hampered in a state which imposes an estate tax but which imposes no or a low generation-skipping transfer tax, if Share A of the trust is structured in the above [paragraph 4 at page 30] manner, which manner necessarily creates automatic *full* Section 2041 estate tax inclusion.

Assume, for example that a beneficiary of a trust having an inclusion ratio of one resides in a state which imposes an estate tax rate of 17% but a generation-skipping transfer tax rate of only 2%. Assume also that the beneficiary has an independent taxable estate which exceeds the available federal and state estate tax exemption amounts. Does it make sense, in this scenario, to automatically include the entire Share A of the beneficiary's trust having an inclusion ratio of one included in the beneficiary's taxable estate for both federal and state estate tax purposes?

The federal estate tax will be 40%, and the net state estate tax payable will be 10.2%, after factoring in the federal estate tax deduction for the state estate taxes paid. However, had the trust property not been intentionally and fully included in the beneficiary's taxable estate, the federal generation-skipping transfer tax rate would be 40%, but the net state generation-skipping transfer tax would be only 1.2%, after factoring in the federal generation-skipping transfer tax deduction for the state generation-skipping transfer taxes paid.

If this situation is a concern in a particular drafting case involving Share A of a trust having an inclusion ratio of other than zero, consideration should be given to utilizing an alternative route (i.e., to paragraph 4 at page 30) for causing estate tax inclusion, which route might involve intentionally triggering the Delaware Tax Trap, but only to the extent the trigger achieves the same "optimum" level of estate tax inclusion - if any - which the above sample form achieves in the case of Share B of the same trust. [See the triggering the Delaware Tax Trap discussion at pages 33-37.]

# III

# Estate Planning for Married Couples' IRAs and 401ks

The rise in the stock market over the past several years, teamed with the passage of the SECURE Act two years ago and the scheduled 50 percent reduction in the size of the federal estate tax exemption four years from now, has resulted in a renewed interest in estate planning for IRA and 401k accounts owned by married couples. For married couples owning significant IRA and 401k accounts, the question is whether the couple should now consider paying all or a portion of the same to a so-called "bypass" trust for the benefit of the surviving spouse, in order to remove the designated portion of the IRA or 401k proceeds from the surviving spouse's taxable estate, as well as to achieve certain other non-tax objectives.

## Limitations of the Spousal Portability Election

In 2013 Congress permanently passed into law what is known as the portability election for assets passing outright to a surviving spouse at the first spouse to die's death. Portability allows a surviving spouse to use the unused federal estate tax exemption of the deceased spouse, thus claiming two estate tax exemptions. Given the obvious beneficial aspects of this now nine-year old law, why is there any longer a need for a married couple to consider utilizing a bypass trust in their estate planning? There are actually at least five such reasons:

1. The portability election will not remove appreciation in the value of the "ported" assets from the surviving spouse's taxable estate, whereas a bypass trust will remove all appreciation.

2. The portability election will not apply (at least as to the first spouse to die's estate tax unused exemption) if the surviving spouse remarries and the new spouse predeceases him or her, whereas remarriage of the surviving spouse is irrelevant in the case of assets transferred to a bypass trust;

3. The portability election will not apply for federal generation-skipping transfer tax purposes, meaning that the amount which could have passed to an estate and generation-skipping transfer tax-exempt bypass trust, including all appreciation in the value of the same, will now potentially be subject to federal transfer tax in the children's estates;

4. Utilizing the portability election will cause the "ported" assets to be subject to potential lawsuits against the surviving spouse as well as to the potential claims of a new spouse, whereas lawsuits and claims against a surviving spouse will be avoided if a bypass trust is utilized; and

5. Utilizing the portability election will result in the first spouse to die losing the ability to control where the "ported" assets pass at the surviving spouse's death, control which could have been retained had a bypass trust been used, instead.

As sixth and final reason would apply in states which do not include a portability election as part of of their own estate and/or inheritance tax laws.

**The Traditional Bypass Trust as an Alternative**

In light of the above-described limitations of the spousal portability election when compared to so-called "bypass trust planning," whereby married couples divide their assets in some fashion so that, at the death of the first spouse to die, all or a portion of his or her separate assets pass to an estate tax-exempt trust for the survivor, the latter type of planning is obviously still in play after 2013. The question is: are bypass trusts an appropriate receptacle for IRA and 401k plan proceeds given that, after the SECURE Act, these trusts are generally subject to a 10-year maximum payout rule, whereas the outright payment of IRA and 401k plan proceeds to a surviving spouse is entitled to spousal rollover treatment, and therefore greater income tax deferral? Further, bypass trusts are generally subject to the highest federal income tax rate at levels of gross income of as low as only $13,550, include an exemption of only $100, and do not qualify for income tax basis step-up at the surviving spouse's death.

It is a simple matter to dispatch with the last issues mentioned. Judicious use of Internal Revenue Code Section 678 in the drafting of the bypass trust will generally eliminate the relevance of high trust income tax rates, as well as the minimal exemption, because the trust is not even taxed to the extent the surviving spouse is taxed instead, under Section 678. [See chapters I and II.] What is more, utilizing Section 678 of the Internal Revenue Code will cause the estate tax-exempt bypass trust to be unreduced by the annual income taxes which are payable by the surviving spouse, thereby further buttressing its importance in estate planning for married couples. Finally, a so-called "conditional general testamentary power of appointment" can be included in the terms of the bypass trust, which inclusion can oftentimes result in income tax basis step-up for all or a

portion of the appreciated assets in the trust at the surviving spouse's death. [See chapters I and II.]

As far as the loss of greater income tax deferral when IRA or 401k plan proceeds are paid to a bypass trust versus outright to the surviving spouse, the question becomes whether having the surviving spouse maximize income tax deferral on the IRA or 401k proceeds always makes economic sense after the SECURE Act, given the demise of so-called "stretch IRA" treatment to the children at the surviving spouse's passing. Observing that the children will likely be in their highest income tax brackets when the surviving spouse passes, and will now need to add the IRA or 401k plan proceeds to their peak taxable incomes over a maximum period of 10 years, it could actually turn out to be that, by intentionally choosing *not* to maximize income tax deferral of the IRA and 401k plan proceeds after the death of the first spouse-to-die and before the surviving spouse's death, overall income taxes to the family will be reduced.

The "after-tax math" will obviously be different in each estate planning situation. The estate planner will need to be cognizant of (i) the likely size of the IRA or 401k plan account at the first spouse-to-die's death as well as at the surviving spouse's passing, (ii) the likely tax situation of the surviving spouse, (iii) the likely tax situations of the couple's children after the surviving spouse's death, and (iv) the number of children who will be dividing the IRA or 401k plan proceeds at the surviving spouse's death, and therefore the amount of IRA or 401k plan proceeds each child will receive, to be taxed to each of them over 10 years. The age of the surviving spouse will also be a relevant factor. For example, if the surviving spouse will already be at least age 72, the income tax deferral benefits from a spousal rollover will not be as significant as they would have been if the surviving spouse was only age 55.

It may also make overall sense in a given situation to pay a portion of the IRA or 401k plan proceeds to the bypass trust, and a portion to the surviving spouse outright. Assuming the IRA or 401k plan administrator makes it available, use of a beneficiary designation which will allow for a full or partial disclaimer by a surviving spouse, in favor of a bypass trust, would be an excellent estate planning tool here, due to the flexibility the technique affords, and should therefore definitely be explored.

# IV

# Trust Planning for S Corporations

25 years ago Section 1361(e) of the Internal Revenue Code ("the Code"), commonly referred to as the Electing Small Business Trust, or "ESBT," for short, became law. The provision was initially praised by attorneys and their business owner clients, because it did not include the two major restrictions of the Qualified Subchapter S Trust, or "QSST," for short, i.e., that the trust could only have one beneficiary, and that all of the income of the trust needed to be distributed currently to the sole beneficiary. At the same time, the ESBT was criticized because all of the trust's income from the S corporation was taxed at the highest federal income tax rate, even if the income was distributed to one or more of the trust's beneficiaries. Further study of the applicable Code provisions and regulations reveals that this criticism of the ESBT may have been unwarranted, however, and that for many business owners the ESBT may actually be the clear choice for holding S corporation interests in trust.

## Overview of Tax Treatment of QSSTs and ESBTs

Section 1361(c)(2)(A)(i) of the Code provides that a "trust all of which is treated (under subpart E of part I of subchapter J of this chapter) as owned by an individual who is a citizen of the United States" is a permissible shareholder of an S corporation. Section 1361(d)(1)(A) then provides that a QSST with respect to which a beneficiary makes an election is treated as a trust

described in (c)(2)(A)(i). Finally, Section 1361(d)(1)(B) provides that, for purposes of section 678(a), the beneficiary of such trust shall be treated as the owner of that portion of the trust which consists of stock in an S corporation with respect to which the beneficiary makes the election. As the deemed owner of the trust's S corporation's shares, the beneficiary of a QSST is therefore taxed on the entirety of the trust's share of the S corporation's income.

A ESBT is handled differently under the Code. With a ESBT, whether and to what extent the beneficiaries of the trust are treated as owners of the trust for purposes of section 678(a) is up to the drafter of the trust. Section 1361(c)(2)(A)(v) provides merely that a ESBT is a permissible shareholder of an S corporation. The ESBT and its beneficiaries are then taxed under Section 641(c) of the Code and the regulations thereunder. Section 1.641(c)-1 of the regulations clarifies that, although in general the ESBT's portion of the income from the S corporation will be taxed at the highest federal income tax rate, taxation of the trust's beneficiaries under Section 678(a) of the Code takes precedence over this general rule.

**Limitations of the QSST**

Except in the case of a QSST which is being used in conjunction with a QTIP trust, where only the surviving spouse can be a lifetime beneficiary and all of the trust's income must be distributed to the surviving spouse currently, the significant disadvantages of the QSST in estate planning, when compared to an ESBT, include:

1. There can be only one beneficiary of a QSST during the beneficiary’s lifetime, i.e., the beneficiary’s children cannot also be current beneficiaries, which is not the case for a ESBT;

2. Unlike a ESBT, all of the ordinary income of the QSST must be distributed to the beneficiary currently, regardless of need, thus causing unnecessary (i) build up of the beneficiary's taxable estate by the compounded value of the QSST's share of the S corporation's distributed income, (ii) exposure of the compounded value of the QSST's share of the S corporation's distributed income to potential lawsuits against the QSST's beneficiary, and (iii) exposure of the compounded value of the QSST's share of the S corporation's distributed income to potential marital rights of the QSST's beneficiary; and

3. Because the clients will most likely not want the income generated by all of their other assets, including IRA and 401k plan benefits, to be automatically distributed to the trust beneficiary, unlike a ESBT two separate trusts (or at least two separate shares of one trust) will normally need to be established for each beneficiary.

**The ESBT as an Alternative**

In light of the above-described limitations of the QSST when compared to the ESBT, the latter option for holding S corporation interests in trust may need to be explored more than it has been in the past. As discussed in chapters I through III, judicious use of Code Section 678 in the drafting of the ESBT, for example, can largely eliminate the relevance of the maximum federal trust income tax rate on the trust's share of the S corporation's income. The ESBT is not even taxed to the extent the trust beneficiaries are taxed under Section 678. What is more, utilizing Section 678 of the Code will cause an estate or generation-skipping tax-exempt ESBT to be unreduced by the annual income taxes which are payable by the trust's beneficiaries, thereby further buttressing the ESBT's significance in estate planning for business owners.

Utilizing Code Section 678 merely means that the beneficiaries of the ESBT are granted the sole power to withdraw the ordinary income of the trust, annually, and are therefore taxed on this trust income, at their own tax rates. The ESBT itself is not taxed on the income of the trust attributable to the S corporation to the extent the beneficiaries are taxed under Section 678. If the ESBT beneficiaries need funds to pay the income tax attributable to their Section 678 withdrawal rights, they need merely exercise their withdrawal power to the extent so necessary. An alternative would be to allow an independent trustee to pay these taxes, either directly or indirectly by reimbursing the beneficiaries.

Each of the beneficiaries' withdrawal rights should be designed to fully or partially (i.e., subject to a “hanging power”) lapse at the end of each year, but only to the extent of 5% of the value of the trust each year, in order to avoid annual taxable gifts by the beneficiaries under IRC Section 2514(e). In most states, and under the Uniform Trust Code, the beneficiaries' annual withdrawal powers (including, presumably, any “hanging power”) will not be protected from lawsuits against the beneficiaries, but the lapsed portions of the withdrawal rights generally will be so protected. [The American College of Trust & Estate Counsel, or ACTEC, has an excellent web link on this topic.] In the balance of the states which do not protect the lapsed portions of the withdrawal rights from the beneficiaries' creditors the question must be asked: Who is the real “creditor” here, when the alternative to “Section 678 planning” is to either pay the maximum income tax to the IRS on the ESBT's share of the S corporation's income, or suffer all of the above-outlined negative estate tax and other consequences associated with the QSST, including the full exposure of the distributed income to potential creditors of the beneficiary?

It is doubtful whether the income which the trust beneficiaries do not elect to withdraw from the trust will be considered divisible marital property in most states, not just because it can be argued that it is property received by way of inheritance or gift, but primarily because the property is not actually owned by the beneficiaries, once the power to withdraw the same has lapsed. A ESBT with other beneficiaries (including remainder beneficiaries) does not constitute the beneficiaries' property, marital or nonmarital. Arguably in some states a beneficiary's spouse has the power to force the beneficiary to exercise his or her power of withdrawal over the trust's income, thereby also arguably causing the trust income to become marital property to the extent it is so withdrawn. If the spouse does not exercise this power, however, then he or she has presumably waived the right to argue this "lapsed income" is divisible marital property, assuming the trustee even possessed the fiduciary power to release these funds in the event a beneficiary divorces. Instead, and at best, it would seem that section 5(c) of the Uniform Marital Property Act should apply: "The right to manage and control marital property transferred to a trust is determined by the trust."

**A Word of Caution**

There needs to be one word of caution when applying Section 678 of the Code to ESBTs. In certain situations it may be impossible to cause all of the taxable income allocable to the ESBT's interest in the S corporation to be taxed to the trust's beneficiaries under Section 678. By way of background, Section 1.671-2(b) of the regulations provides:

> [W]hen it is stated in the regulations under subpart E that "income" is attributable 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. When it is intended to emphasize that income for trust accounting purposes (determined in accordance with the provisions set forth in §1.643(b)-1) is meant, the phrase "ordinary income" is used.

In the case of a ESBT, it is of course impossible for income (including taxable income) not actually distributed by the S corporation to the trust (i.e., in the way of dividends) to be withdrawable by the trust's beneficiaries. Only the ordinary income of the S corporation portion of the ESBT is therefore withdrawable. In this situation Section 1.678(a)-1 refers to Sections "1.671-1 and 1.671-3 for rules for treatment of items of income, deduction, and credit where a person is treated as the owner of . . . only a portion of a trust."

Section 1.671-3(b)(1) provides that "[o]nly ordinary income is included by reason of an interest in or a power over ordinary income alone. Thus, if a grantor . . . or another person is treated under sections 674-678 as an owner of a portion by reason of a power over ordinary income only, items of income allocable to corpus are not included in that portion."

Based on these regulations, if a portion of the taxable income of the S corporation is not distributed to the ESBT (i.e., as a result of working capital or other needs), and in effect is therefore allocable to trust corpus, this retained taxable income of the S corporation will be taxed to the ESBT at the highest federal income tax rate. If the client's family controls the S corporation, one possible workaround to this situation would be for the S corporation to distribute this income to the ESBT and then have the trustee of the ESBT voluntarily invest the same back into the corporation.

If the client's situation is such that there will be significant annual retained income of the S corporation that cannot be distributed to the ESBT and recontributed to the corporation via a work around, then the QSST may be the preferred estate planning choice over the ESBT, provided the client's family is able to control distributions of the corporation's income to the trust. The reason for this is that only the income which the corporation actually distributes to the trust need be distributed to the trust beneficiary, under the QSST rules and Section 1361(d)(3)(B) of the Code. The balance can remain in the corporation (and therefore in the protected trust), yet still be taxed to the beneficiary as the Section 678 deemed owner of that portion of the trust which consists of the trust's interest in the corporation.

**Existing Trusts**

If a trustee feels that an existing irrevocable QSST would be better structured as a ESBT with Section 678 income withdrawal powers in the beneficiary, or that an existing ESBT lacking Section 678 income withdrawal rights should be converted to one which does include them, or to a QSST, the use of a state decanting statute or other form of nonjudicial or judicial modification of the trust, or perhaps even a power granted the trustee in the trust document itself, may be in order. In drafting the decanting or other trust modification documents, the advisor should bear in mind the potential federal estate and gift tax issues involved.

If the documents converting an existing QSST into a ESBT with appropriate Section 678 income withdrawal powers in the beneficiary are carefully drafted, so that the only change relates to the right to withdraw income distributed from the S corporation to the trust (i.e., trust accounting income, within the meaning of

Sections 643(b) and 1361(d)(3)(B) of the Code), it would seem that the income beneficiary has given up nothing, on a current basis. There should therefore be no adverse estate or gift tax consequences as a result of the decanting.

Note, however, that when dealing with an existing QSST which is grandfathered from the 1986 generation-skipping transfer tax laws, at least where the modification power is not granted the trustee in the trust document itself, an argument can be fashioned by the Internal Revenue Service that this change constitutes a "substantial modification" of the trust instrument, i.e., because it shifts a beneficial interest in the trust (i.e., the income not withdrawn) down to succeeding generations, and therefore destroys the grandfathered generation-skipping transfer tax-exempt status of the trust. Caution should therefore be the rule when dealing with pre-1986 QSSTs.

Finally, note that, under an overly-restrictive interpretation of the Internal Revenue Code, some states' decanting laws may purport to prohibit decanting an existing QSST into any form of trust other than another QSST. These statutes should be reviewed carefully, however, because while their purpose may have been to prohibit the decanting of a QSST to, for example, a ESBT, read closely the statutes may actually permit this form of decanting to take place.

# V

# Epilogue

As alluded to at the conclusion of the preceding chapter, most states now provide different avenues which can be explored to "amend" an existing irrevocable trust in order to minimize income taxes on SECURE Act or other income of the same, without forcing the annual distribution of the trust's income into the hands of the beneficiary, and thereby disrupting the underlying purposes of the trust. These options, which include state "decanting" statutes and other measures, should be examined along with local estate planning counsel where deemed potentially desirable in a particular case.

Note, however, that none of these "trust amendment" options will affect the maximum distribution period for IRA and other defined contribution plan benefits, discussed in chapter II, which are already payable to the trust, nor can a "trust amendment" add beneficiaries to the trust (whether current or future) who or which did not already exist.

The estate planning team should also be careful not to cause a "grandfathered" generation-skipping transfer tax-exempt trust to inadvertently lose its exempt status as a result of an impermissible modification, or to create any other adverse estate or gift tax consequences.

# Relevant Internal Revenue Code Sections

## IRC Section 641

(c) Special rules for taxation of electing small business trusts

(1) In general

For purposes of this chapter—

(A) the portion of any electing small business trust which consists of stock in 1 or more S corporations shall be treated as a separate trust, and

(B) the amount of the tax imposed by this chapter on such separate trust shall be determined with the modifications of paragraph (2).

(2) Modifications

For purposes of paragraph (1), the modifications of this paragraph are the following:

(A) Except as provided in section 1(h), the amount of the tax imposed by section 1(e) shall be determined by using the highest rate of tax set forth in section 1(e).

(B) The exemption amount under section 55(d) shall be zero.

(C) The only items of income, loss, deduction, or credit to be taken into account are the following:

(i) The items required to be taken into account under section 1366.

(ii) Any gain or loss from the disposition of stock in an S corporation.

(iii) To the extent provided in regulations, State or local income taxes or administrative expenses to the extent allocable to items described in clauses (i) and (ii).

(iv) Any interest expense paid or accrued on indebtedness incurred to acquire stock in an S corporation.

No deduction or credit shall be allowed for any amount not described in this paragraph, and no item described in this paragraph shall be apportioned to any beneficiary.

(D) No amount shall be allowed under paragraph (1) or (2) of section 1211(b).

(E)

(i) Section 642(c) shall not apply.

(ii) For purposes of section 170(b)(1)(G), adjusted gross income shall be computed in the same manner as in the case of an individual, except that the deductions for costs which are paid or incurred in connection with the administration of the trust and which would not have been incurred if the property were not held in such trust shall be treated as allowable in arriving at adjusted gross income.

(3) Treatment of remainder of trust and distributions

For purposes of determining—

(A) the amount of the tax imposed by this chapter on the portion of any electing small business trust not treated as a separate trust under paragraph (1), and

(B) the distributable net income of the entire trust,

the items referred to in paragraph (2)(C) shall be excluded. Except as provided in the preceding sentence, this subsection shall not affect the taxation of any distribution from the trust.

(4) Treatment of unused deductions where termination of separate trust

If a portion of an electing small business trust ceases to be treated as a separate trust under paragraph (1), any carryover or excess deduction of the separate trust which is referred to in section 642(h) shall be taken into account by the entire trust.

(5) Electing small business trust

For purposes of this subsection, the term “electing small business trust” has the meaning given such term by section 1361(e)(1).

## IRC Section 671

Where it is specified in this subpart that the grantor or another person shall be treated as the owner of any portion of a trust, there shall then be included in computing the taxable income and credits of the grantor or the other person those items of income, deductions, and credits against tax of the trust which are attributable to that portion of the trust to the extent that such items would be taken into account under this chapter in computing taxable income or credits against the tax of an individual. Any remaining portion of the trust shall be subject to subparts A through D. No items of a trust shall be included in computing the taxable income and credits of the grantor or of any other person solely on the grounds of his dominion and control over the trust under section 61 (relating to definition of gross income) or any other provision of this title, except as specified in this subpart.

## IRC Section 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) such person has previously partially released or otherwise modified such a power and after the release or modification retains such control as would, within the principles of sections 671 to 677, inclusive, subject a grantor of a trust to treatment as the owner thereof.

(b) Exception where grantor is taxable

Subsection (a) shall not apply with respect to a power over income, as originally granted or thereafter modified, if the grantor of the trust or a transferor (to whom section 679 applies) is otherwise treated as the owner under the provisions of this subpart other than this section.

(c) Obligations of support

Subsection (a) shall not apply to a power which enables such person, in the capacity of trustee or cotrustee, merely to apply the income of the trust to the support or maintenance of a person whom the holder of the power is obligated to support or maintain except to the extent that such income is so applied. In cases where the amounts so applied or distributed are paid out of corpus or out of other than income of the taxable year, such amounts shall be considered to be an amount paid or credited within the meaning of paragraph (2) of section 661(a) and shall be taxed to the holder of the power under section 662.

(d) Effect of renunciation or disclaimer

Subsection (a) shall not apply with respect to a power which has been renounced or disclaimed within a reasonable time after the holder of the power first became aware of its existence.

(e) Cross reference

For provision under which beneficiary of trust is treated as owner of the portion of the trust which consists of stock in an S corporation, see section 1361(d).

## IRC Section 1361

(e) Electing small business trust defined

(1) Electing small business trust

For purposes of this section—

(A) In general

Except as provided in subparagraph (B), the term "electing small business trust" means any trust if—

(i) such trust does not have as a beneficiary any person other than (I) an individual, (II) an estate, (III) an organization described in paragraph (2), (3), (4), or (5) of section 170(c), or (IV) an organization described in section 170(c)(1) which holds a contingent interest in such trust and is not a potential current beneficiary,

(ii) no interest in such trust was acquired by purchase, and

(iii) an election under this subsection applies to such trust.

(B) Certain trusts not eligible

The term "electing small business trust" shall not include—

(i) any qualified subchapter S trust (as defined in subsection (d)(3)) if an election under subsection (d)(2) applies to any corporation the stock of which is held by such trust,

(ii) any trust exempt from tax under this subtitle, and

(iii) any charitable remainder annuity trust or charitable remainder unitrust (as defined in section 664(d)).

(C) Purchase

For purposes of subparagraph (A), the term "purchase" means any acquisition if the basis of the property acquired is determined under section 1012.

(2) Potential current beneficiary

For purposes of this section, the term “potential current beneficiary” means, with respect to any period, any person who at any time during such period is entitled to, or at the discretion of any person may receive, a distribution from the principal or income of the trust (determined without regard to any power of appointment to the extent such power remains unexercised at the end of such period). If a trust disposes of all of the stock which it holds in an S corporation, then, with respect to such corporation, the term “potential current beneficiary” does not include any person who first met the requirements of the preceding sentence during the 1-year period ending on the date of such disposition.

(3) Election

An election under this subsection shall be made by the trustee. Any such election shall apply to the taxable year of the trust for which made and all subsequent taxable years of such trust unless revoked with the consent of the Secretary.

(4) Cross reference

For special treatment of electing small business trusts, see section 641(c).

# Relevant Treasury Regulation Sections

## Section 1.641(c)-1 - Electing small business trust.

(a) In general. An electing small business trust (ESBT) within the meaning of section 1361(e) is treated as two separate trusts for purposes of chapter 1 of the Internal Revenue Code. The portion of an ESBT that consists of stock in one or more S corporations is treated as one trust. The portion of an ESBT that consists of all the other assets in the trust is treated as a separate trust. The grantor or another person may be treated as the owner of all or a portion of either or both such trusts under subpart E, part I, subchapter J, chapter 1 of the Internal Revenue Code. The ESBT is treated as a single trust for administrative purposes, such as having one taxpayer identification number and filing one tax return. See § 1.1361-1(m).

(b) Definitions -

(1) Grantor portion -

(i) In general. Subject to paragraph (b)(1)(ii) of this section, the grantor portion of an ESBT is the portion of the trust that is treated as owned by the grantor or another person under subpart E of the Code.

(ii) Nonresident alien deemed owner. If, pursuant to section 672(f)(2)(A)(ii), the deemed owner of a grantor portion of the ESBT is a nonresident alien, as defined in section 7701(b)(1)(B) (NRA), the items of income, deduction, and credit from that grantor portion must be reallocated from the grantor portion to the S portion, as defined in paragraph (b)(2) of this section, of the ESBT.

(2) S portion -

(i) In general. Subject to paragraph (b)(2)(ii) of this section, the S portion of an ESBT is the portion of the trust that consists of S corporation stock and that is not treated as owned by the grantor or another person under subpart E of the Code.

(ii) Nonresident alien (NRA) deemed owner of grantor portion. The S portion of an ESBT also includes the grantor portion of the items of income, deduction, and credit reallocated under paragraph (b)(1)(ii) of this section from the grantor portion of the ESBT to the S portion of the ESBT.

(3) Non-S portion. The non-S portion of an ESBT is the portion of the trust that consists of all assets other than S corporation stock and that is not treated as owned by the grantor or another person under subpart E.

(c) Taxation of grantor portion. The grantor or another person who is treated as the owner of a portion of the ESBT includes in computing taxable income items of income, deductions, and credits against tax attributable to that portion of the ESBT under section 671.

(d) Taxation of S portion -

(1) In general. The taxable income of the S portion is determined by taking into account only the items of income, loss, deduction, or credit specified in paragraphs (d)(2), (3), and (4) of this section, to the extent not attributable to the grantor portion.

(2) Section 1366 amounts -

(i) In general. The S portion takes into account the items of income, loss, deduction, or credit that are taken into account by an S corporation shareholder pursuant to section 1366 and the regulations thereunder. Rules otherwise applicable to trusts apply in determining the extent to which any loss, deduction, or credit may be taken into account in determining the taxable income of the S portion. See § 1.1361-1(m)(3)(iv) for allocation of those items in the taxable year of the S corporation in which the trust is an ESBT for part of the year and

an eligible shareholder under section 1361(a)(2)(A)(i) through (iv) for the rest of the year.

(ii) Special rule for charitable contributions. If a deduction described in paragraph (d)(2)(i) of this section is attributable to an amount of the S corporation's gross income that is paid by the S corporation for a charitable purpose specified in section 170(c) (without regard to section 170(c)(2)(A)), the contribution will be deemed to be paid by the S portion pursuant to the terms of the trust's governing instrument within the meaning of section 642(c)(1). The limitations of section 681, regarding unrelated business income, apply in determining whether the contribution is deductible in computing the taxable income of the S portion.

(iii) Multiple S corporations. If an ESBT owns stock in more than one S corporation, items of income, loss, deduction, or credit from all the S corporations are aggregated for purposes of determining the S portion's taxable income.

(3) Gains and losses on disposition of S stock -

(i) In general. The S portion takes into account any gain or loss from the disposition of S corporation stock. No deduction is allowed under section 1211(b)(1) and (2) for capital losses that exceed capital gains.

(ii) Installment method. If income from the sale or disposition of stock in an S corporation is reported by the trust on the installment method, the income recognized under this method is taken into account by the S portion. See paragraph (g)(3) of this section for the treatment of interest on the installment obligation. See § 1.1361-1(m)(5)(ii) regarding treatment of a trust as an ESBT upon the sale of all S corporation stock using the installment method.

(iii) Distributions in excess of basis. Gain recognized under section 1368(b)(2) from distributions in excess of the ESBT's basis in its S corporation stock is taken into account by the S portion.

(4) State and local income taxes and administrative expenses -

(i) In general. State and local income taxes and administrative expenses directly related to the S portion and those allocated to that portion in accordance with paragraph (h) are taken into account by the S portion.

(ii) Special rule for certain interest. Interest paid by the trust on money borrowed by the trust to purchase stock in an S corporation is allocated to the S portion but is not a deductible administrative expense for purposes of determining the taxable income of the S portion.

(e) Tax rates and exemption of S portion -

(1) Income tax rate. Except for capital gains, the highest marginal trust rate provided in section 1(e) is applied to the taxable income of the S portion. See section 1(h) for the rates that apply to the S portion's net capital gain.

(2) Alternative minimum tax exemption. The exemption amount of the S portion under section 55(d) is zero.

(f) Adjustments to basis of stock in the S portion under section 1367. The basis of S corporation stock in the S portion must be adjusted in accordance with section 1367 and the regulations thereunder. If the ESBT owns stock in more than one S corporation, the adjustments to the basis in the S corporation stock of each S corporation must be determined separately with respect to each S corporation. Accordingly, items of income, loss, deduction, or credit of an S corporation that are taken into account by the ESBT under section 1366 can only result in an adjustment to the basis of the stock of that S corporation and cannot affect the basis in the stock of the other S corporations held by the ESBT.

(g) Taxation of non-S portion -

(1) In general. The taxable income of the non-S portion is determined by taking into account all items of income, deduction, and credit to the extent not taken into account by either the grantor portion or the S

portion. The items attributable to the non-S portion are taxed under subparts A through D of part I, subchapter J, chapter 1 of the Internal Revenue Code. The non-S portion may consist of more than one share pursuant to section 663(c).

(2) Dividend income under section 1368(c)(2). Any dividend income within the meaning of section 1368(c)(2) is includible in the gross income of the non-S portion.

(3) Interest on installment obligations. If income from the sale or disposition of stock in an S corporation is reported by the trust on the installment method, the interest on the installment obligation is includible in the gross income of the non-S portion. See paragraph (d)(3)(ii) of this section for the treatment of income from such a sale or disposition.

(4) Charitable deduction. For purposes of applying section 642(c)(1) to payments made by the trust for a charitable purpose, the amount of gross income of the trust is limited to the gross income of the non-S portion. See paragraph (d)(2)(ii) of this section for special rules concerning charitable contributions paid by the S corporation that are deemed to be paid by the S portion.

(h) Allocation of state and local income taxes and administration expenses. Whenever state and local income taxes or administration expenses relate to more than one portion of an ESBT, they must be allocated between or among the portions to which they relate. These items may be allocated in any manner that is reasonable in light of all the circumstances, including the terms of the governing instrument, applicable local law, and the practice of the trustee with respect to the trust if it is reasonable and consistent. The taxes and expenses apportioned to each portion of the ESBT are taken into account by that portion.

(i) Treatment of distributions from the trust. Distributions to beneficiaries from the S portion or the non-S portion, including distributions of the S corporation stock, are deductible under section 651 or 661 in determining the taxable income of the non-S portion, and

are includible in the gross income of the beneficiaries under section 652 or 662. However, the amount of the deduction or inclusion cannot exceed the amount of the distributable net income of the non-S portion. Items of income, loss, deduction, or credit taken into account by the grantor portion or the S portion are excluded for purposes of determining the distributable net income of the non-S portion of the trust.

(j) Termination or revocation of ESBT election. If the ESBT election of the trust terminates pursuant to § 1.1361-1(m)(5) or the ESBT election is revoked pursuant to § 1.1361-1(m)(6), the rules contained in this section are thereafter not applicable to the trust. If, upon termination or revocation, the S portion has a net operating loss under section 172; a capital loss carryover under section 1212; or deductions in excess of gross income; then any such loss, carryover, or excess deductions shall be allowed as a deduction, in accordance with the regulations under section 642(h), to the trust, or to the beneficiaries succeeding to the property of the trust if the entire trust terminates.

(k) Applicability date. This section generally is applicable for taxable years of ESBTs beginning on and after May 14, 2002. However, paragraphs (a), (b), (c), and (l)(1)(Example 1) of this section are applicable for taxable years of ESBTs that end on and after December 29, 2000. ESBTs may apply paragraphs (d)(4) and (h) of this section for taxable years of ESBTs beginning after December 31, 1996. Paragraphs (b)(1) and (2) of this section, and Example 6 in paragraph (l)(6) of this section, apply to all ESBTs after December 31, 2017.

(l) Examples. The following examples illustrate the rules of this section:

(1) Example 1: Comprehensive example.

(i) Trust has a valid ESBT election in effect. Under section 678, B is treated as the owner of a portion of Trust consisting of a 10% undivided fractional interest in Trust. No other person is treated as the owner of any other portion of Trust under subpart E. Trust owns stock in X, an S corporation, and in Y, a C corporation. During 2000, Trust

receives a distribution from X of $5,100, of which $5,000 is applied against Trust's adjusted basis in the X stock in accordance with section 1368(c)(1) and $100 is a dividend under section 1368(c)(2). Trust makes no distributions to its beneficiaries during the year.

(ii) For 2000, Trust has the following items of income and deduction:

Table 1 to paragraph (l)(1)(ii)

Ordinary income attributable to X under section 1366 $5,000

Dividend income from Y $900

Dividend from X representing C corporation earnings and profits $100

Total trust income $6,000

Charitable contributions attributable to X under section 1366 $300

Trustee fees $200

State and local income taxes $100

(iii) Trust's items of income and deduction are divided into a grantor portion, an S portion, and a non-S portion for purposes of determining the taxation of those items. Income is allocated to each portion as follows:

(A) B must take into account the items of income attributable to the grantor portion, that is, 10% of each item, as follows:

Table 2 to paragraph (l)(1)(iii)(A)

Ordinary income from X $500

Dividend income from Y $90

Dividend income from X $10

Total grantor portion income $600

(B) The total income of the S portion is $4,500, determined as follows:

Table 3 to paragraph (l)(1)(iii)(B)

| | |
|---|---|
| Ordinary income from X | $5,000 |
| Less: Grantor portion | ($500) |
| Total S portion income | $4,500 |

(C) The total income of the non-S portion is $900 determined as follows:

Table 4 to paragraph (l)(1)(iii)(C)

| | |
|---|---|
| Dividend income from Y (less grantor portion) | $810 |
| Dividend income from X (less grantor portion) | $90 |
| Total non-S portion income | $900 |

(iv) The administrative expenses and the state and local income taxes relate to all three portions and under state law would be allocated ratably to the $6,000 of trust income. Thus, these items would be allocated 10% (600/6000) to the grantor portion, 75% (4500/6000) to the S portion and 15% (900/6000) to the non-S portion.

(v) B must take into account the following deductions attributable to the grantor portion of the trust:

Table 5 to paragraph (l)(1)(v)

| | |
|---|---|
| Charitable contributions from X | $30 |
| Trustee fees | $20 |
| State and local income taxes | $10 |

(vi) The taxable income of the S portion is $4,005, determined as follows:

Table 6 to paragraph (l)(1)(vi)

| | |
|---|---|
| Ordinary income from X | $4,500 |

Less: Charitable contributions from X (less grantor portion) ($270)

75% of trustee fees ($150)

75% of state and local income taxes ($75)

Taxable income of S portion $4,005

(vii) The taxable income of the non-S portion is $755, determined as follows:

Table 7 to paragraph (l)(1)(vii)

Dividend income from Y $810

Dividend income from X $90

Total non-S portion income $900

Less: 15% of trustee fees ($30)

15% state and local income taxes ($15)

Personal exemption ($100)

Taxable income of non-S portion $755

(2) Example 2: Sale of S stock.

Trust has a valid ESBT election in effect and owns stock in X, an S corporation. No person is treated as the owner of any portion of Trust under subpart E. In 2003, Trust sells all of its stock in X to a person who is unrelated to Trust and its beneficiaries and realizes a capital gain of $5,000. This gain is taken into account by the S portion and is taxed using the appropriate capital gain rate found in section 1(h).

(3) Example 3 -

(i) Sale of S stock for an installment note. Assume the same facts as in Example 2, in paragraph (l)(2) of this section except that Trust sells its stock in X for a $400,000 installment note payable with stated

interest over ten years. After the sale, Trust does not own any S corporation stock.

(ii) Loss on installment sale. Assume Trust's basis in its X stock was $500,000. Therefore, Trust sustains a capital loss of $100,000 on the sale. Upon the sale, the S portion terminates and the excess loss, after being netted against the other items taken into account by the S portion, is made available to the entire trust as provided in section 641(c)(4).

(iii) Gain on installment sale. Assume Trust's basis in its X stock was $300,000 and that the $100,000 gain will be recognized under the installment method of section 453. Interest income will be recognized annually as part of the installment payments. The portion of the $100,000 gain recognized annually is taken into account by the S portion. However, the annual interest income is includible in the gross income of the non-S portion.

(4) Example 4: Charitable lead annuity trust.

Trust is a charitable lead annuity trust which is not treated as owned by the grantor or another person under subpart E. Trust acquires stock in X, an S corporation, and elects to be an ESBT. During the taxable year, pursuant to its terms, Trust pays $10,000 to a charitable organization described in section 170(c)(2). The non-S portion of Trust receives an income tax deduction for the charitable contribution under section 642(c) only to the extent the amount is paid out of the gross income of the non-S portion. To the extent the amount is paid from the S portion by distributing S corporation stock, no charitable deduction is available to the S portion.

(5) Example 5: ESBT distributions.

(i) As of January 1, 2002, Trust owns stock in X, a C corporation. No portion of Trust is treated as owned by the grantor or another person under subpart E. X elects to be an S corporation effective January 1, 2003, and Trust elects to be an ESBT effective January 1, 2003. On February 1, 2003, X makes an $8,000 distribution to Trust, of which $3,000 is treated as a dividend from accumulated earnings and profits under section 1368(c)(2) and the remainder is applied against Trust's

basis in the X stock under section 1368(b). The trustee of Trust makes a distribution of $4,000 to Beneficiary during 2003. For 2003, Trust's share of X's section 1366 items is $5,000 of ordinary income. For the year, Trust has no other income and no expenses or state or local taxes.

(ii) For 2003, Trust has $5,000 of taxable income in the S portion. This income is taxed to Trust at the maximum rate provided in section 1(e). Trust also has $3,000 of distributable net income (DNI) in the non-S portion. The non-S portion of Trust receives a distribution deduction under section 661(a) of $3,000, which represents the amount distributed to Beneficiary during the year ($4,000), not to exceed the amount of DNI ($3,000). Beneficiary must include this amount in gross income under section 662(a). As a result, the non-S portion has no taxable income.

(6) Example 6: NRA as potential current beneficiary. Domestic Trust (DT) has a valid ESBT election in effect. DT owns S corporation stock. The S corporation owns U.S. and foreign assets. The foreign assets produce foreign source income. B, an NRA, is the grantor and the only trust beneficiary and potential current beneficiary of DT. B is not a resident of a country with which the United States has an income tax treaty. Under section 677(a), B is treated as the owner of DT because, under the trust documents, income and corpus may be distributed only to B during B's lifetime. Paragraph (b)(2)(ii) of this section requires that the S corporation income of the ESBT that otherwise would have been allocated to B under the grantor trust rules must be reallocated from B's grantor portion to the S portion of DT. In the example in this paragraph (l)(6), the S portion of DT is treated as including the grantor portion of the ESBT, and thus all of DT's income from the S corporation is taxable to DT.

## Section 1.671-1 - Grantors and others treated as substantial owners; scope.

(a) Subpart E (section 671 and following), part I, subchapter J, chapter 1 of the Code, contains provisions taxing income of a trust to the

grantor or another person under certain circumstances even though he is not treated as a beneficiary under subparts A through D (section 641 and following) of such part I. Sections 671 and 672 contain general provisions relating to the entire subpart. Sections 673 through 677 define the circumstances under which income of a trust is taxed to a grantor. These circumstances are in general as follows:

(1) If the grantor has retained a reversionary interest in the trust, within specified time limits (section 673);

(2) If the grantor or a nonadverse party has certain powers over the beneficial interests under the trust (section 674);

(3) If certain administrative powers over the trust exist under which the grantor can or does benefit (section 675).

(4) If the grantor or a nonadverse party has a power to revoke the trust or return the corpus to the grantor (section 676); or

(5) If the grantor or a nonadverse party has the power to distribute income to or for the benefit of the grantor or the grantor's spouse (section 677).

Under section 678, income of a trust is taxed to a person other than the grantor to the extent that he has the sole power to vest corpus or income in himself.

(b) Sections 671 through 677 do not apply if the income of a trust is taxable to a grantor's spouse under section 71 or 682 (relating respectively to alimony and separate maintenance payments, and the income of an estate or trust in the case of divorce, etc.).

(c) Except as provided in such subpart E, income of a trust is not included in computing the taxable income and credits of a grantor or another person solely on the grounds of his dominion and control over the trust. However, the provisions of subpart E do not apply in situations involving an assignment of future income, whether or not the assignment is to a trust. Thus, for example, a person who assigns his right to future income under an employment contract may be taxed on

that income even though the assignment is to a trust over which the assignor has retained none of the controls specified in sections 671 through 677. Similarly, a bondholder who assigns his right to interest may be taxed on interest payments even though the assignment is to an un controlled trust. Nor are the rules as to family partnerships affected by the provisions of subpart E, even though a partnership interest is held in trust. Likewise, these sections have no application in determining the right of a grantor to deductions for payments to a trust under a transfer and leaseback arrangement. In addition, the limitation of the last sentence of section 671 does not prevent any person from being taxed on the income of a trust when it is used to discharge his legal obligation. See § 1.662 (a)-4. He is then treated as a beneficiary under subparts A through D or treated as an owner under section 677 because the income is distributed for his benefit, and not because of his dominion or control over the trust.

(d) The provisions of subpart E are not applicable with respect to a pooled income fund as defined in paragraph (5) of section 642(c) and the regulations thereunder, a charitable remainder annuity trust as defined in paragraph (1) of section 664(d) and the regulations thereunder, or a charitable remainder unitrust as defined in paragraph (2) of section 664(d) and the regulations thereunder.

(e) For the effective date of subpart E see section 683 and the regulations thereunder.

(f) For rules relating to the treatment of liabilities resulting on the sale or other disposition of encumbered trust property due to a renunciation of powers by the grantor or other owner, see § 1.1001-2.

## Section 1.671-2 - Applicable principles.

(a) Under section 671 a grantor or another person includes in computing his taxable income and credits those items of income, deduction, and credit against tax which are attributable to or included in any portion of a trust of which he is treated as the owner. Sections

673 through 678 set forth the rules for determining when the grantor or another person is treated as the owner of any portion of a trust. The rules for determining the items of income, deduction, and credit against tax that are attributable to or included in a portion of the trust are set forth in § 1.671-3.

(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. When it is intended to emphasize that income for trust accounting purposes (determined in accordance with the provisions set forth in § 1.643(b)-1 is meant, the phrase "ordinary income" is used.

(c) An item of income, deduction, or credit included in computing the taxable income and credits of a grantor or another person under section 671 is treated as if it had been received or paid directly by the grantor or other person (whether or not an individual). For example, a charitable contribution made by a trust which is attributed to the grantor (an individual) under sections 671 through 677 will be aggregated with his other charitable contributions to determine their deductibility under the limitations of section 170(b)(1). Likewise, dividends received by a trust from sources in a particular foreign country which are attributed to a grantor or another person under subpart E will be aggregated with his other income from sources within that country to determine whether the taxpayer is subject to the limitations of section 904 with respect to credit for the tax paid to that country.

(d) Items of income, deduction, and credit not attributed to or included in any portion of a trust of which the grantor or another person is treated as the owner under subpart E are subject to the provisions of subparts A through D (section 641 and following), of such part I.

(e)

(1) For purposes of part I of subchapter J, chapter 1 of the Internal Revenue Code, a grantor includes any person to the extent such person either creates a trust, or directly or indirectly makes a gratuitous transfer (within the meaning of paragraph (e)(2) of this section) of property to a trust. For purposes of this section, the term property includes cash. If a person creates or funds a trust on behalf of another person, both persons are treated as grantors of the trust. (See section 6048 for reporting requirements that apply to grantors of foreign trusts.) However, a person who creates a trust but makes no gratuitous transfers to the trust is not treated as an owner of any portion of the trust under sections 671 through 677 or 679. Also, a person who funds a trust with an amount that is directly reimbursed to such person within a reasonable period of time and who makes no other transfers to the trust that constitute gratuitous transfers is not treated as an owner of any portion of the trust under sections 671 through 677 or 679. See also § 1.672(f)-5(a).

(2)

(i) A gratuitous transfer is any transfer other than a transfer for fair market value. A transfer of property to a trust may be considered a gratuitous transfer without regard to whether the transfer is treated as a gift for gift tax purposes.

(ii) For purposes of this paragraph (e), a transfer is for fair market value only to the extent of the value of property received from the trust, services rendered by the trust, or the right to use property of the trust. For example, rents, royalties, interest, and compensation paid to a trust are transfers for fair market value only to the extent that the payments reflect an arm's length price for the use of the property of, or for the services rendered by, the trust. For purposes of this determination, an

interest in the trust is not property received from the trust. In addition, a person will not be treated as making a transfer for fair market value merely because the transferor recognizes gain on the transaction. See, for example, section 684 regarding the recognition of gain on certain transfers to foreign trusts.

(iii) For purposes of this paragraph (e), a gratuitous transfer does not include a distribution to a trust with respect to an interest held by such trust in either a trust described in paragraph (e)(3) of this section or an entity other than a trust.

For example, a distribution to a trust by a corporation with respect to its stock described in section 301 is not a gratuitous transfer.

(3) A grantor includes any person who acquires an interest in a trust from a grantor of the trust if the interest acquired is an interest in certain investment trusts described in § 301.7701-4(c) of this chapter, liquidating trusts described in § 301.7701-4(d) of this chapter, or environmental remediation trusts described in § 301.7701-4(e) of this chapter.

(4) If a gratuitous transfer is made by a partnership or corporation to a trust and is for a business purpose of the partnership or corporation, the partnership or corporation will generally be treated as the grantor of the trust. For example, if a partnership makes a gratuitous transfer to a trust in order to secure a legal obligation of the partnership to a third party unrelated to the partnership, the partnership will be treated as the grantor of the trust. However, if a partnership or a corporation makes a gratuitous transfer to a trust that is not for a business purpose of the partnership or corporation but is for the personal purposes of one or more of the partners or shareholders, the gratuitous transfer will be treated as a constructive distribution to such partners or shareholders under federal tax principles and the partners or the shareholders will be treated as the grantors of the trust. For example, if a partnership makes a gratuitous transfer to a trust that is for the benefit of a child of a partner, the gratuitous transfer will be treated as a distribution to the partner under section 731 and a subsequent gratuitous transfer by the partner to the trust.

(5) 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. However, if a person with a general power of appointment over the transferor trust exercises that power in favor of another trust, then such person will be treated as the grantor of the transferee trust, even if the grantor of the transferor trust is treated as the owner of the transferor trust under subpart E of part I, subchapter J, chapter 1 of the Internal Revenue Code.

(6) The following examples illustrate the rules of this paragraph (e). Unless otherwise indicated, all trusts are domestic trusts, and all other persons are United States persons. The examples are as follows:

Example 1.

A creates and funds a trust, T, for the benefit of her children. B subsequently makes a gratuitous transfer to T. Under paragraph (e)(1) of this section, both A and B are grantors of T.

Example 2.

A makes an investment in a fixed investment trust, T, that is classified as a trust under § 301.7701-4(c)(1) of this chapter. A is a grantor of T. B subsequently acquires A's entire interest in T. Under paragraph (e)(3) of this section, B is a grantor of T with respect to such interest.

Example 3.

A, an attorney, creates a foreign trust, FT, on behalf of A's client, B, and transfers $100 to FT out of A's funds. A is reimbursed by B for the $100 transferred to FT. The trust instrument states that the trustee has discretion to distribute the income or corpus of FT to B and B's children. Both A and B are treated as grantors of FT under paragraph (e)(1) of this section. In addition, B is treated as the owner of the entire trust under section 677. Because A is reimbursed for the $100 transferred to FT on behalf of B, A is not treated as transferring any property to FT. Therefore, A is not an owner of any portion of FT under sections 671 through 677 regardless of whether A retained any power over or interest in FT described in sections 673 through 677.

Furthermore, A is not treated as an owner of any portion of FT under section 679. Both A and B are responsible parties for purposes of the requirements in section 6048.

Example 4.

A creates and funds a trust, T. A does not retain any power or interest in T that would cause A to be treated as an owner of any portion of the trust under sections 671 through 677. B holds an unrestricted power, exercisable solely by B, to withdraw certain amounts contributed to the trust before the end of the calendar year and to vest those amounts in B. B is treated as an owner of the portion of T that is subject to the withdrawal power under section 678(a)(1). However, B is not a grantor of T under paragraph (e)(1) of this section because B neither created T nor made a gratuitous transfer to T.

Example 5.

A transfers cash to a trust, T, through a broker, in exchange for units in T. The units in T are not property for purposes of determining whether A has received fair market value under paragraph (e)(2)(ii) of this section. Therefore, A has made a gratuitous transfer to T, and, under paragraph (e)(1) of this section, A is a grantor of T.

Example 6.

A borrows cash from T, a trust. A has not made any gratuitous transfers to T. Arm's length interest payments by A to T will not be treated as gratuitous transfers under paragraph (e)(2)(ii) of this section. Therefore, under paragraph (e)(1) of this section, A is not a grantor of T with respect to the interest payments.

Example 7.

A, B's brother, creates a trust, T, for B's benefit and transfers $50,000 to T. The trustee invests the $50,000 in stock of Company X. C, B's uncle, purportedly sells property with a fair market value of $1,000,000 to T in exchange for the stock when it has appreciated to a fair market value of $100,000. Under paragraph (e)(2)(ii) of this section, the

$900,000 excess value is a gratuitous transfer by C. Therefore, under paragraph (e)(1) of this section, A is a grantor with respect to the portion of the trust valued at $100,000, and C is a grantor of T with respect to the portion of the trust valued at $900,000. In addition, A or C or both will be treated as the owners of the respective portions of the trust of which each person is a grantor if A or C or both retain powers over or interests in such portions under sections 673 through 677.

Example 8.

G creates and funds a trust, T1, for the benefit of G's children and grandchildren. After G's death, under authority granted to the trustees in the trust instrument, the trustees of T1 transfer a portion of the assets of T1 to another trust, T2, and retain a power to revoke T2 and revest the assets of T2 in T1. Under paragraphs (e)(1) and (5) of this section, G is the grantor of T1 and T2. In addition, because the trustees of T1 have retained a power to revest the assets of T2 in T1, T1 is treated as the owner of T2 under section 678(a).

Example 9.

G creates and funds a trust, T1, for the benefit of B. G retains a power to revest the assets of T1 in G within the meaning of section 676. Under the trust agreement, B is given a general power of appointment over the assets of T1. B exercises the general power of appointment with respect to one-half of the corpus of T1 in favor of a trust, T2, that is for the benefit of C, B's child. Under paragraph (e)(1) of this section, G is the grantor of T1, and under paragraphs (e)(1) and (5) of this section, B is the grantor of T2.

(7) The rules of this section are applicable to any transfer to a trust, or transfer of an interest in a trust, on or after August 10, 1999.

## Section 1.671-3 - Attribution or inclusion of income, deductions, and credits against tax.

(a) When a grantor or another person is treated under subpart E (section 671 and following) as the owner of any portion of a trust, there are included in computing his tax liability those items of income, deduction, and credit against tax attributable to or included in that portion. For example:

(1) If a grantor or another person is treated as the owner of an entire trust (corpus as well as ordinary income), he takes into account in computing his income tax liability all items of income, deduction, and credit (including capital gains and losses) to which he would have been entitled had the trust not been in existence during the period he is treated as owner.

(2) If the portion treated as owned consists of specific trust property and its income, all items directly related to that property are attributable to the portion. Items directly related to trust property not included in the portion treated as owned by the grantor or other person are governed by the provisions of subparts A through D (section 641 and following), part I, subchapter J, chapter 1 of the Code. Items that relate both to the portion treated as owned by the grantor and to the balance of the trust must be apportioned in a manner that is reasonable in the light of all the circumstances of each case, including the terms of the governing instrument, local law, and the practice of the trustee if it is reasonable and consistent.

(3) If the portion of a trust treated as owned by a grantor or another person consists of an undivided fractional interest in the trust, or of an interest represented by a dollar amount, a pro rata share of each item of income, deduction, and credit is normally allocated to the portion. Thus, where the portion owned consists of an interest in or a right to an amount of corpus only, a fraction of each item (including items allocated to corpus, such as capital gains) is attributed to the portion. The numerator of this fraction is the amount which is subject to the control of the grantor or other person and the denominator is normally

the fair market value of the trust corpus at the beginning of the taxable year in question. The share not treated as owned by the grantor or other person is governed by the provisions of subparts A through D. See the last three sentences of paragraph (c) of this section for the principles applicable if the portion treated as owned consists of an interest in part of the ordinary income in contrast to an interest in corpus alone.

(b) If a grantor or another person is treated as the owner of a portion of a trust, that portion may or may not include both ordinary income and other income allocable to corpus. For example:

(1) Only ordinary income is included by reason of an interest in or a power over ordinary income alone. Thus, if a grantor is treated under section 673 as an owner by reason of a reversionary interest in ordinary income only, items of income allocable to corpus will not be included in the portion he is treated as owning. Similarly, if a grantor or another person is treated under sections 674-678 as an owner of a portion by reason of a power over ordinary income only, items of income allocable to corpus are not included in that portion. (See paragraph (c) of this section to determine the treatment of deductions and credits when only ordinary income is included in the portion.)

(2) Only income allocable to corpus is included by reason of an interest in or a power over corpus alone, if satisfaction of the interest or an exercise of the power will not result in an interest in or the exercise of a power over ordinary income which would itself cause that income to be included. For example, if a grantor has a reversionary interest in a trust which is not such as to require that he be treated as an owner under section 673, he may nevertheless be treated as an owner under section 677(a)(2) since any income allocable to corpus is accumulated for future distribution to him, but items of income included in determining ordinary income are not included in the portion he is treated as owning. Similarly, he may have a power over corpus which is such that he is treated as an owner under section 674 or 676 (a), but ordinary income will not be included in the portion he owns, if his power can only affect income received after a period of time such that he would not be treated as an owner of the income if the power

were a reversionary interest. (See paragraph (c) of this section to determine the treatment of deductions and credits when only income allocated to corpus is included in the portion.)

(3) Both ordinary income and other income allocable to corpus are included by reason of an interest in or a power over both ordinary income and corpus, or an interest in or a power over corpus alone which does not come within the provisions of subparagraph (2) of this paragraph. For example, if a grantor is treated under section 673 as the owner of a portion of a trust by reason of a reversionary interest in corpus, both ordinary income and other income allocable to corpus are included in the portion. Further, a grantor includes both ordinary income and other income allocable to corpus in the portion he is treated as owning if he is treated under section 674 or 676 as an owner because of a power over corpus which can affect income received within a period such that he would be treated as an owner under section 673 if the power were a reversionary interest. Similarly, a grantor or another person includes both ordinary income and other income allocable to corpus in the portion he is treated as owning if he is treated as an owner under section 675 or 678 because of a power over corpus.

(c) If only income allocable to corpus is included in computing a grantor's tax liability, he will take into account in that computation only those items of income, deductions, and credit which would not be included under subparts A through D in the computation of the tax liability of the current income beneficiaries if all distributable net income had actually been distributed to those beneficiaries. On the other hand, if the grantor or another person is treated as an owner solely because of his interest in or power over ordinary income alone, he will take into account in computing his tax liability those items which would be included in computing the tax liability of a current income beneficiary, including expenses allocable to corpus which enter into the computation of distributable net income. If the grantor or other person is treated as an owner because of his power over or right to a dollar amount of ordinary income, he will first take into account a portion of those items of income and expense entering into the computation of ordinary income under the trust instrument or local law sufficient to

produce income of the dollar amount required. There will then be attributable to him a pro rata portion of other items entering into the computation of distributable net income under subparts A through D, such as expenses allocable to corpus, and a pro rata portion of credits of the trust. For examples of computations under this paragraph, see paragraph (g) of § 1.677(a)-1.

## Section 1.1361-1 - S corporation defined.

(m) Electing small business trust (ESBT) -

(1) Definition -

(i) General rule. An electing small business trust (ESBT) means any trust if it meets the following requirements: the trust does not have as a beneficiary any person other than an individual, an estate, an organization described in section 170(c)(2) through (5), or an organization described in section 170(c)(1) that holds a contingent interest in such trust and is not a potential current beneficiary; no interest in the trust has been acquired by purchase; and the trustee of the trust makes a timely ESBT election for the trust.

(ii) Qualified beneficiaries -

(A) In general. For purposes of this section, a beneficiary includes a person who has a present, remainder, or reversionary interest in the trust.

(B) Distributee trusts. A distributee trust is the beneficiary of the ESBT only if the distributee trust is an organization described in section 170(c)(2) or (3). In all other situations, any person who has a beneficial interest in a distributee trust is a beneficiary of the ESBT. A distributee trust is a trust that receives or may receive a distribution from an ESBT, whether the rights to receive the distribution are fixed or contingent, or immediate or deferred.

(C) Powers of appointment. A person in whose favor a power of appointment could be exercised is not a beneficiary of an ESBT until the holder of the power of appointment actually exercises the power in favor of such person.

(D) Nonresident aliens. A nonresident alien (NRA), as defined in section 7701(b)(1)(B), is an eligible beneficiary of an ESBT and an eligible potential current beneficiary.

(iii) Interests acquired by purchase. A trust does not qualify as an ESBT if any interest in the trust has been acquired by purchase. Generally, if a person acquires an interest in the trust and thereby becomes a beneficiary of the trust as defined in paragraph (m)(1)(ii)(A), and any portion of the basis in the acquired interest in the trust is determined under section 1012, such interest has been acquired by purchase. This includes a net gift of a beneficial interest in the trust, in which the person acquiring the beneficial interest pays the gift tax. The trust itself may acquire S corporation stock or other property by purchase or in a part-gift, part-sale transaction.

(iv) Ineligible trusts. An ESBT does not include -

(A) Any qualified subchapter S trust (as defined in section 1361(d)(3)) if an election under section 1361(d)(2) applies with respect to any corporation the stock of which is held by the trust;

(B) Any trust exempt from tax or not subject to tax under subtitle A; or

(C) Any charitable remainder annuity trust or charitable remainder unitrust (as defined in section 664(d)).

(2) ESBT election -

(i) In general. The trustee of the trust must make the ESBT election by signing and filing, with the service center where the S corporation files its income tax return, a statement that meets the requirements of paragraph (m)(2)(ii) of this section. If there is more than one trustee, the trustee or trustees with authority to legally bind the trust must sign

the election statement. If any one of several trustees can legally bind the trust, only one trustee needs to sign the election statement. Generally, only one ESBT election is made for the trust, regardless of the number of S corporations whose stock is held by the ESBT. However, if the ESBT holds stock in multiple S corporations that file in different service centers, the ESBT election must be filed with all the relevant service centers where the corporations file their income tax returns. This requirement applies only at the time of the initial ESBT election; if the ESBT later acquires stock in an S corporation which files its income tax return at a different service center, a new ESBT election is not required.

(ii) Election statement. The election statement must include -

(A) The name, address, and taxpayer identification number of the trust, the potential current beneficiaries, and the S corporations in which the trust currently holds stock. If the trust includes a power described in paragraph (m)(4)(vi)(B) of this section, then the election statement must include a statement that such a power is included in the instrument, but does not need to include the name, address, or taxpayer identification number of any particular charity or any other information regarding the power.

(B) An identification of the election as an ESBT election made under section 1361(e)(3);

(C) The first date on which the trust owned stock in each S corporation;

(D) The date on which the election is to become effective (not earlier than 15 days and two months before the date on which the election is filed); and

(E) Representations signed by the trustee stating that -

(1) The trust meets the definitional requirements of section 1361(e)(1); and

(2) All potential current beneficiaries of the trust meet the shareholder requirements of section 1361(b)(1); for the purpose of this paragraph (m)(2)(ii)(E)(2), an NRA potential current beneficiary does not violate the requirement under section 1361(b)(1)(C) that an S corporation cannot have an NRA as a shareholder.

(iii) Due date for ESBT election. The ESBT election must be filed within the time requirements prescribed in paragraph (j)(6)(iii) of this section for filing a qualified subchapter S trust (QSST) election.

(iv) Election by a trust described in section 1361(c)(2)(A)(ii) or (iii). A trust that is a qualified S corporation shareholder under section 1361(c)(2)(A)(ii) or (iii) may elect ESBT treatment at any time during the 2-year period described in those sections or the 16-day-and-2-month period beginning on the date after the end of the 2-year period. If the trust makes an ineffective ESBT election, the trust will continue nevertheless to qualify as an eligible S corporation shareholder for the remainder of the period described in section 1361(c)(2)(A)(ii) or (iii).

(v) No protective election. A trust cannot make a conditional ESBT election that would be effective only in the event the trust fails to meet the requirements for an eligible trust described in section 1361(c)(2)(A)(i) through (iv). If a trust attempts to make such a conditional ESBT election and it fails to qualify as an eligible S corporation shareholder under section 1361(c)(2)(A)(i) through (iv), the S corporation election will be ineffective or will terminate because the corporation will have an ineligible shareholder. Relief may be available under section 1362(f) for an inadvertent ineffective S corporation election or an inadvertent S corporation election termination. In addition, a trust that qualifies as an ESBT may make an ESBT election notwithstanding that the trust is a wholly-owned grantor trust.

(3) Effect of ESBT election -

(i) General rule. If a trust makes a valid ESBT election, the trust will be treated as an ESBT for purposes of chapter 1 of the Internal Revenue Code as of the effective date of the ESBT election.

(ii) Employer Identification Number. An ESBT has only one employer identification number (EIN). If an existing trust makes an ESBT election, the trust continues to use the EIN it currently uses.

(iii) Taxable year. If an ESBT election is effective on a day other than the first day of the trust's taxable year, the ESBT election does not cause the trust's taxable year to close. The termination of the ESBT election (including a termination caused by a conversion of the ESBT to a QSST) other than on the last day of the trust's taxable year also does not cause the trust's taxable year to close. In either case, the trust files one tax return for the taxable year.

(iv) Allocation of S corporation items. If, during the taxable year of an S corporation, a trust is an ESBT for part of the year and an eligible shareholder under section 1361(c)(2)(A)(i) through (iv) for the rest of the year, the S corporation items are allocated between the two types of trusts under section 1377(a). See § 1.1377-1(a)(2)(iii).

(v) Estimated taxes. If an ESBT election is effective on a day other than the first day of the trust's taxable year, the trust is considered one trust for purposes of estimated taxes under section 6654.

(4) Potential current beneficiaries -

(i) In general. For purposes of determining whether a corporation is a small business corporation within the meaning of section 1361(b)(1), each potential current beneficiary of an ESBT generally is treated as a shareholder of the corporation. Subject to the provisions of this paragraph (m)(4), a potential current beneficiary generally is, with respect to any period, any person who at any time during such period is entitled to, or in the discretion of any person may receive, a distribution from the principal or income of the trust. A person is treated as a shareholder of the S corporation at any moment in time when that person is entitled to, or in the discretion of any person may, receive a distribution of principal or income of the trust. No person is

treated as a potential current beneficiary solely because that person holds any future interest in the trust. An NRA potential current beneficiary of an ESBT is treated as a shareholder for purposes of the 100-shareholder limit under section 1361(b)(1)(A). However, an NRA potential current beneficiary of an ESBT is not treated as a shareholder in determining whether a corporation is a small business corporation for purposes of the NRA-shareholder prohibition under section 1361(b)(1)(C).

(ii) Grantor trusts. If all or a portion of an ESBT is treated as owned by a person under subpart E, part I, subchapter J, chapter 1 of the Internal Revenue Code, such owner is a potential current beneficiary in addition to persons described in paragraph (m)(4)(i) of this section.

(iii) Special rule for dispositions of stock. Notwithstanding the provisions of paragraph (m)(4)(i) of this section, if a trust disposes of all of the stock which it holds in an S corporation, then, with respect to that corporation, any person who first met the definition of a potential current beneficiary during the 1-year period ending on the date of such disposition is not a potential current beneficiary and thus is not a shareholder of that corporation.

(iv) Distributee trusts -

(A) In general. This paragraph (m)(4)(iv) contains the rules for determining who are the potential current beneficiaries of an ESBT if a distributee trust becomes entitled to, or at the discretion of any person, may receive a distribution from principal or income of an ESBT. A distributee trust does not include a trust that is not currently in existence. For this purpose, a trust is not currently in existence if the trust has no assets and no items of income, loss, deduction, or credit. Thus, if a trust instrument provides for a trust to be funded at some future time, the future trust is not currently a distributee trust.

(B) If the distributee trust is not a trust described in section 1361(c)(2)(A), then the distributee trust is the potential current beneficiary of the ESBT and the corporation's S corporation election terminates.

(C) If the distributee trust is a trust described in section 1361(c)(2)(A), the persons who would be its potential current beneficiaries (as defined in paragraphs (m)(4)(i) and (ii) of this section) if the distributee trust were an ESBT are treated as the potential current beneficiaries of the ESBT. Notwithstanding the preceding sentence, however, if the distributee trust is a trust described in section 1361(c)(2)(A)(ii) or (iii), the estate described in section 1361(c)(2)(B) (ii) or (iii) is treated as the potential current beneficiary of the ESBT for the 2-year period during which such trust would be permitted as a shareholder.

(D) For the purposes of paragraph (m)(4)(iv)(C) of this section, a trust will be deemed to be described in section 1361(c)(2)(A) if such trust would qualify for a QSST election under section 1361(d) or an ESBT election under section 1361(e) if it owned S corporation stock.

(v) Contingent distributions. A person who is entitled to receive a distribution only after a specified time or upon the occurrence of a specified event (such as the death of the holder of a power of appointment) is not a potential current beneficiary until such time or the occurrence of such event.

(vi) Currently exercisable powers of appointment and other powers -

(A) Powers of appointment. A person to whom a distribution may be made during any period pursuant to a power of appointment (as described for transfer tax purposes in section 2041 and § 20.2041-1(b) of this chapter and section 2514 and § 25.2514-1(b) of this chapter) is not a potential current beneficiary unless the power is exercised in favor of that person during the period. It is immaterial for purposes of this paragraph (m)(4)(vi)(A) whether such power of appointment is a "general power of appointment" for transfer tax purposes as described in §§ 20.2041-1(c) and 25.2514-1(c) of this chapter. The mere existence of one or more powers of appointment during the lifetime of a power holder that would permit current distributions from the trust to be made to more than the number of persons described in section 1361(b)(1)(A) or to a person described in section 1361(b)(1)(B) or (C) will not cause the S corporation election to terminate unless one or more of such powers are exercised, collectively, in favor of an

excessive number of persons or in favor of a person who is ineligible to be an S corporation shareholder. For purposes of this paragraph (m)(4)(vi)(A), a "power of appointment" includes a power, regardless of by whom held, to add a beneficiary or class of beneficiaries to the class of potential current beneficiaries, but generally does not include a power held by a fiduciary who is not also a beneficiary of the trust to spray or sprinkle trust distributions among beneficiaries. Nothing in this paragraph (m)(4)(vi)(A) alters the definition of "power of appointment" for purposes of any provision of the Internal Revenue Code or the regulations.

(B) Powers to distribute to certain organizations not pursuant to powers of appointment. If a trustee or other fiduciary has a power (that does not constitute a power of appointment for transfer tax purposes as described in §§ 20.2041-1(b) and 25.2514-1(b) of this chapter) to make distributions from the trust to one or more members of a class of organizations described in section 1361(c)(6), such organizations will be counted collectively as only one potential current beneficiary for purposes of this paragraph (m), except that each organization receiving a distribution also will be counted as a potential current beneficiary. This paragraph (m)(4)(vi)(B) shall not apply to a power to currently distribute to one or more particular charitable organizations described in section 1361(c)(6). Each of such organizations is a potential current beneficiary of the trust.

(vii) Number of shareholders. Each potential current beneficiary of the ESBT, as defined in paragraphs (m)(4)(i) through (vi) of this section, is counted as a shareholder of any S corporation whose stock is owned by the ESBT. During any period in which the ESBT has no potential current beneficiaries, the ESBT is counted as the shareholder. A person is counted as only one shareholder of an S corporation even though that person may be treated as a shareholder of the S corporation by direct ownership and through one or more eligible trusts described in section 1361(c)(2)(A). Thus, for example, if a person owns stock in an S corporation and is a potential current beneficiary of an ESBT that owns stock in the same S corporation, that person is counted as one shareholder of the S corporation. Similarly, if a husband owns stock in

an S corporation and his wife is a potential current beneficiary of an ESBT that owns stock in the same S corporation, the husband and wife will be counted as one shareholder of the S corporation.

(viii) Miscellaneous. Payments made by an ESBT to a third party on behalf of a beneficiary are considered to be payments made directly to the beneficiary. The right of a beneficiary to assign the beneficiary's interest to a third party does not result in the third party being a potential current beneficiary until that interest is actually assigned.

(5) ESBT terminations -

(i) Ceasing to meet ESBT requirements. A trust ceases to be an ESBT on the first day the trust fails to meet the definition of an ESBT under section 1361(e). The last day the trust is treated as an ESBT is the day before the date on which the trust fails to meet the definition of an ESBT.

(ii) Disposition of S stock. In general, a trust ceases to be an ESBT on the first day following the day the trust disposes of all S corporation stock. However, if the trust is using the installment method to report income from the sale or disposition of its stock in an S corporation, the trust ceases to be an ESBT on the day following the earlier of the day the last installment payment is received by the trust or the day the trust disposes of the installment obligation.

(iii) Potential current beneficiaries that are ineligible shareholders. If a potential current beneficiary of an ESBT is not an eligible shareholder of a small business corporation within the meaning of section 1361(b)(1), the S corporation election terminates. For example, the S corporation election will terminate if a charitable remainder trust becomes a potential current beneficiary of an ESBT. Such a potential current beneficiary is treated as an ineligible shareholder beginning on the day such person becomes a potential current beneficiary, and the S corporation election terminates on that date. However, see the special rule of paragraph (m)(4)(iii) of this section. If the S corporation election terminates, relief may be available under section 1362(f).

(6) Revocation of ESBT election. An ESBT election may be revoked only with the consent of the Commissioner. The application for consent to revoke the election must be submitted to the Internal Revenue Service in the form of a letter ruling request under the appropriate revenue procedure.

(7) Converting an ESBT to a QSST. For a trust that seeks to convert from an ESBT to a QSST, the consent of the Commissioner is hereby granted to revoke the ESBT election as of the effective date of the QSST election, if all the following requirements are met:

(i) The trust meets all of the requirements to be a QSST under section 1361(d).

(ii) The trustee and the current income beneficiary of the trust sign the QSST election. The QSST election must be filed with the service center where the S corporation files its income tax return. This QSST election must state at the top of the document "ATTENTION ENTITY CONTROL - CONVERSION OF AN ESBT TO A QSST PURSUANT TO SECTION 1.1361-1(m)" and include all information otherwise required for a QSST election under § 1.1361-1(j)(6). A separate QSST election must be made with respect to the stock of each S corporation held by the trust.

(iii) The trust has not converted from a QSST to an ESBT within the 36-month period preceding the effective date of the new QSST election.

(iv) The date on which the QSST election is to be effective cannot be more than 15 days and two months prior to the date on which the election is filed and cannot be more than 12 months after the date on which the election is filed. If an election specifies an effective date more than 15 days and two months prior to the date on which the election is filed, it will be effective on the day that is 15 days and two months prior to the date on which it is filed. If an election specifies an effective date more than 12 months after the date on which the election is filed, it will be effective on the day that is 12 months after the date it is filed.

(8) Examples. The provisions of this paragraph (m) are illustrated by the following examples in which it is assumed, unless otherwise specified, that all noncorporate persons are citizens or residents of the United States:

(i) Example 1 -

(A) ESBT election with section 663(c) separate shares. On January 1, 2003, M contributes S corporation stock to Trust for the benefit of M's three children A, B, and C. Pursuant to section 663(c), each of Trust's separate shares for A, B, and C will be treated as separate trusts for purposes of determining the amount of distributable net income (DNI) in the application of sections 661 and 662. On January 15, 2003, the trustee of Trust files a valid ESBT election for Trust effective January 1, 2003. Trust will be treated as a single ESBT and will have a single S portion taxable under section 641(c).

(B) ESBT acquires stock of an additional S corporation. On February 15, 2003, Trust acquires stock of an additional S corporation. Because Trust is already an ESBT, Trust does not need to make an additional ESBT election.

(C) Section 663(c) shares of ESBT convert to separate QSSTs. Effective January 1, 2004, A, B, C, and Trust's trustee elect to convert each separate share of Trust into a separate QSST pursuant to paragraph (m)(7) of this section. For each separate share, they file a separate election for each S corporation whose stock is held by Trust. Each separate share will be treated as a separate QSST.

(ii) Example 2 -

(A) Invalid potential current beneficiary. Effective January 1, 2005, Trust makes a valid ESBT election. On January 1, 2006, A, a partnership, becomes a potential current beneficiary of Trust. Trust does not dispose of all of its S corporation stock within one year after January 1, 2006. As of January 1, 2006, A is the potential current beneficiary of Trust and therefore is treated as a shareholder of the S corporation. Because A is not an eligible shareholder of an S corporation under section 1361(b)(1), the S corporation election of any

corporation in which Trust holds stock terminates effective January 1, 2006. Relief may be available under section 1362(f).

(B) Invalid potential current beneficiary and disposition of S stock. Assume the same facts as in Example 2 in paragraph (m)(8)(ii)(A) of this section except that within one year after January 1, 2006, trustee of Trust disposes of all Trust's S corporation stock. A is not considered a potential current beneficiary of Trust and therefore is not treated as a shareholder of any S corporation in which Trust previously held stock.

(iii) Example 3. Subpart E trust. M transfers stock in X, an S corporation, and other assets to Trust for the benefit of B and B's siblings. M retains no powers or interest in Trust. Under section 678(a), B is treated as the owner of a portion of Trust that includes a portion of the X stock. No beneficiary has acquired any portion of his or her interest in Trust by purchase, and Trust is not an ineligible trust under paragraph (m)(1)(iv) of this section. Trust is eligible to make an ESBT election.

(iv) Example 4. Subpart E trust continuing after grantor's death. On January 1, 2003, M transfers stock in X, an S corporation, and other assets to Trust. Under the terms of Trust, the trustee of Trust has complete discretion to distribute the income or principal to M during M's lifetime and to M's children upon M's death. During M's life, M is treated as the owner of Trust under section 677. The trustee of Trust makes a valid election to treat Trust as an ESBT effective January 1, 2003. On March 28, 2004, M dies. Under applicable local law, Trust does not terminate on M's death. Trust continues to be an ESBT after M's death, and no additional ESBT election needs to be filed for Trust after M's death.

(v) Example 5. Potential current beneficiaries and distributee trust holding S corporation stock. Trust-1 has a valid ESBT election in effect. The trustee of Trust-1 has the power to make distributions to A directly or to any trust created for the benefit of A. On January 1, 2003, M creates Trust-2 for the benefit of A. Also on January 1, 2003, the trustee of Trust-1 distributes some S corporation stock to Trust-2. A,

as the current income beneficiary of Trust-2, makes a timely and effective election to treat Trust-2 as a QSST. Because Trust-2 is a valid S corporation shareholder, the distribution to Trust-2 does not terminate the ESBT election of Trust-1. Trust-2 itself will not be counted toward the shareholder limit of section 1361(b)(1)(A). Additionally, because A is already counted as an S corporation shareholder because of A's status as a potential current income beneficiary of Trust-1, A is not counted again by reason of A's status as the deemed owner of Trust-2.

(vi) Example 6. Potential current beneficiaries and distributee trust not holding S corporation stock -

(A) Distributee trust that would itself qualify as an ESBT. Trust-1 holds stock in X, an S corporation, and has a valid ESBT election in effect. Under the terms of Trust-1, the trustee has discretion to make distributions to A, B, and Trust-2, a trust for the benefit of C, D, and E. Trust-2 would qualify to be an ESBT, but it owns no S corporation stock and has made no ESBT election. Under paragraph (m)(4)(iv) of this section, Trust-2's potential current beneficiaries are treated as the potential current beneficiaries of Trust-1 and are counted as shareholders for purposes of section 1361(b)(1). Thus, A, B, C, D, and E are potential current beneficiaries of Trust-1 and are counted as shareholders for purposes of section 1361(b)(1). Trust-2 itself will not be counted as a shareholder of Trust-1 for purposes of section 1361(b)(1).

(B) Distributee trust that would not qualify as an ESBT or a QSST. Assume the same facts as Example 6 in paragraph (m)(8)(vi)(A) of this section except that D is a charitable remainder trust. Trust-2 would not be eligible to make an ESBT or QSST election if it owned S corporation stock and therefore Trust-2 is a potential current beneficiary of Trust-1. Since Trust-2 is not an eligible shareholder, X's S corporation election terminates.

(C) Distributee trust that is a section 1361(c)(2)(A)(ii) trust. Assume the same facts as in Example 6 in paragraph (m)(8)(vi)(A) of this section except that Trust-2 is a trust treated as owned by A under section 676 because A has the power to revoke Trust-2 at any time prior to A's death. On January 1, 2003, A dies. Because Trust-2 is a trust described in section 1361(c)(2)(A)(ii) during the 2-year period beginning on the day of A's death, under paragraph (m)(4)(iv)(C) of this section, Trust-2's only potential current beneficiary is the person listed in section 1361(c)(2)(B)(ii), A's estate. Thus, B and A's estate are potential current beneficiaries of Trust-1 and are counted as shareholders for purposes of section 1361(b)(1).

(vii) Example 7. Potential current beneficiaries and powers of appointment. M creates Trust from which A has a right to all net income and funds it with S corporation stock. A also has a currently exercisable power to appoint income or principal to anyone except A, A's creditors, A's estate, and the creditors of A's estate. The potential current beneficiaries of Trust for any period will be A and each person who receives a distribution from Trust pursuant to A's exercise of A's power of appointment during that period.

(viii) Example 8. Power to distribute to an unlimited class of charitable organizations not pursuant to a power of appointment.M creates Trust from which A has a right to all net income and funds it with S corporation stock. In addition, the trustee of Trust, who is not A or a descendant of M, has the power to make discretionary distributions of principal to the living descendants of M and to any organizations described in section 1361(c)(6). The potential current beneficiaries of Trust for any period will be A, each then-living descendant of M, and each exempt organization described in section 1361(c)(6) that receives a distribution during that period. In addition, the class of exempt organizations will be counted as one potential current beneficiary.

(ix) Example 9. Power to distribute to a class of named charitable organizations not pursuant to a power of appointment. M creates Trust from which A has a right to all net income and funds it with S

corporation stock. In addition, the trustee of Trust, who is not A or a descendant of M, has the power to make discretionary distributions of principal to the living descendants of M and to X, Y, and Z, each of which is an organization described in section 1361(c)(6). The potential current beneficiaries of Trust for any period will be A, X, Y, Z, and each living descendant of M.

(9) Effective date. This paragraph (m) is applicable for taxable years of ESBTs beginning on and after May 14, 2002. Paragraphs (m)(2)(ii)(A) and (m)(4)(iii) and (vi) of this section and Examples 2, 5, and 7 through 9 in paragraphs (m)(8)(ii), (v), and (vii) through (ix), respectively, of this section are effective on August 14, 2008. Paragraphs (m)(1)(ii)(D), (m)(2)(ii)(E)(2), (m)(4)(i), (m)(5)(iii), and (m)(8) of this section apply to all ESBTs after December 31, 2017.

# About the Author

James G. Blase is a 40-year experienced estate planning attorney with offices in St. Louis, Missouri. He has been an adjunct professor in the Villanova University School of Law graduate tax program, and in the St. Louis University School of Law.

Jim spent the first 17 years of his legal career with the St. Louis law firms Thompson Coburn (then Thompson Mitchell) and Armstrong Teasdale, the latter where he also served as chair of the firm's Trusts & Estates department.

He is a 1981 graduate of Notre Dame Law School, where he served as Managing Editor of the *Notre Dame Law Review*, and is a 1982 graduate of the New York University Law School Graduate Program in Taxation, where he served as Graduate Editor of the *Tax Law Review.* Jim also owns a Certified Public Accountant certificate from the State of Missouri.

The author of over 75 articles for various tax and estate planning professional publications, Jim is also a frequent presenter at estate planning symposiums and is the author of the 2017 book, *Optimum Estate Planning: Explanation and Sample Forms*, and the 2021 book, *Estate Planning for the SECURE Act: Strategies to Minimize Taxes on IRAs and 401ks*.

Jim has also authored three books on Theodore Roosevelt along with the first biography on St. Jacinta of Fatima.