Taxation of Irrevocable Trusts

Upstream SLATs, Upstream Optimal Basis Increase Trusts and Upstream BDOTs

Southern Arizona Estate Planning Council

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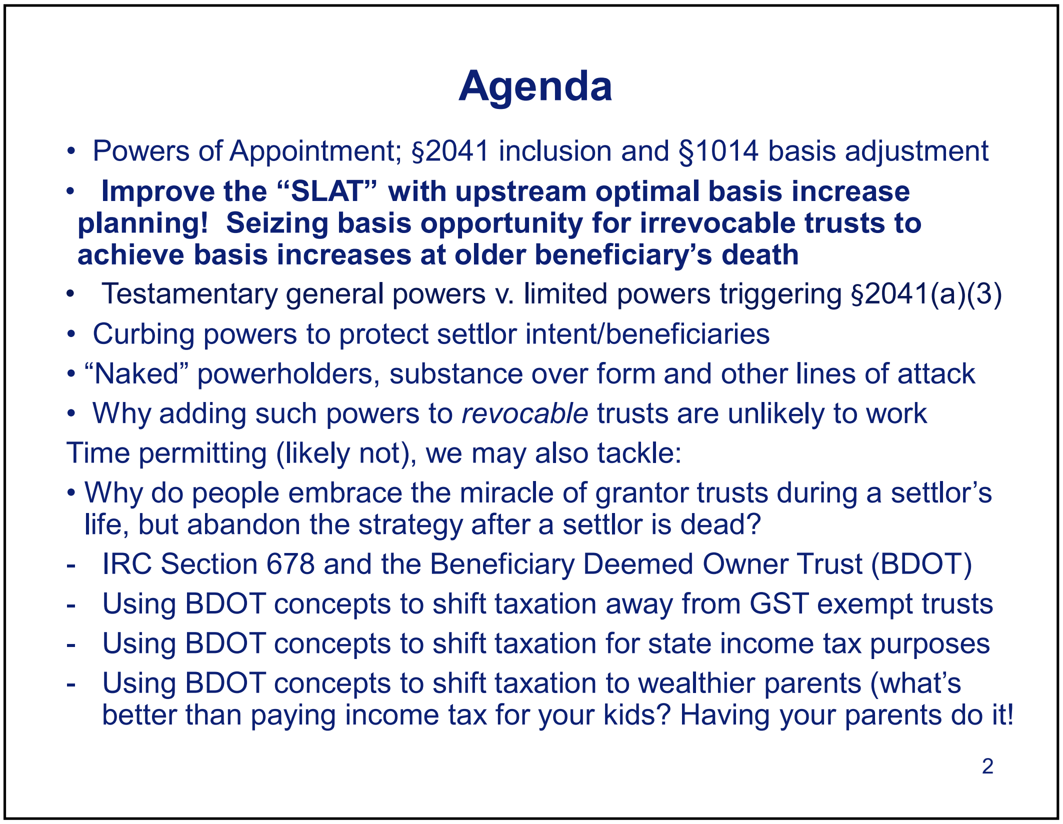

Agenda

- Powers of Appointment; §2041 inclusion and §1014 basis adjustment
- **Improve the “SLAT” with upstream optimal basis increase planning! Seizing basis opportunity for irrevocable trusts to achieve basis increases at older beneficiary’s death**
- Testamentary general powers v. limited powers triggering §2041(a)(3)
- Curbing powers to protect settlor intent/beneficiaries
- “Naked” powerholders, substance over form and other lines of attack
- Why adding such powers to *revocable* trusts are unlikely to work

Time permitting (likely not), we may also tackle:

- Why do people embrace the miracle of grantor trusts during a settlor’s life, but abandon the strategy after a settlor is dead?
- IRC Section 678 and the Beneficiary Deemed Owner Trust (BDOT)
- Using BDOT concepts to shift taxation away from GST exempt trusts
- Using BDOT concepts to shift taxation for state income tax purposes
- Using BDOT concepts to shift taxation to wealthier parents (what’s better than paying income tax for your kids? Having your parents do it!

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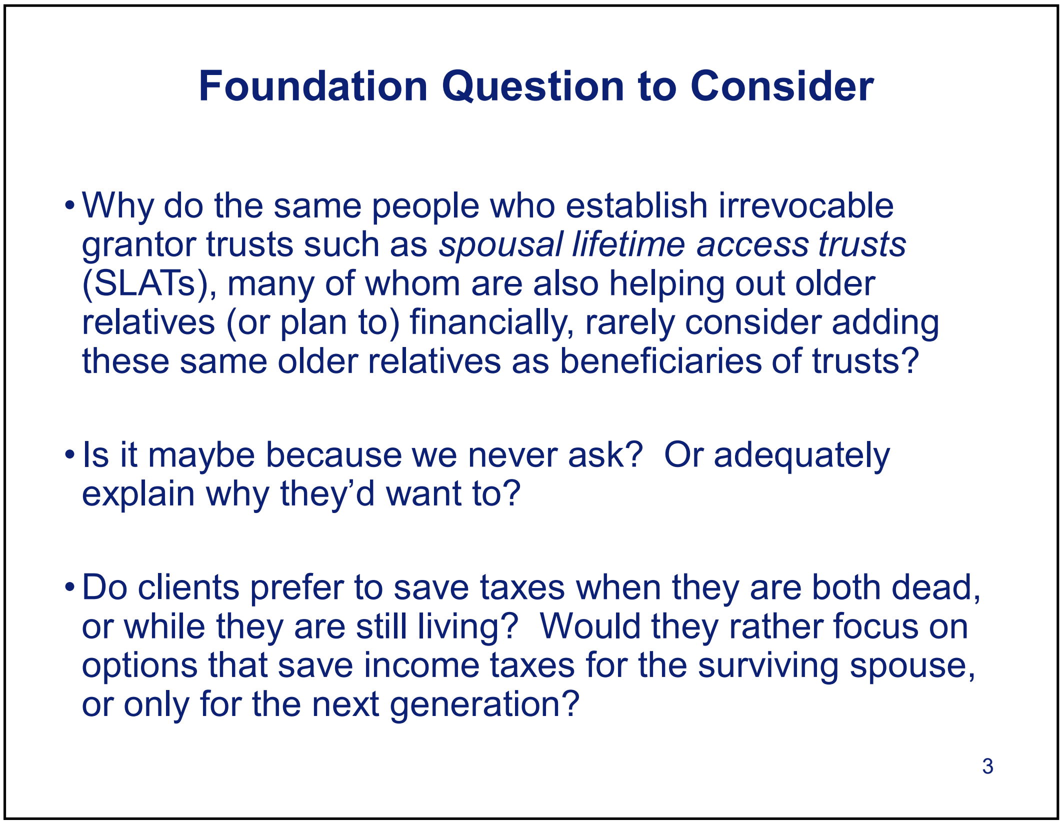

Foundation Question to Consider

- Why do the same people who establish irrevocable grantor trusts such as *spousal lifetime access trusts* (SLATs), many of whom are also helping out older relatives (or plan to) financially, rarely consider adding these same older relatives as beneficiaries of trusts?

- Is it maybe because we never ask? Or adequately explain why they'd want to?

- Do clients prefer to save taxes when they are both dead, or while they are still living? Would they rather focus on options that save income taxes for the surviving spouse, or only for the next generation?

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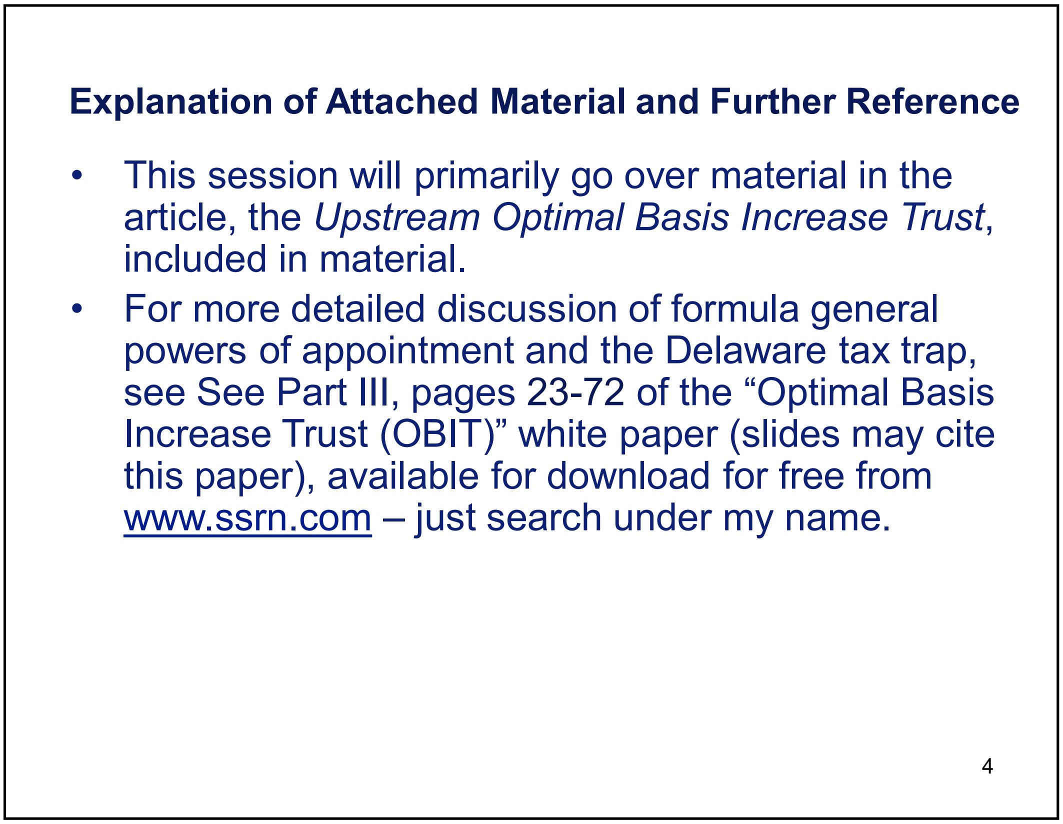

Explanation of Attached Material and Further Reference

- This session will primarily go over material in the article, the *Upstream Optimal Basis Increase Trust*, included in material.
- For more detailed discussion of formula general powers of appointment and the Delaware tax trap, see See Part III, pages 23-72 of the "Optimal Basis Increase Trust (OBIT)" white paper (slides may cite this paper), available for download for free from www.ssrn.com – just search under my name.

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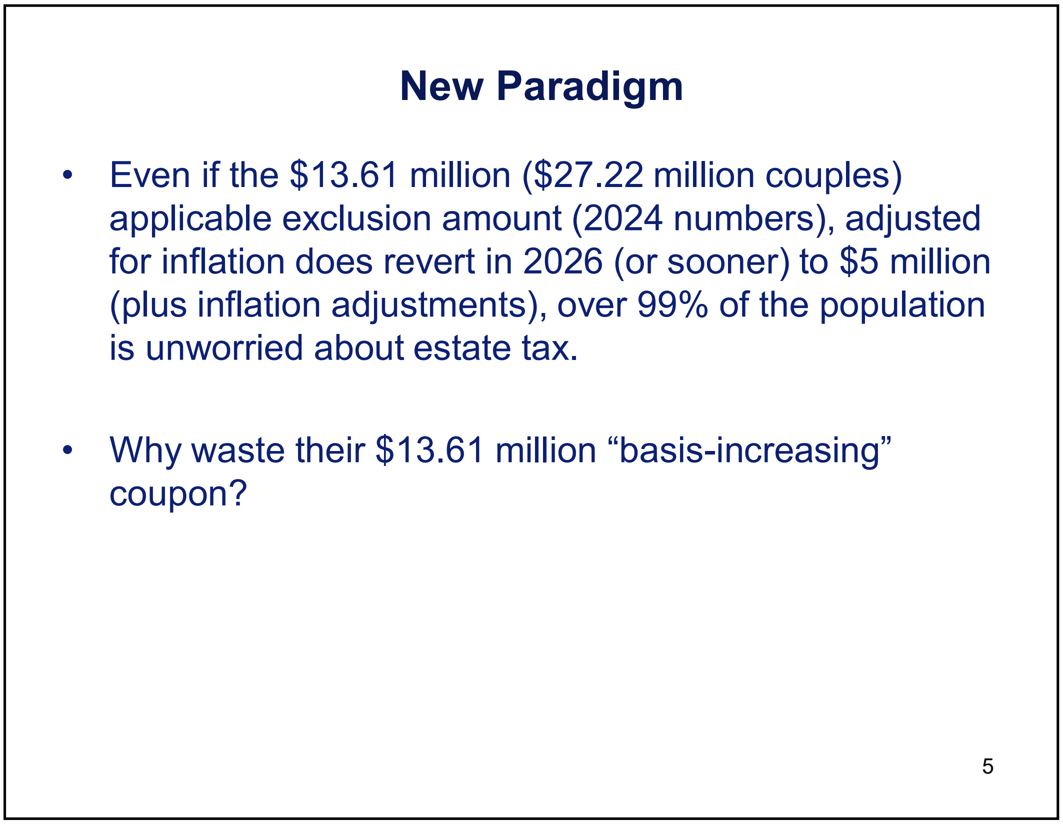
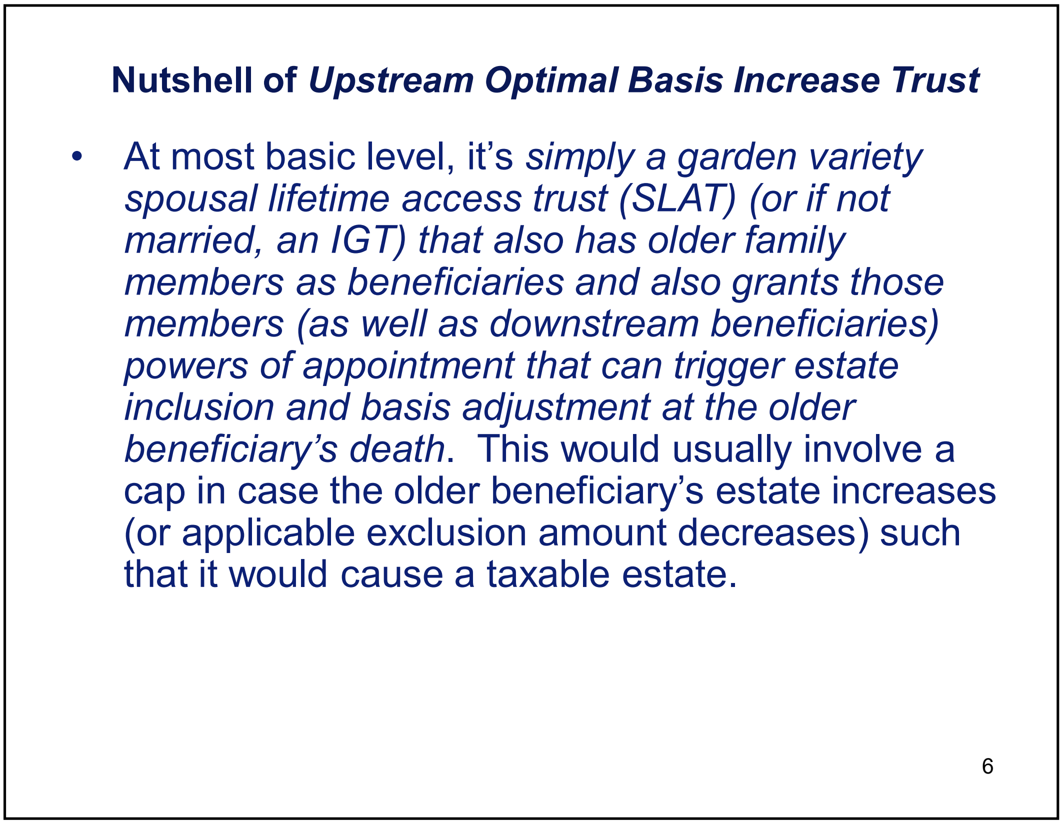


New Paradigm

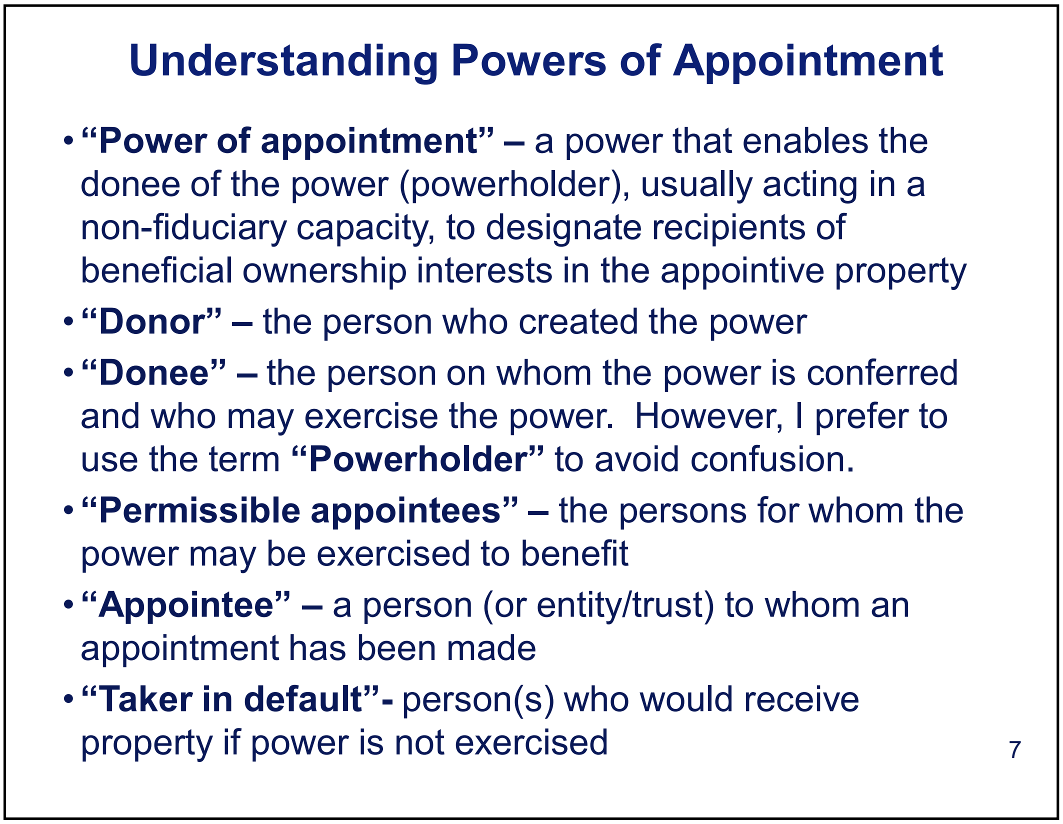
- Even if the $13.61 million ($27.22 million couples) applicable exclusion amount (2024 numbers), adjusted for inflation does revert in 2026 (or sooner) to $5 million (plus inflation adjustments), over 99% of the population is unworried about estate tax.

- Why waste their $13.61 million “basis-increasing” coupon?



Nutshell of *Upstream Optimal Basis Increase Trust*

- At most basic level, it’s *simply a garden variety spousal lifetime access trust (SLAT) (or if not married, an IGT) that also has older family members as beneficiaries and also grants those members (as well as downstream beneficiaries) powers of appointment that can trigger estate inclusion and basis adjustment at the older beneficiary’s death*. This would usually involve a cap in case the older beneficiary’s estate increases (or applicable exclusion amount decreases) such that it would cause a taxable estate.



Understanding Powers of Appointment

- **"Power of appointment" –** a power that enables the donee of the power (powerholder), usually acting in a non-fiduciary capacity, to designate recipients of beneficial ownership interests in the appointive property
- **"Donor" –** the person who created the power
- **"Donee" –** the person on whom the power is conferred and who may exercise the power. However, I prefer to use the term **"Powerholder"** to avoid confusion.
- **"Permissible appointees" –** the persons for whom the power may be exercised to benefit
- **"Appointee" –** a person (or entity/trust) to whom an appointment has been made
- **"Taker in default"-** person(s) who would receive property if power is not exercised

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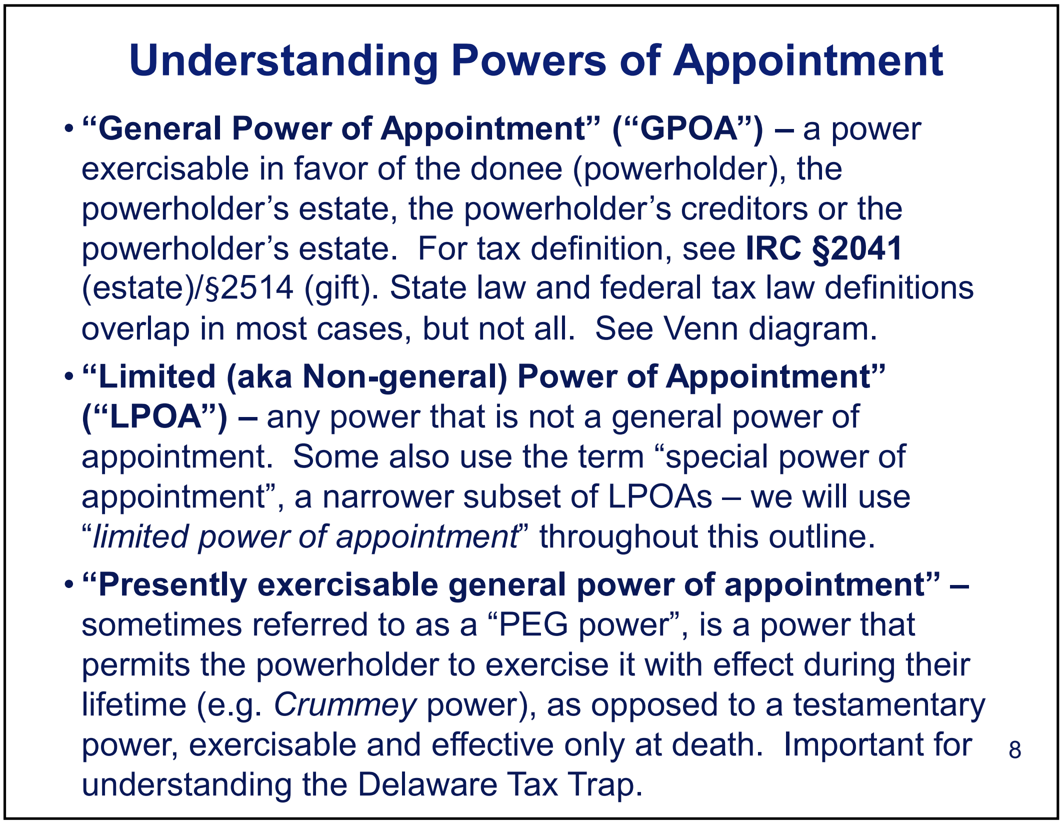

Understanding Powers of Appointment

- **"General Power of Appointment" ("GPOA") –** a power exercisable in favor of the donee (powerholder), the powerholder's estate, the powerholder's creditors or the powerholder's estate. For tax definition, see **IRC §2041** (estate)/§2514 (gift). State law and federal tax law definitions overlap in most cases, but not all. See Venn diagram.
- **"Limited (aka Non-general) Power of Appointment" ("LPOA") –** any power that is not a general power of appointment. Some also use the term "special power of appointment", a narrower subset of LPOAs – we will use "*limited power of appointment*" throughout this outline.
- **"Presently exercisable general power of appointment" –** sometimes referred to as a "PEG power", is a power that permits the powerholder to exercise it with effect during their lifetime (e.g. *Crummey* power), as opposed to a testamentary power, exercisable and effective only at death. Important for understanding the Delaware Tax Trap.

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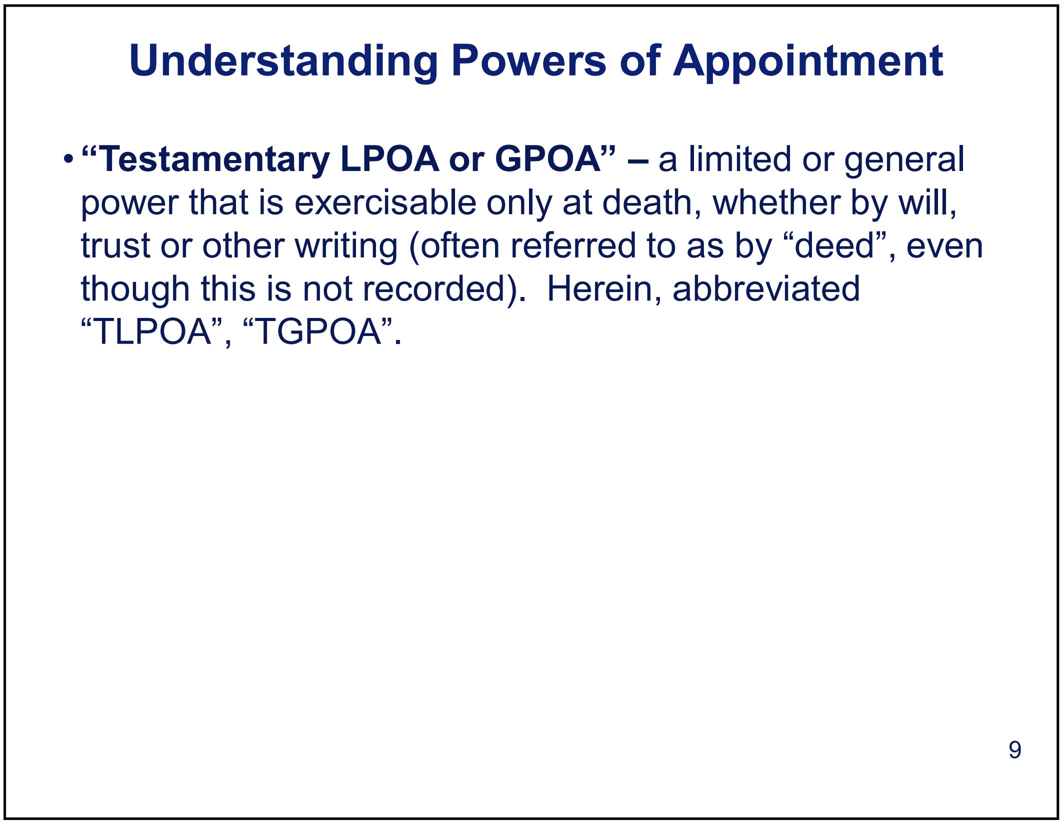
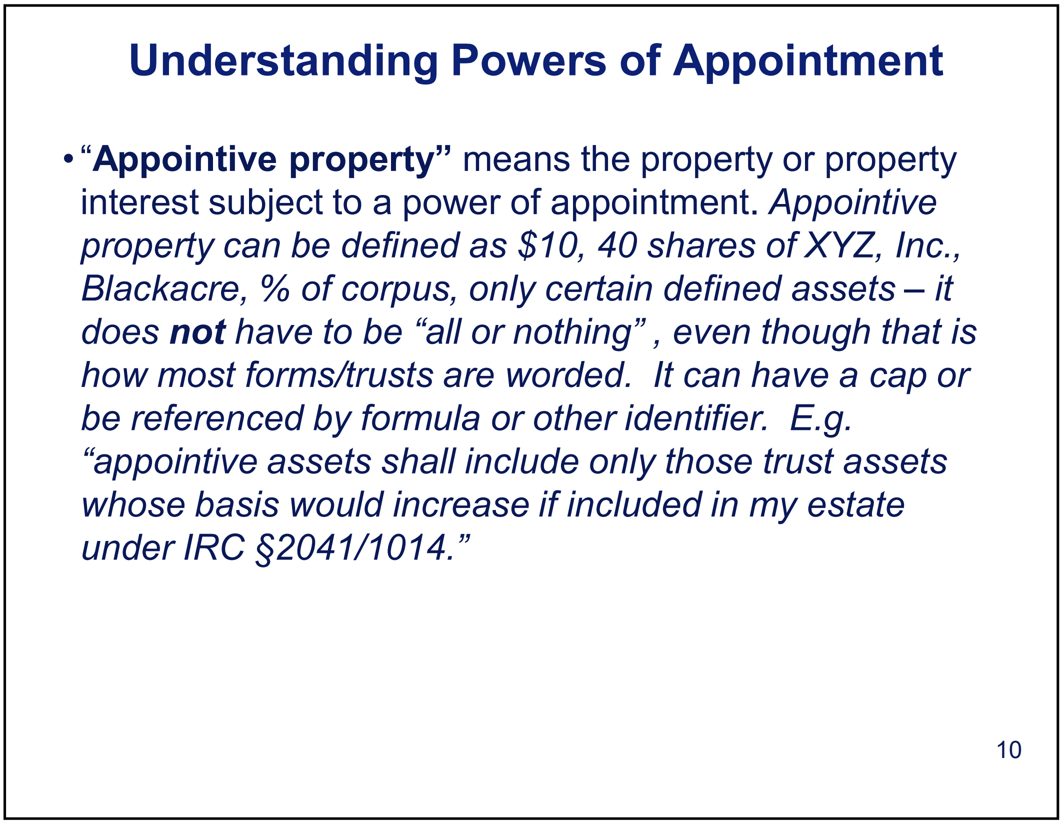


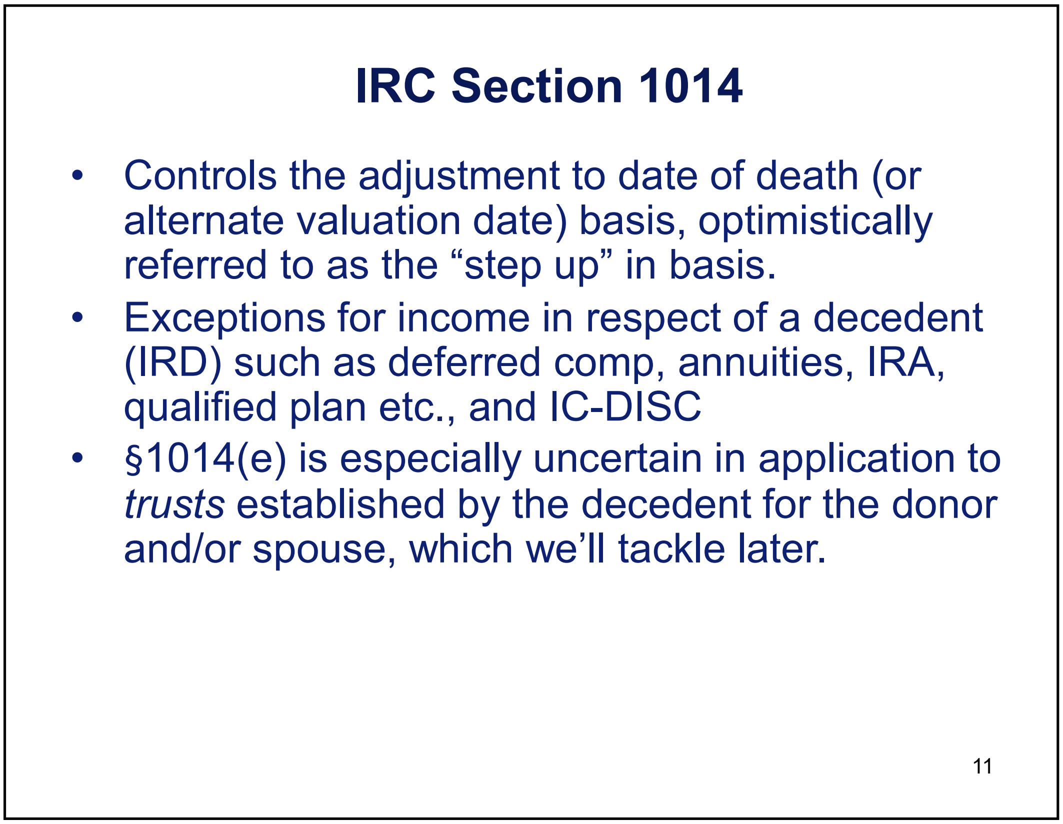
Understanding Powers of Appointment

- **“Testamentary LPOA or GPOA” –** a limited or general power that is exercisable only at death, whether by will, trust or other writing (often referred to as by “deed”, even though this is not recorded). Herein, abbreviated “TLPOA”, “TGPOA”.



Understanding Powers of Appointment

- “**Appointive property”** means the property or property interest subject to a power of appointment. *Appointive property can be defined as $10, 40 shares of XYZ, Inc., Blackacre, % of corpus, only certain defined assets – it does* ***not*** *have to be “all or nothing” , even though that is how most forms/trusts are worded. It can have a cap or be referenced by formula or other identifier. E.g. “appointive assets shall include only those trust assets whose basis would increase if included in my estate under IRC §2041/1014.”*



IRC Section 1014

- Controls the adjustment to date of death (or alternate valuation date) basis, optimistically referred to as the “step up” in basis.
- Exceptions for income in respect of a decedent (IRD) such as deferred comp, annuities, IRA, qualified plan etc., and IC-DISC
- §1014(e) is especially uncertain in application to *trusts* established by the decedent for the donor and/or spouse, which we’ll tackle later.

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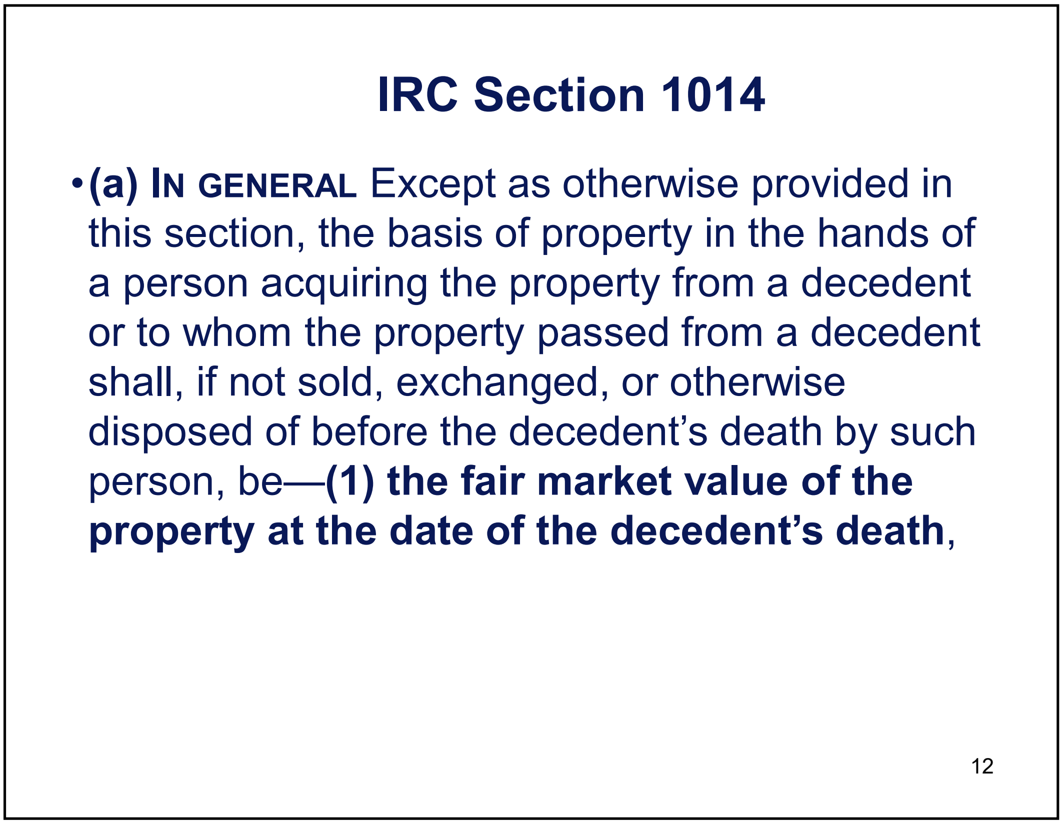

IRC Section 1014

- **(a) In general** Except as otherwise provided in this section, the basis of property in the hands of a person acquiring the property from a decedent or to whom the property passed from a decedent shall, if not sold, exchanged, or otherwise disposed of before the decedent’s death by such person, be—**(1) the fair market value of the property at the date of the decedent’s death**,

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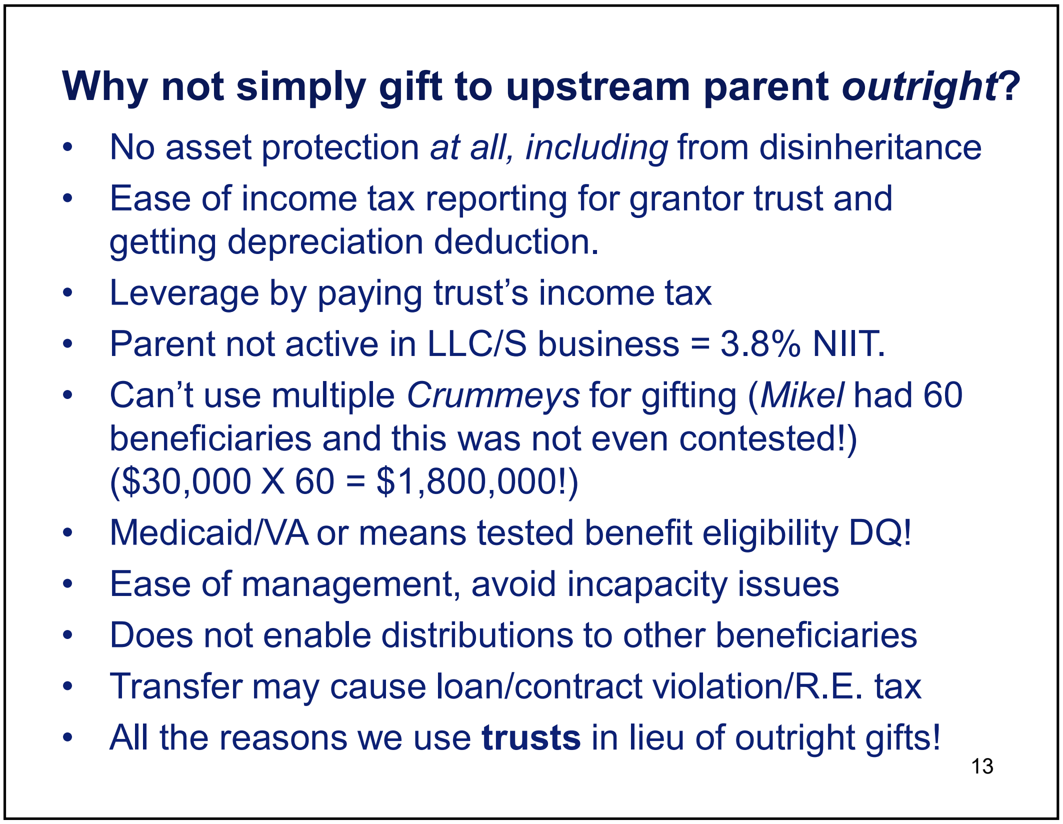
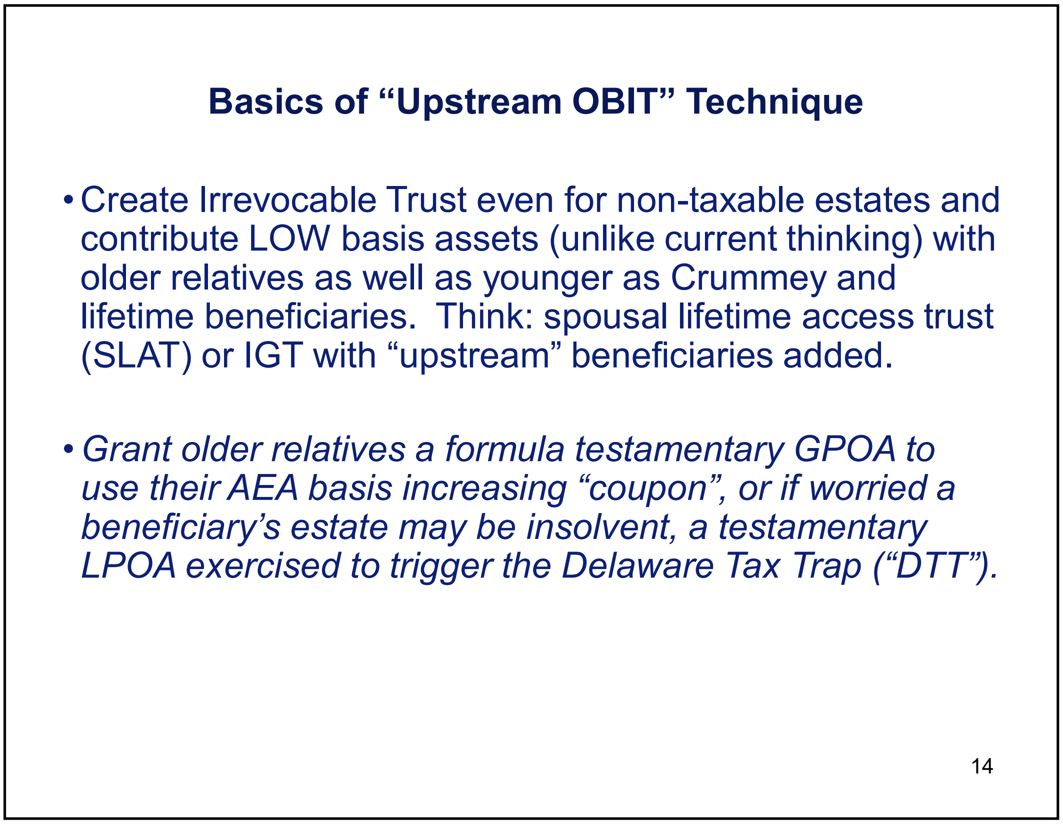


Why not simply gift to upstream parent *outright*?

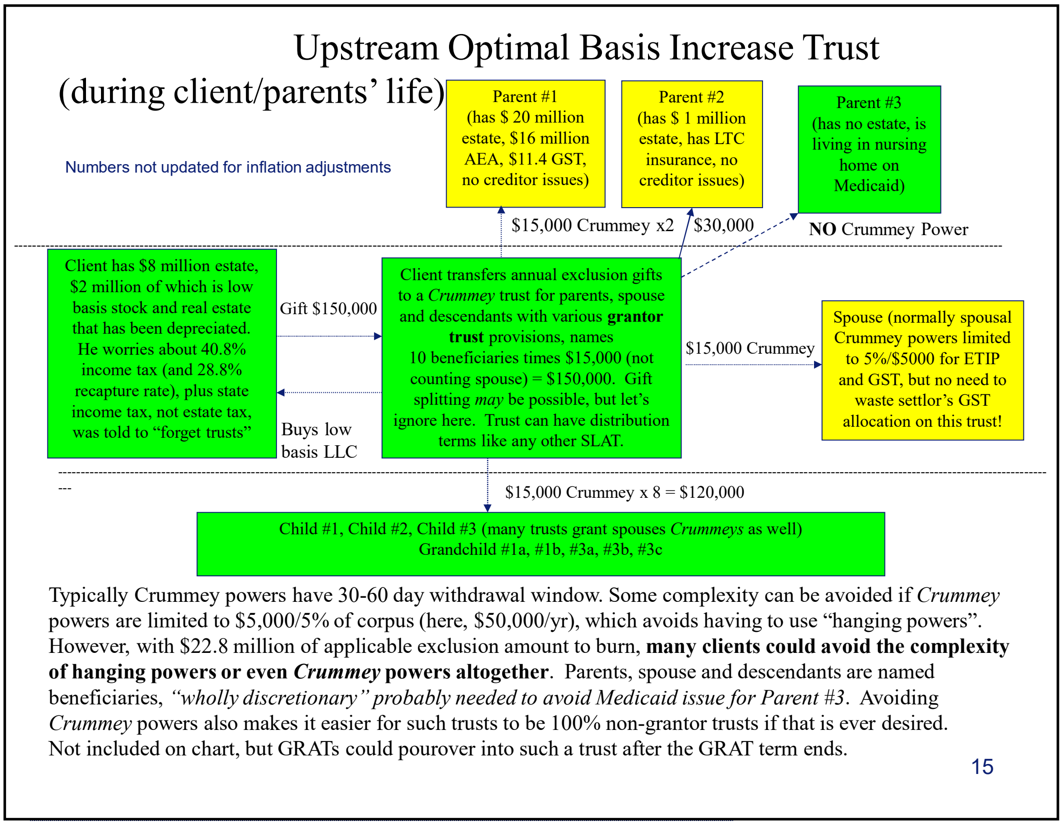
- No asset protection *at all, including* from disinheritance
- Ease of income tax reporting for grantor trust and getting depreciation deduction.
- Leverage by paying trust’s income tax
- Parent not active in LLC/S business = 3.8% NIIT.
- Can’t use multiple *Crummeys* for gifting (*Mikel* had 60 beneficiaries and this was not even contested!) ($30,000 X 60 = $1,800,000!)
- Medicaid/VA or means tested benefit eligibility DQ!
- Ease of management, avoid incapacity issues
- Does not enable distributions to other beneficiaries
- Transfer may cause loan/contract violation/R.E. tax
- All the reasons we use **trusts** in lieu of outright gifts!



Basics of “Upstream OBIT” Technique

- Create Irrevocable Trust even for non-taxable estates and contribute LOW basis assets (unlike current thinking) with older relatives as well as younger as Crummey and lifetime beneficiaries. Think: spousal lifetime access trust (SLAT) or IGT with “upstream” beneficiaries added.

- *Grant older relatives a formula testamentary GPOA to use their AEA basis increasing “coupon”, or if worried a beneficiary’s estate may be insolvent, a testamentary LPOA exercised to trigger the Delaware Tax Trap (“DTT”).*



Upstream Optimal Basis Increase Trust (during client/parents' life)

Numbers not updated for inflation adjustments

Parent #1 (has $ 20 million estate, $16 million AEA, $11.4 GST, no creditor issues)

Parent #2 (has $ 1 million estate, has LTC insurance, no creditor issues)

Parent #3 (has no estate, is living in nursing home on Medicaid)

$15,000 Crummey x2

$30,000

NO Crummey Power

Client has $8 million estate, $2 million of which is low basis stock and real estate that has been depreciated. He worries about 40.8% income tax (and 28.8% recapture rate), plus state income tax, not estate tax, was told to "forget trusts"

Gift $150,000

Buys low basis LLC

Client transfers annual exclusion gifts to a *Crummey* trust for parents, spouse and descendants with various **grantor trust** provisions, names 10 beneficiaries times $15,000 (not counting spouse) = $150,000. Gift splitting *may* be possible, but let's ignore here. Trust can have distribution terms like any other SLAT.

$15,000 Crummey

Spouse (normally spousal Crummey powers limited to 5%/$5000 for ETIP and GST, but no need to waste settlor's GST allocation on this trust!

$15,000 Crummey x 8 = $120,000

Child #1, Child #2, Child #3 (many trusts grant spouses *Crummeys* as well) Grandchild #1a, #1b, #3a, #3b, #3c

Typically Crummey powers have 30-60 day withdrawal window. Some complexity can be avoided if *Crummey* powers are limited to $5,000/5% of corpus (here, $50,000/yr), which avoids having to use "hanging powers". However, with $22.8 million of applicable exclusion amount to burn, **many clients could avoid the complexity of hanging powers or even *Crummey* powers altogether**. Parents, spouse and descendants are named beneficiaries, *"wholly discretionary" probably needed to avoid Medicaid issue for Parent #3*. Avoiding *Crummey* powers also makes it easier for such trusts to be 100% non-grantor trusts if that is ever desired. Not included on chart, but GRATs could pourover into such a trust after the GRAT term ends.

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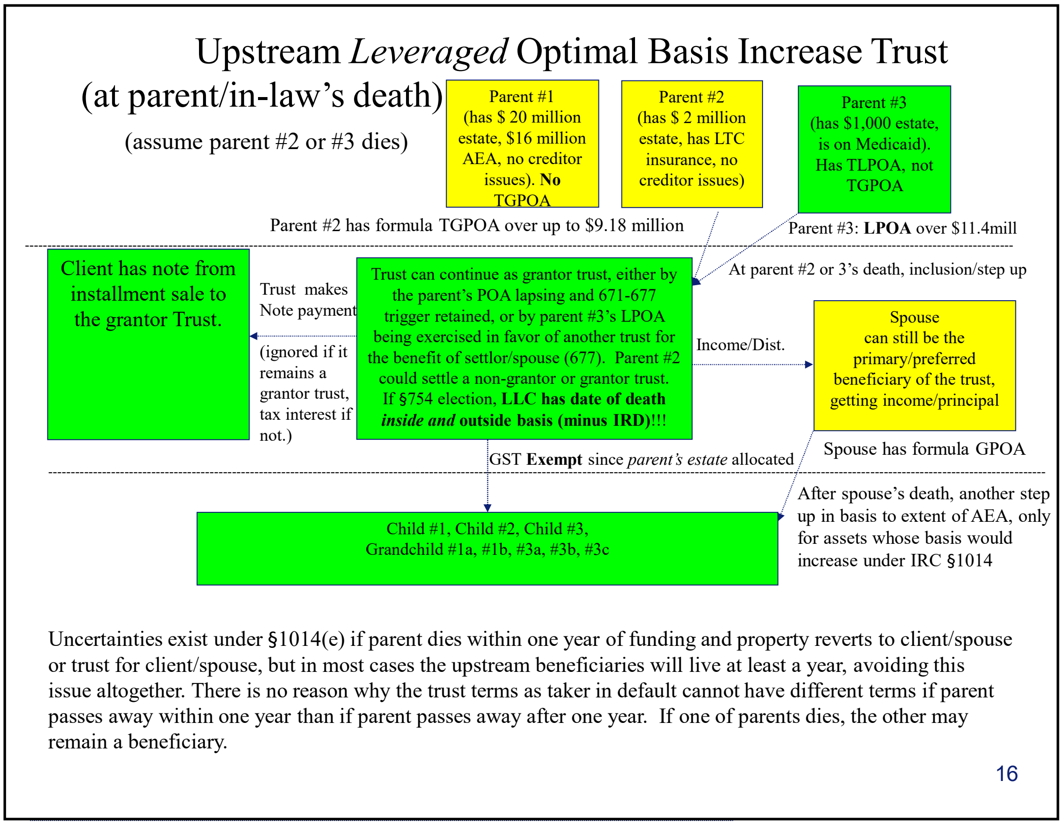

Upstream *Leveraged* Optimal Basis Increase Trust (at parent/in-law's death)

(assume parent #2 or #3 dies)

Parent #1 (has $ 20 million estate, $16 million AEA, no creditor issues). **No** TGPOA

Parent #2 (has $ 2 million estate, has LTC insurance, no creditor issues)

Parent #3 (has $1,000 estate, is on Medicaid). Has TLPOA, not TGPOA

Parent #2 has formula TGPOA over up to $9.18 million

Parent #3: **LPOA** over $11.4mill

At parent #2 or 3's death, inclusion/step up

Client has note from installment sale to the grantor Trust.

Trust makes Note payment

(ignored if it remains a grantor trust, tax interest if not.)

Trust can continue as grantor trust, either by the parent's POA lapsing and 671-677 trigger retained, or by parent #3's LPOA being exercised in favor of another trust for the benefit of settlor/spouse (677). Parent #2 could settle a non-grantor or grantor trust. If §754 election, **LLC has date of death *inside and* outside basis (minus IRD)**!!!

Income/Dist.

Spouse can still be the primary/preferred beneficiary of the trust, getting income/principal

Spouse has formula GPOA

GST **Exempt** since *parent's estate* allocated

Child #1, Child #2, Child #3, Grandchild #1a, #1b, #3a, #3b, #3c

After spouse's death, another step up in basis to extent of AEA, only for assets whose basis would increase under IRC §1014

Uncertainties exist under §1014(e) if parent dies within one year of funding and property reverts to client/spouse or trust for client/spouse, but in most cases the upstream beneficiaries will live at least a year, avoiding this issue altogether. There is no reason why the trust terms as taker in default cannot have different terms if parent passes away within one year than if parent passes away after one year. If one of parents dies, the other may remain a beneficiary.

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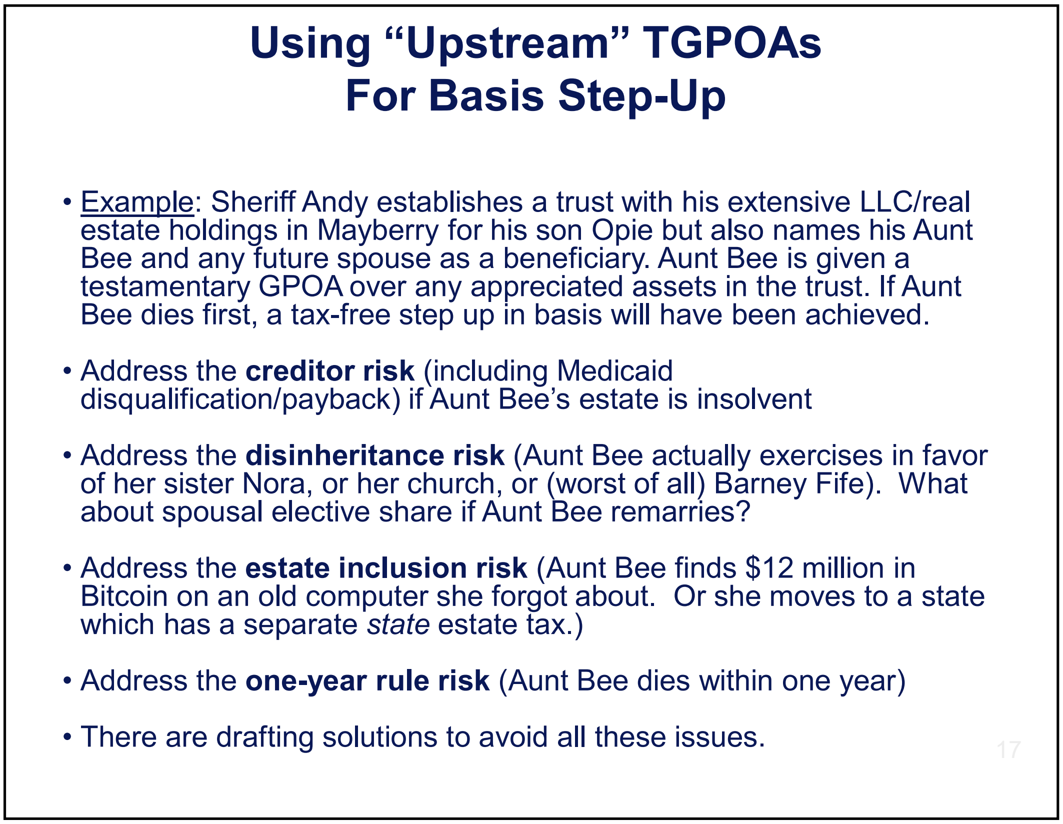
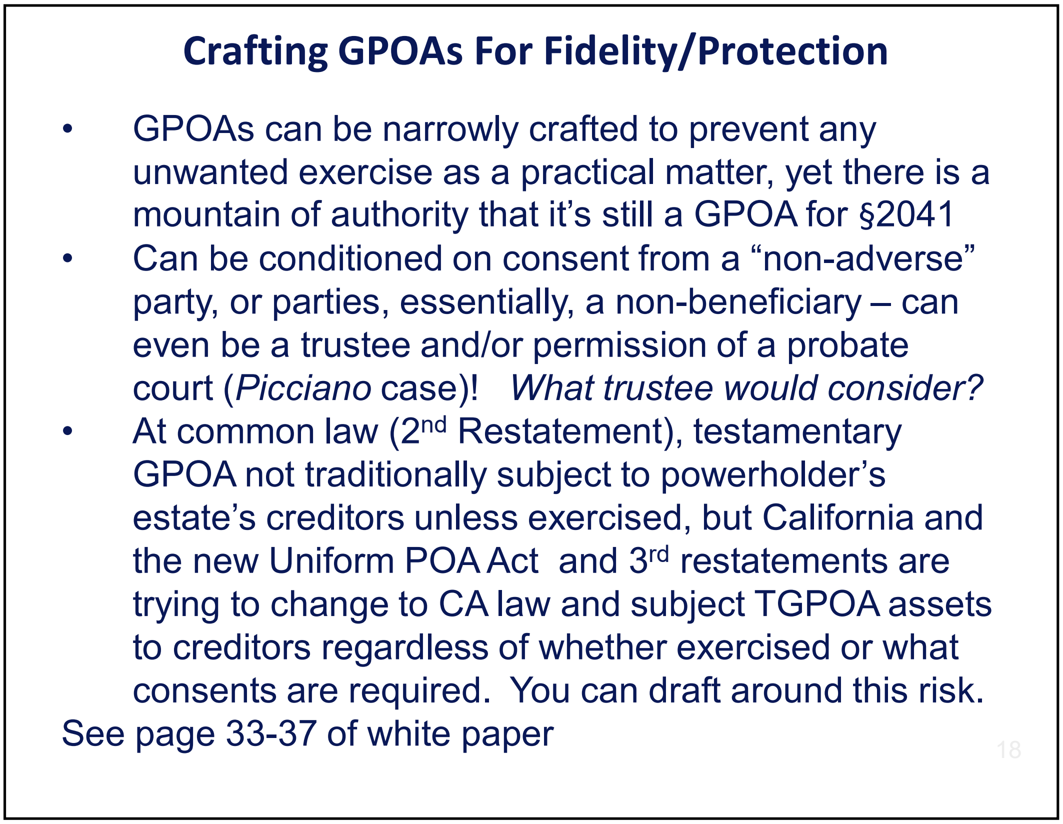


Using "Upstream" TGPOAs For Basis Step-Up

- Example: Sheriff Andy establishes a trust with his extensive LLC/real estate holdings in Mayberry for his son Opie but also names his Aunt Bee and any future spouse as a beneficiary. Aunt Bee is given a testamentary GPOA over any appreciated assets in the trust. If Aunt Bee dies first, a tax-free step up in basis will have been achieved.
- Address the **creditor risk** (including Medicaid disqualification/payback) if Aunt Bee's estate is insolvent
- Address the **disinheritance risk** (Aunt Bee actually exercises in favor of her sister Nora, or her church, or (worst of all) Barney Fife). What about spousal elective share if Aunt Bee remarries?
- Address the **estate inclusion risk** (Aunt Bee finds $12 million in Bitcoin on an old computer she forgot about. Or she moves to a state which has a separate *state* estate tax.)
- Address the **one-year rule risk** (Aunt Bee dies within one year)
- There are drafting solutions to avoid all these issues.



Crafting GPOAs For Fidelity/Protection

- GPOAs can be narrowly crafted to prevent any unwanted exercise as a practical matter, yet there is a mountain of authority that it's still a GPOA for §2041
- Can be conditioned on consent from a "non-adverse" party, or parties, essentially, a non-beneficiary – can even be a trustee and/or permission of a probate court (*Picciano* case)! *What trustee would consider?*
- At common law (2nd Restatement), testamentary GPOA not traditionally subject to powerholder's estate's creditors unless exercised, but California and the new Uniform POA Act and 3rd restatements are trying to change to CA law and subject TGPOA assets to creditors regardless of whether exercised or what consents are required. You can draft around this risk.

See page 33-37 of white paper

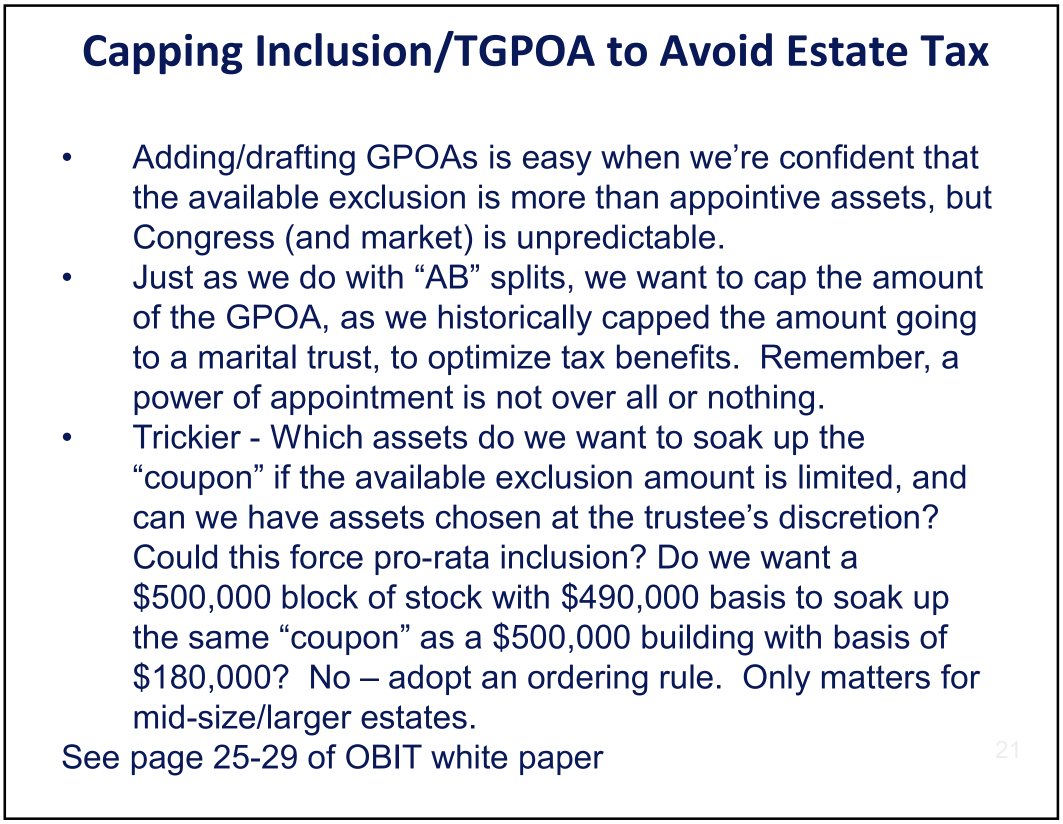
Crafting GPOAs For Fidelity/Protection

- What about spousal creditors, as in our example of Aunt Bee remarrying?
- See Uniform Probate Code § 2-205(1)(A), with Example 1 in the UPC commentary and Restat 3d Property: Wills and Other Donative Transfers, § 23.1 Elective-Share Rights of the Donee's Surviving Spouse in Appointive Assets, Restat 2d of Prop: Donative Transfers, § 13.7 “Spousal Rights in Appointive Assets on Death of Donee, precisely on point. The vast majority do not bring third party created testamentary powers into an augmented estate. Two states may be an issue: 1) Michigan, but only IF the power is exercised or the power holder “manifests an intent to exercise” – Mich. Comp. Laws §556.116 and 2) Delaware at 12 Del. C. § 902

Crafting GPOAs For Fidelity/Protection

- PLR 9110054 gives you sample language to start with (the IRS ruled that the formula GPOA with a cap and estate solvency precondition was still a GPOA under IRC 2041 if estate not insolvent), which should be strongly considered for any CA practitioners, or states with similar creditor-friendly law, such as new UPOAA states. However, it can’t hurt to include even for those in common law rule states or highly protective states (or at least have a limited amendment provision), since we don’t know whether the state law may change or client moves.

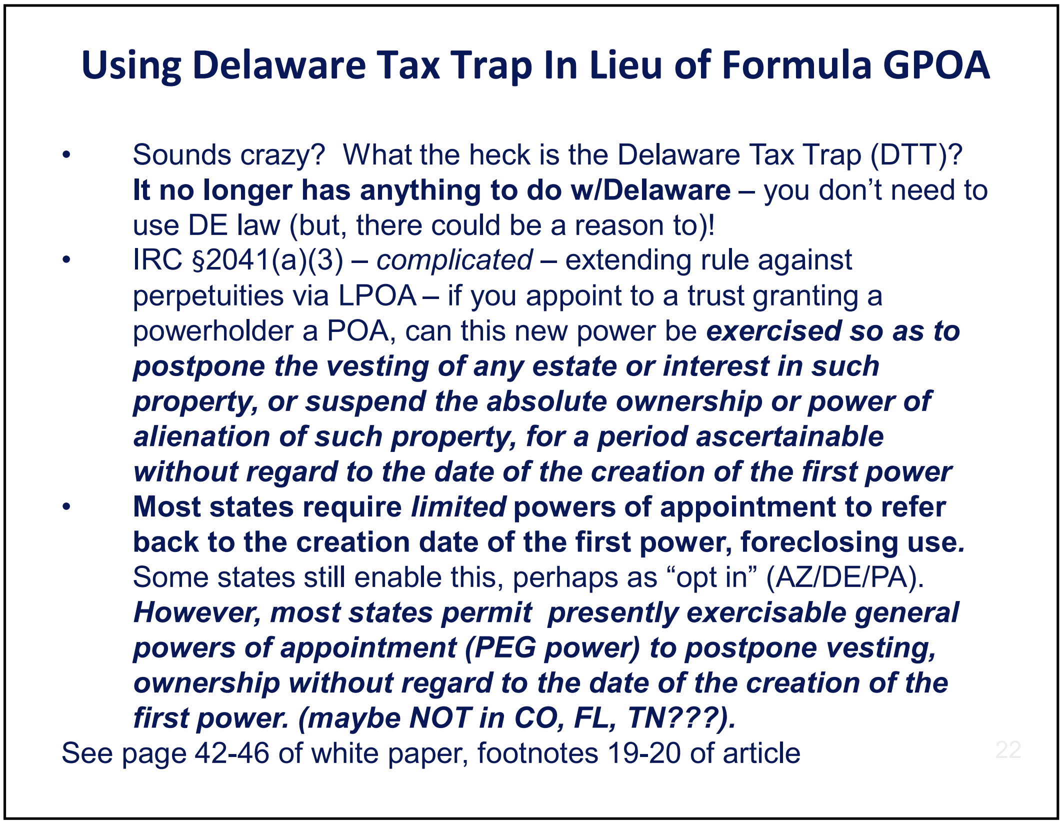
See page 54-55 of white paper with discussion of that section of the PLR.



Capping Inclusion/TGPOA to Avoid Estate Tax

- Adding/drafting GPOAs is easy when we're confident that the available exclusion is more than appointive assets, but Congress (and market) is unpredictable.
- Just as we do with "AB" splits, we want to cap the amount of the GPOA, as we historically capped the amount going to a marital trust, to optimize tax benefits. Remember, a power of appointment is not over all or nothing.
- Trickier - Which assets do we want to soak up the "coupon" if the available exclusion amount is limited, and can we have assets chosen at the trustee's discretion? Could this force pro-rata inclusion? Do we want a $500,000 block of stock with $490,000 basis to soak up the same "coupon" as a $500,000 building with basis of $180,000? No – adopt an ordering rule. Only matters for mid-size/larger estates.

See page 25-29 of OBIT white paper



Using Delaware Tax Trap In Lieu of Formula GPOA

- Sounds crazy? What the heck is the Delaware Tax Trap (DTT)? **It no longer has anything to do w/Delaware** – you don't need to use DE law (but, there could be a reason to)!
- IRC §2041(a)(3) – *complicated* – extending rule against perpetuities via LPOA – if you appoint to a trust granting a powerholder a POA, can this new power be ***exercised so as to postpone the vesting of any estate or interest in such property, or suspend the absolute ownership or power of alienation of such property, for a period ascertainable without regard to the date of the creation of the first power***
- **Most states require *limited* powers of appointment to refer back to the creation date of the first power, foreclosing use.** Some states still enable this, perhaps as "opt in" (AZ/DE/PA). ***However, most states permit presently exercisable general powers of appointment (PEG power) to postpone vesting, ownership without regard to the date of the creation of the first power. (maybe NOT in CO, FL, TN???).***

See page 42-46 of white paper, footnotes 19-20 of article

Using Delaware Tax Trap in Lieu of Formula GPOA

- Thus, a beneficiary powerholder in most states may use a testamentary LPOA to appoint assets for which a basis increase/estate inclusion is desired to a “Delaware Tax Trapping Trust” (sounds complicated, but you have seen these before without knowing it – e.g. *Crummey* trust, revocable trust). Because the power in that trust *can* start a new perpetuities period (whether it does or not), the initial exercise is treated as general power under §2041(a)(3).
- Power holder can later pick and choose which assets to appoint, amending the exercise, to choose highly appreciated assets children are most likely to sell (or depreciate) and only appoint those assets to DTT trust.
- Better protection from powerholder’s estate’s creditors
- Chief drawback of “PEG” power is reduced asset protection, flexibility, and estate inclusion *for children* – but, consider various ideas in outline to mitigate these risks.

See page 42-46 of white paper, extensive comparison page 55

Section 1014(e) – the one year rule

- Ideally, the powerholder would not die until at least a year after funding trust, but what if??
- **(e) APPRECIATED PROPERTY ACQUIRED BY DECEDENT BY GIFT WITHIN 1 YEAR OF DEATH******* if—
  - **(A)** ***appreciated*** *property was acquired* by the decedent *by gift* during the 1-year period ending on the date of the decedent’s death, and
  - **(B)** such property is acquired from the decedent by (or passes from the decedent to) the donor of such property (or the spouse of such donor), the basis of such property in the hands of such donor (or spouse) shall be the adjusted basis of such property in the hands of the decedent immediately before the death of the decedent.

Section 1014(e) – what if we use a trust?

(2)(B)Treatment of certain property sold by estate

"In the case of any appreciated property described in subparagraph (A) of paragraph (1) ***sold*** by the estate of the decedent or ***by a trust of which the decedent was the grantor***, rules similar to the rules of paragraph (1) shall apply ***to the extent*** the donor of such property (or the spouse of such donor) ***is entitled to the proceeds from such sale***."

- requires sale (what about depreciation? exchange?)

- **requires *decedent to be grantor* for income tax (not the case if the decedent uses TLPOA or lets TGPOA lapse)**

- prorated, requires donor/spouse be "entitled" proceeds

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Could a "Power Trust" or DAPT Trust be Used (not SLAT)?

- Client is not married and would love to establish a trust for parent and children, but worries that unlike a SLAT, there is no indirect access to trust funds. Can client grant children and/or parent a lifetime limited power to appoint to them, or use a self-settled DAPT?
- Would clearly be completed gift per Rev. Rul., PLRs ***if*** there is no creditor access, but….
- *At common law, being a mere permissible appointee is not the same as "self-settled", but UTC language muddies this considerably unless your state clarifies like Ohio (see flaw in* UTC: *"With respect to an irrevocable trust, a creditor or assignee of the settlor may reach the maximum amount that can be distributed to or for the settlor's benefit*." Use a DAPT, or consider the loophole on the next slide.

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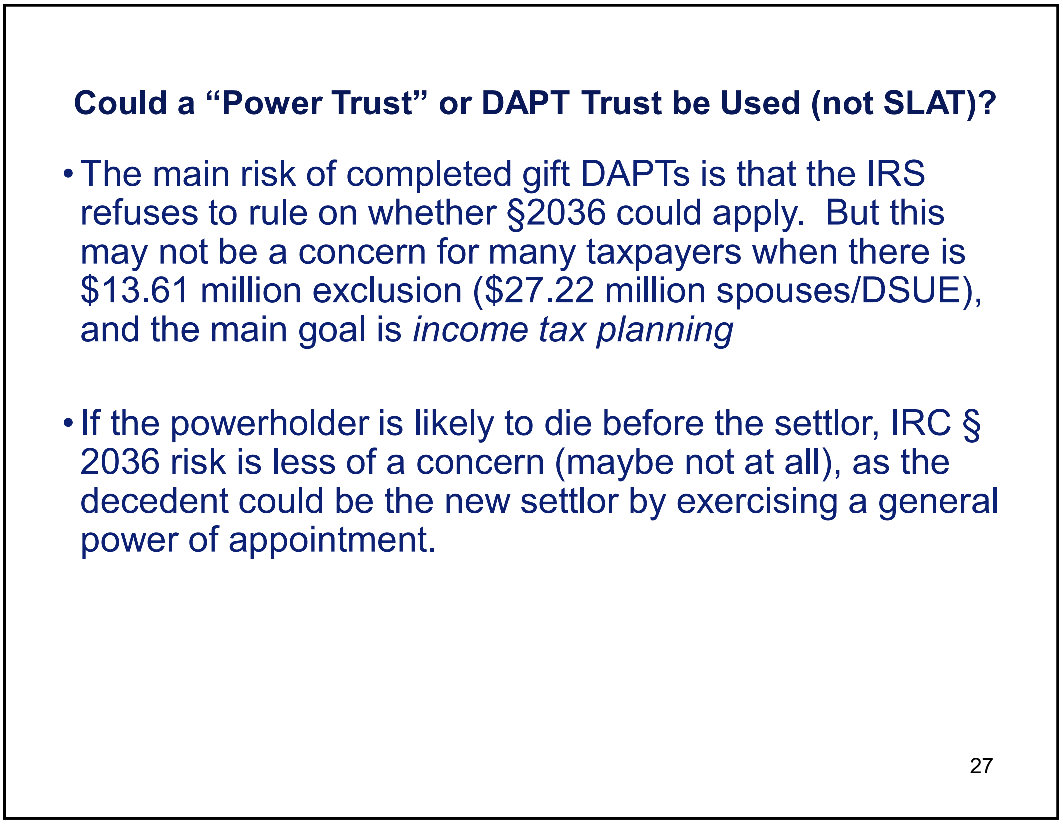
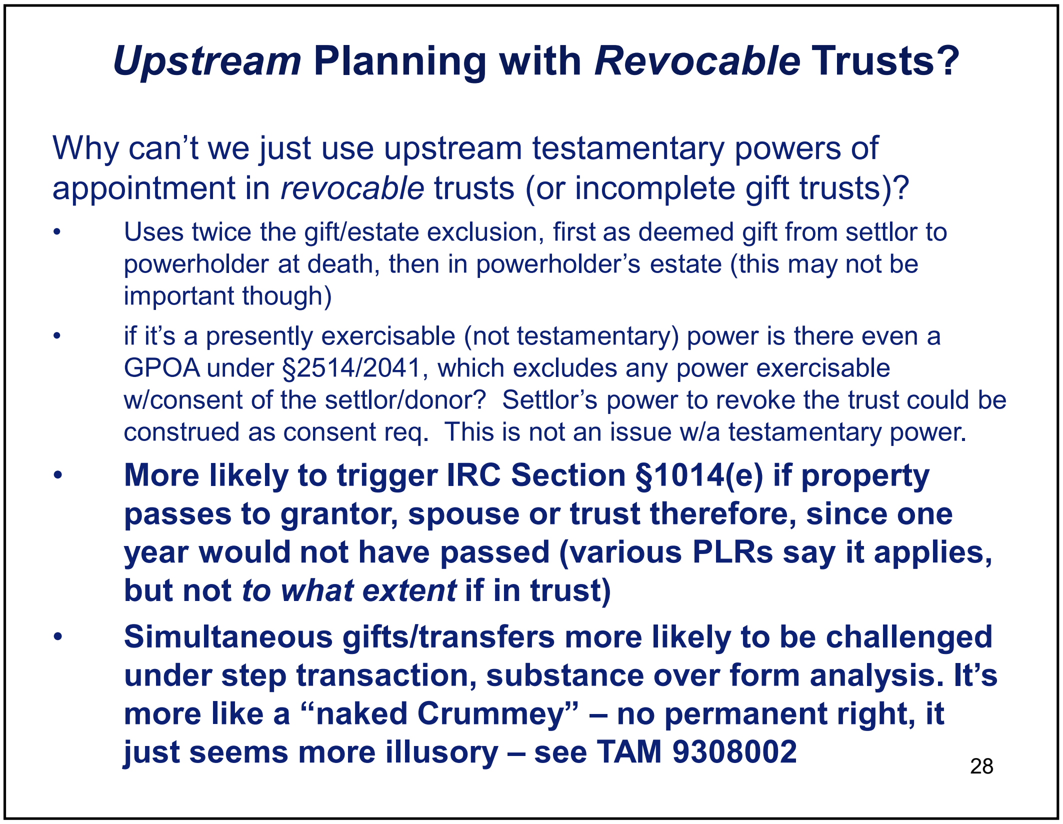


Could a “Power Trust” or DAPT Trust be Used (not SLAT)?

- The main risk of completed gift DAPTs is that the IRS refuses to rule on whether §2036 could apply. But this may not be a concern for many taxpayers when there is $13.61 million exclusion ($27.22 million spouses/DSUE), and the main goal is *income tax planning*

- If the powerholder is likely to die before the settlor, IRC § 2036 risk is less of a concern (maybe not at all), as the decedent could be the new settlor by exercising a general power of appointment.



Upstream Planning with *Revocable* Trusts?

Why can’t we just use upstream testamentary powers of appointment in *revocable* trusts (or incomplete gift trusts)?

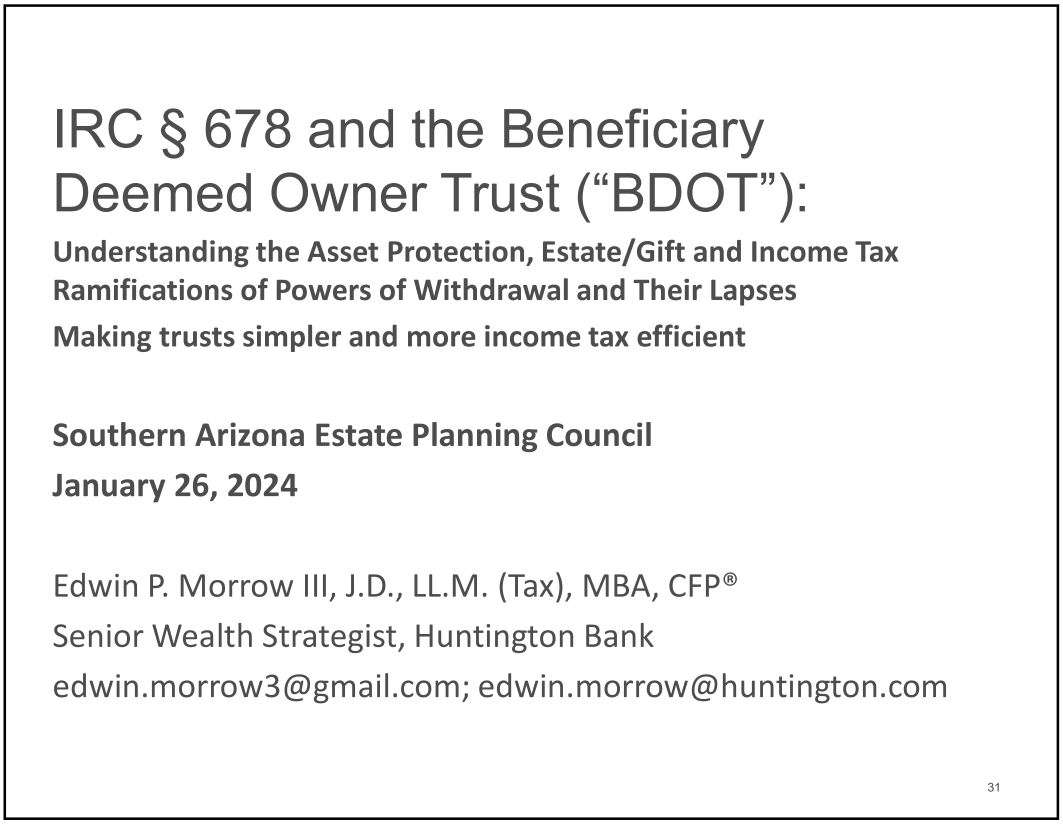
- Uses twice the gift/estate exclusion, first as deemed gift from settlor to powerholder at death, then in powerholder’s estate (this may not be important though)
- if it’s a presently exercisable (not testamentary) power is there even a GPOA under §2514/2041, which excludes any power exercisable w/consent of the settlor/donor? Settlor’s power to revoke the trust could be construed as consent req. This is not an issue w/a testamentary power.
- **More likely to trigger IRC Section §1014(e) if property passes to grantor, spouse or trust therefore, since one year would not have passed (various PLRs say it applies, but not *to what extent* if in trust)**
- **Simultaneous gifts/transfers more likely to be challenged under step transaction, substance over form analysis. It’s more like a “naked Crummey” – no permanent right, it just seems more illusory – see TAM 9308002**

Step Transaction, Substance Over Form Etc.

- Typically collapsing same day simultaneous transactions as part of one common plan, busting arrangements that have no economic effect other than taxes (remember, even a few days between steps can be important – see *Holman v. Comm.* (8th Cir. 2010)
- **Irrevocable trusts that are properly administered for a time do not have nearly the risk that trying to add TGPOAs in *revocable* trusts would have, since any appointment (or decision not to appoint) would occur much later after *real economic change* occurs.**
- "Naked *Crummeys*" – there is always a risk if someone starts adding strangers who have no stake in the trust. While it's clear that a TGPOA power holder need not be a beneficiary for §2041 to apply, it is probably a good idea optics-wise to avoid these various equitable doctrines.

Conclusions – Optimizing Basis and Income Tax Efficiency

- Don't ignore the huge potential of ***upstream*** planning Optimal basis increase clauses (formula testamentary powers of appointment) can vastly improve upon the basis increase at any beneficiary's deaths, and be formulated to avoid a basis decrease and avoid any non-tax asset protection negatives associated with such clauses.
- *Don't waste the free $11.4 ($22.8) million coupon to increase basis!*
- Negative? – No standard trust templates (LegalZoom or otherwise) have these features. However, there can be a huge value added through such planning – for ***even moderate sized*** estates!



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

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

Making trusts simpler and more income tax efficient

Southern Arizona Estate Planning Council

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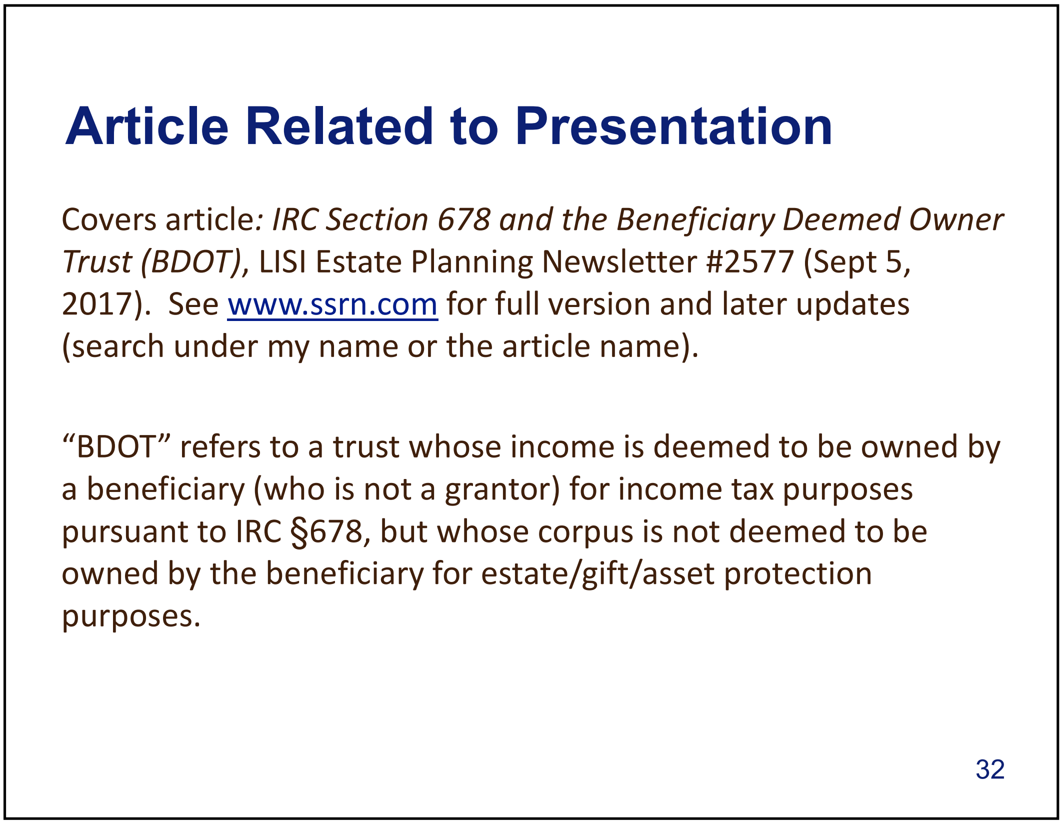


Article Related to Presentation

Covers article: *IRC Section 678 and the Beneficiary Deemed Owner Trust (BDOT)*, LISI Estate Planning Newsletter #2577 (Sept 5, 2017). See www.ssrn.com for full version and later updates (search under my name or the article name).

"BDOT" refers to a trust whose income is deemed to be owned by a beneficiary (who is not a grantor) for income tax purposes pursuant to IRC §678, but whose corpus is not deemed to be owned by the beneficiary for estate/gift/asset protection purposes.

Agenda for Part II (time permitting)

I. Basics of IRC § 678 and Beneficiary Deemed Owner Trust

II. Why GST Exempt Trusts inherited from parents (and reverse QTIPs) should be BDOTs, shifting tax away from GST exempt shares to either the GST non-exempt trust or to the beneficiary directly

III. Manipulating Trust Income for State Income Tax Purposes – shifting taxable income to trusts or beneficiaries in states with no income tax

- Founder state settlor example – shifting income to beneficiary or out of state trust through BDOT provision

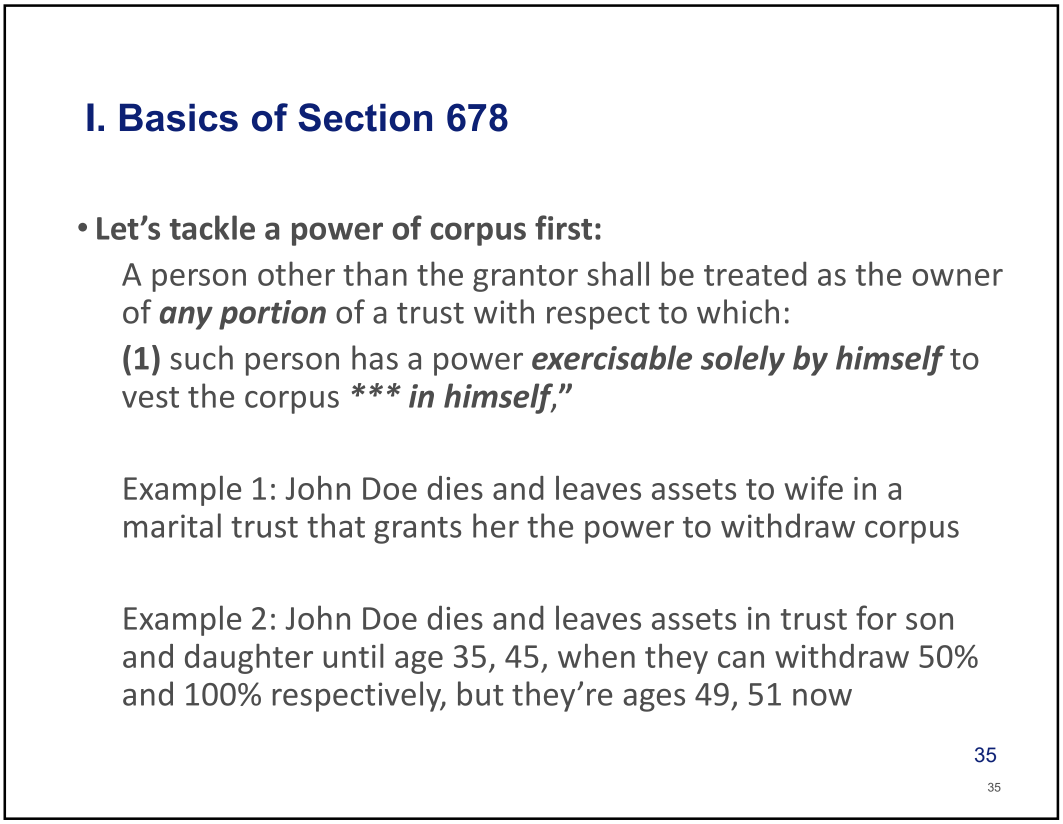
I. Basics of Section 678

- **IRC §678: "a)** General rule

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

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

  (2) ***"



I. Basics of Section 678

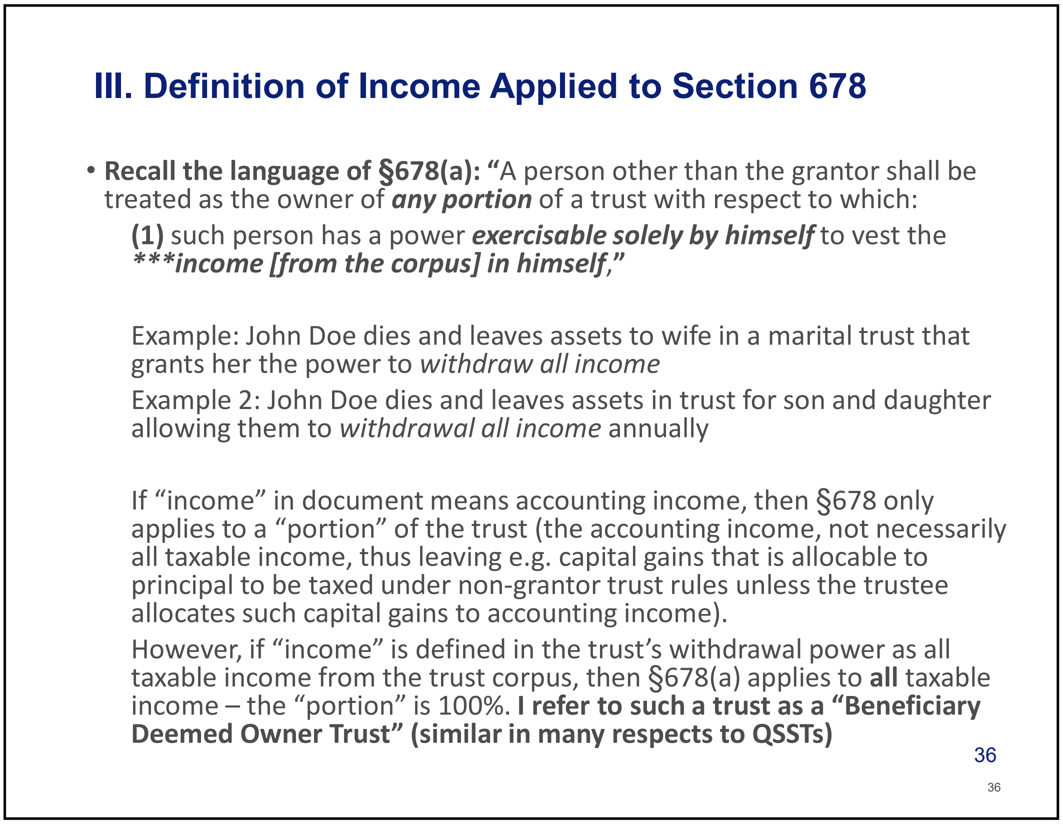
- **Let’s tackle a power of corpus first:**

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

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

  Example 1: John Doe dies and leaves assets to wife in a marital trust that grants her the power to withdraw corpus

  Example 2: John Doe dies and leaves assets in trust for son and daughter until age 35, 45, when they can withdraw 50% and 100% respectively, but they’re ages 49, 51 now



III. Definition of Income Applied to Section 678

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

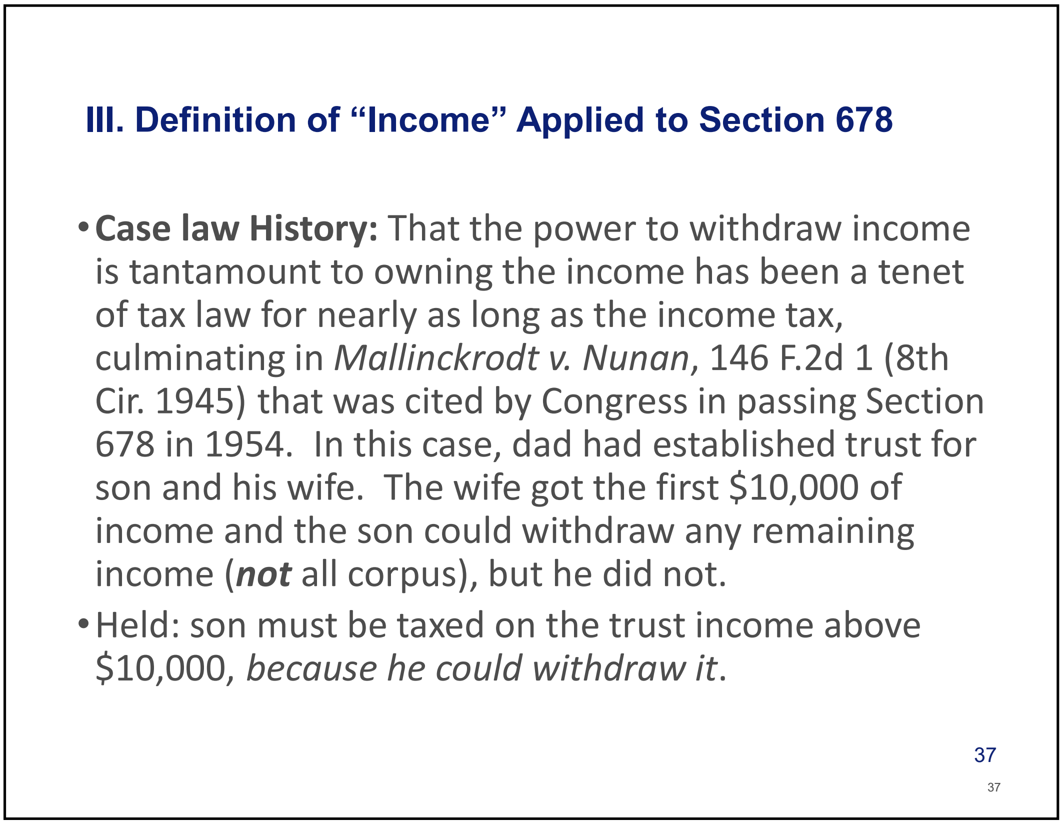
  (1) such person has a power ***exercisable solely by himself*** to vest the ******income [from the corpus] in himself***,”

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

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

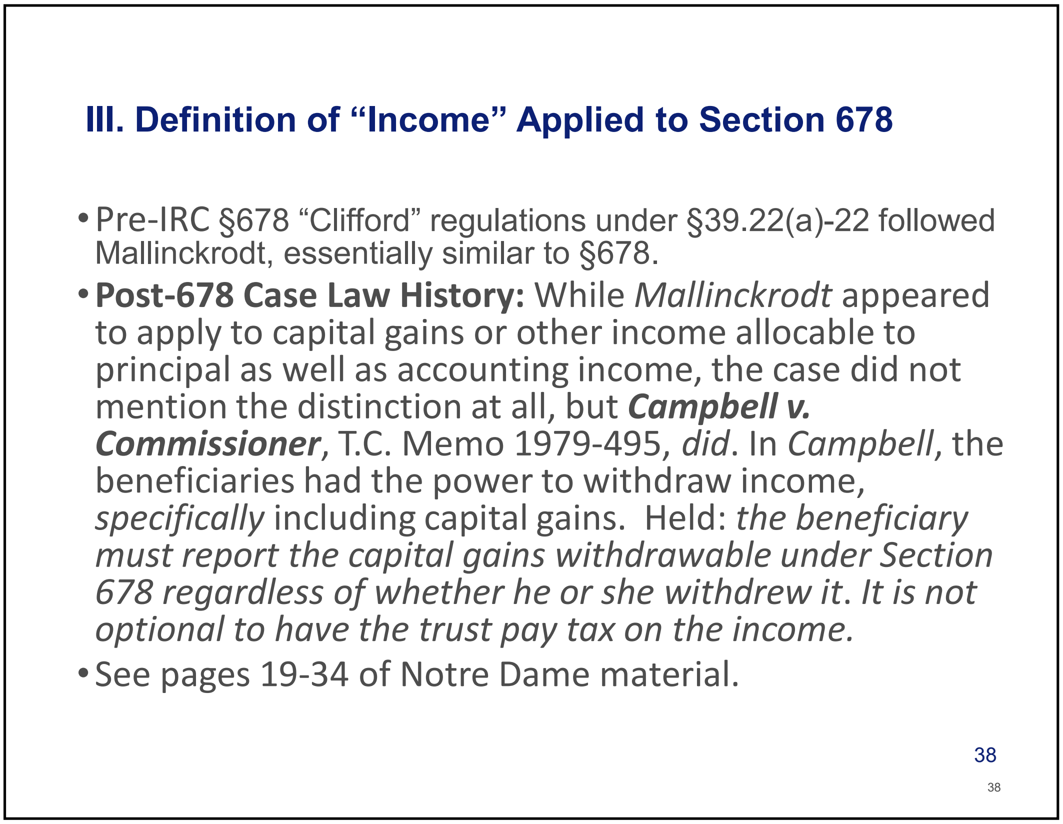
  If “income” in document means accounting income, then §678 only applies to a “portion” of the trust (the accounting income, not necessarily all taxable income, thus leaving e.g. capital gains that is allocable to principal to be taxed under non-grantor trust rules unless the trustee allocates such capital gains to accounting income).

  However, if “income” is defined in the trust’s withdrawal power as all taxable income from the trust corpus, then §678(a) applies to **all** taxable income – the “portion” is 100%. **I refer to such a trust as a “Beneficiary Deemed Owner Trust” (similar in many respects to QSSTs)**



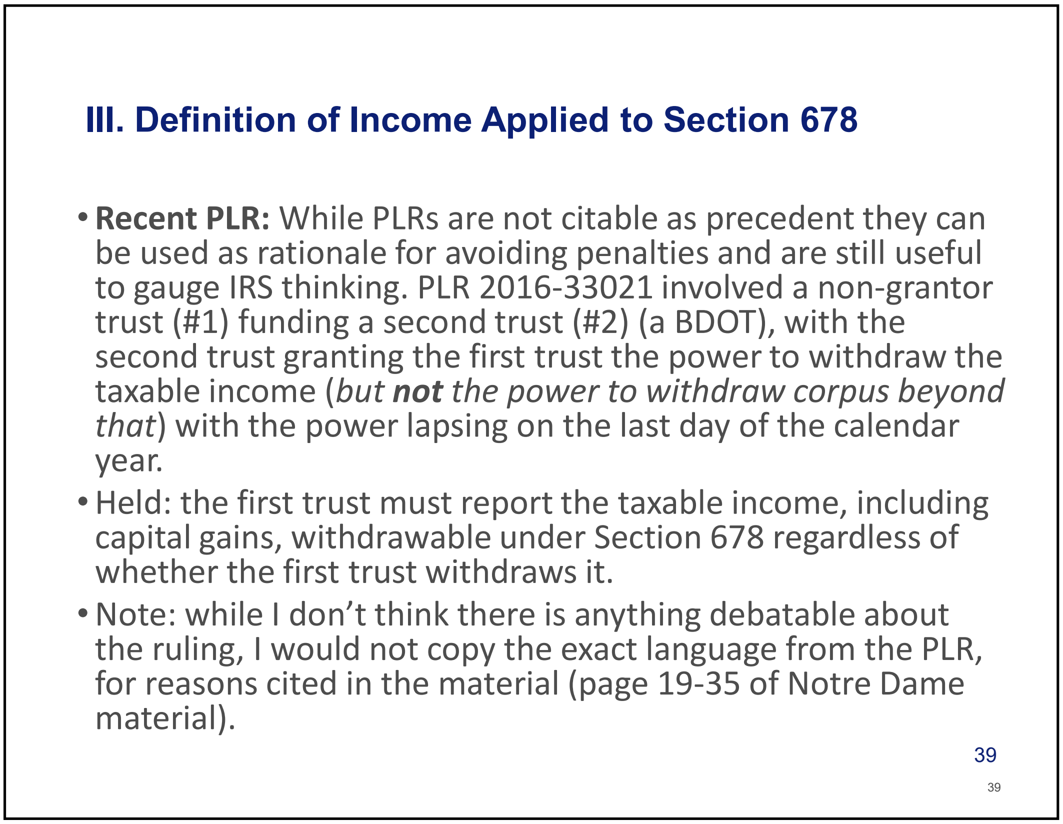
III. Definition of "Income" Applied to Section 678

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



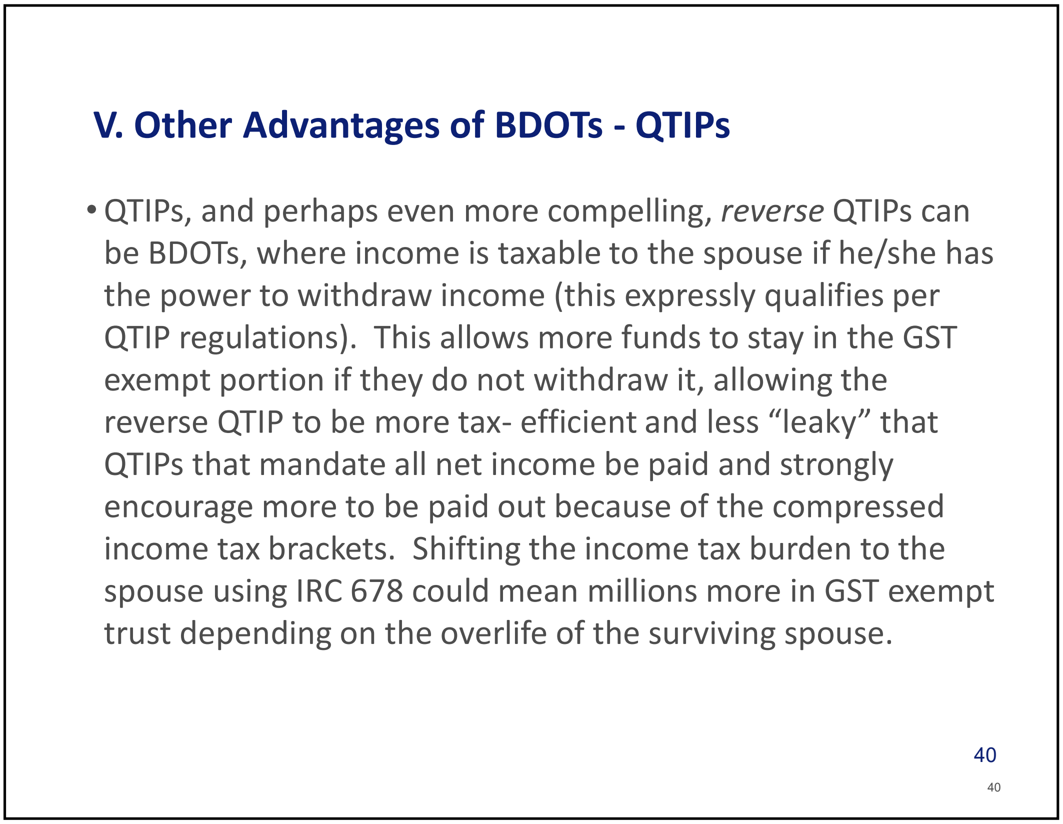
III. Definition of "Income" Applied to Section 678

- Pre-IRC §678 "Clifford" regulations under §39.22(a)-22 followed Mallinckrodt, essentially similar to §678.
- **Post-678 Case Law History:** While *Mallinckrodt* appeared to apply to capital gains or other income allocable to principal as well as accounting income, the case did not mention the distinction at all, but ***Campbell v. Commissioner***, T.C. Memo 1979-495, *did*. In *Campbell*, the beneficiaries had the power to withdraw income, *specifically* including capital gains. Held: *the beneficiary must report the capital gains withdrawable under Section 678 regardless of whether he or she withdrew it. It is not optional to have the trust pay tax on the income.*
- See pages 19-34 of Notre Dame material.



III. Definition of Income Applied to Section 678

- **Recent PLR:** While PLRs are not citable as precedent they can be used as rationale for avoiding penalties and are still useful to gauge IRS thinking. PLR 2016-33021 involved a non-grantor trust (#1) funding a second trust (#2) (a BDOT), with the second trust granting the first trust the power to withdraw the taxable income (*but **not** the power to withdraw corpus beyond that*) with the power lapsing on the last day of the calendar year.
- Held: the first trust must report the taxable income, including capital gains, withdrawable under Section 678 regardless of whether the first trust withdraws it.
- Note: while I don't think there is anything debatable about the ruling, I would not copy the exact language from the PLR, for reasons cited in the material (page 19-35 of Notre Dame material).



V. Other Advantages of BDOTs - QTIPs

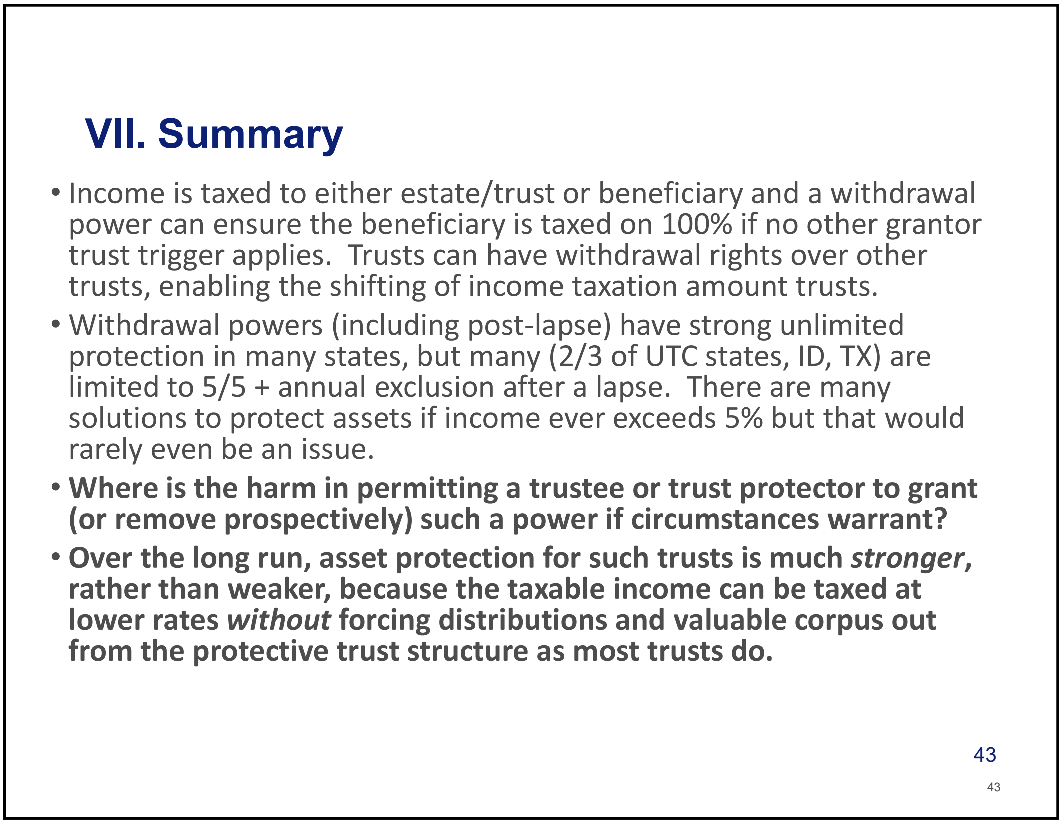
- QTIPs, and perhaps even more compelling, *reverse* QTIPs can be BDOTs, where income is taxable to the spouse if he/she has the power to withdraw income (this expressly qualifies per QTIP regulations). This allows more funds to stay in the GST exempt portion if they do not withdraw it, allowing the reverse QTIP to be more tax- efficient and less "leaky" that QTIPs that mandate all net income be paid and strongly encourage more to be paid out because of the compressed income tax brackets. Shifting the income tax burden to the spouse using IRC 678 could mean millions more in GST exempt trust depending on the overlife of the surviving spouse.

V. Other Advantages of BDOTs– GST Exempt v. Non

- Simple contrast: John leaves his $20 million net estate after tax as follows: 1) $10 million to his children in GST *exempt* trust, and 2) $10 million to his children in a GST *non-exempt* trust. Common.
- John grants the GST non-exempt trust the power to withdraw the greater of the taxable income and/or 5% from the GST exempt trust. At first glance, this sounds terrible, until you realize that if the GST non-exempt trust *does not actually withdraw* the income, the GST exempt trust is growing tax-free at the expense of the GST non-exempt trust, because the non-exempt trust must pay the income tax on the GST exempt trust's income!
- If each trust makes $400,000 of income, the GST non-exempt trust will pay tax on $800,000, the GST exempt trust will pay *no* income tax. A near-*freeze* of GST non-exempt w/tax-free growth to the GST exempt.
- Alternatively, both could grant the beneficiary the withdraw right

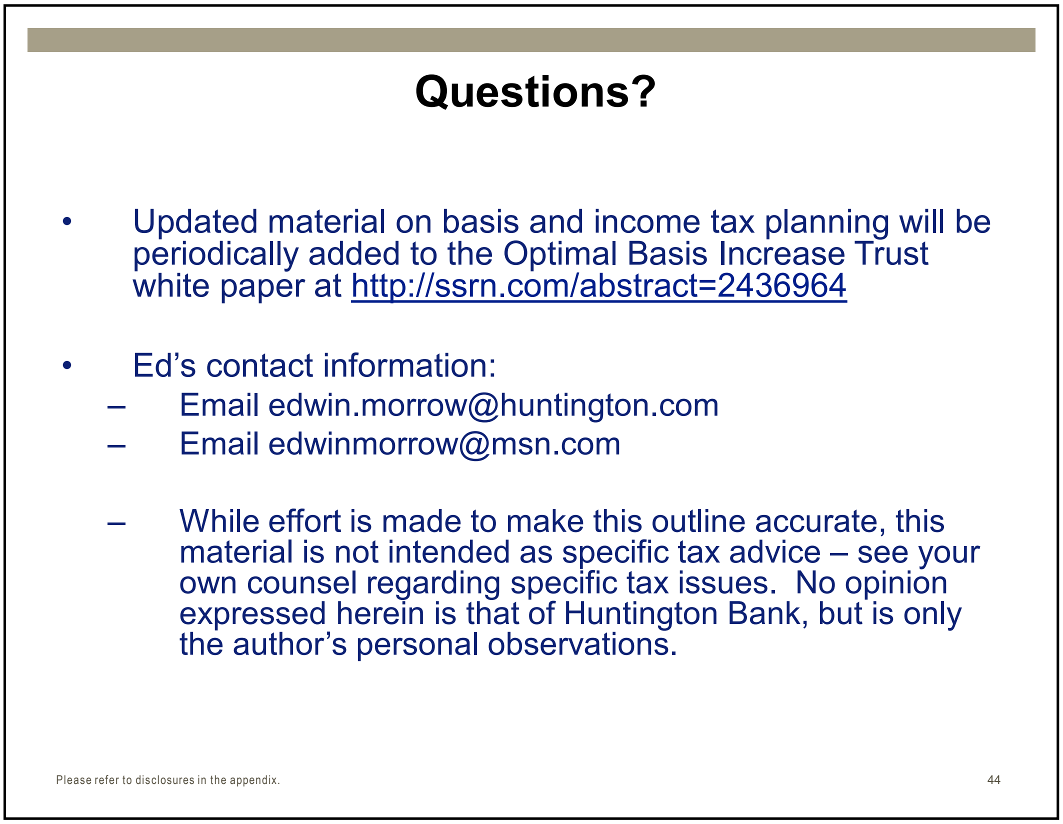
V. Other Advantages of BDOTs– state income tax

- John leaves his $20 million net estate after tax as follows: 1) $10 million to his children in GST *exempt* trust, and 2) $10 million to his children in a GST *non-exempt* trust. He lives in a "founder state" that will forever attempt to tax these trusts.
- If the children live in a no-tax or low tax state, he simply grants them a withdrawal right (BDOT), shifting tax away from the founder state trust without a constitutional challenge. As in prior slide, they would take the funds from the non-exempt trust first.
- If the children do not live in a low tax state, but do not live in a founder state, the children could establish an ING or other non-grantor trust trust in TX, FL, OH, SD, DE etc, which is granted the right to withdraw taxable income from their father's trust, shifting income tax to that trust.



VII. Summary

- Income is taxed to either estate/trust or beneficiary and a withdrawal power can ensure the beneficiary is taxed on 100% if no other grantor trust trigger applies. Trusts can have withdrawal rights over other trusts, enabling the shifting of income taxation amount trusts.
- Withdrawal powers (including post-lapse) have strong unlimited protection in many states, but many (2/3 of UTC states, ID, TX) are limited to 5/5 + annual exclusion after a lapse. There are many solutions to protect assets if income ever exceeds 5% but that would rarely even be an issue.
- **Where is the harm in permitting a trustee or trust protector to grant (or remove prospectively) such a power if circumstances warrant?**
- **Over the long run, asset protection for such trusts is much *stronger*, rather than weaker, because the taxable income can be taxed at lower rates *without* forcing distributions and valuable corpus out from the protective trust structure as most trusts do.**



Questions?

- Updated material on basis and income tax planning will be periodically added to the Optimal Basis Increase Trust white paper at http://ssrn.com/abstract=2436964
- Ed's contact information:
  - Email edwin.morrow@huntington.com
  - Email edwinmorrow@msn.com
  - While effort is made to make this outline accurate, this material is not intended as specific tax advice – see your own counsel regarding specific tax issues. No opinion expressed herein is that of Huntington Bank, but is only the author's personal observations.

Please refer to disclosures in the appendix.