

CCA 202352018:
What Every Fiduciary Needs to Know About the Most
Consequential IRS Decanting Guidance in Decades

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History of Decanting

New York—first decanting
statute in 1992

2015 Uniform Decanting Act

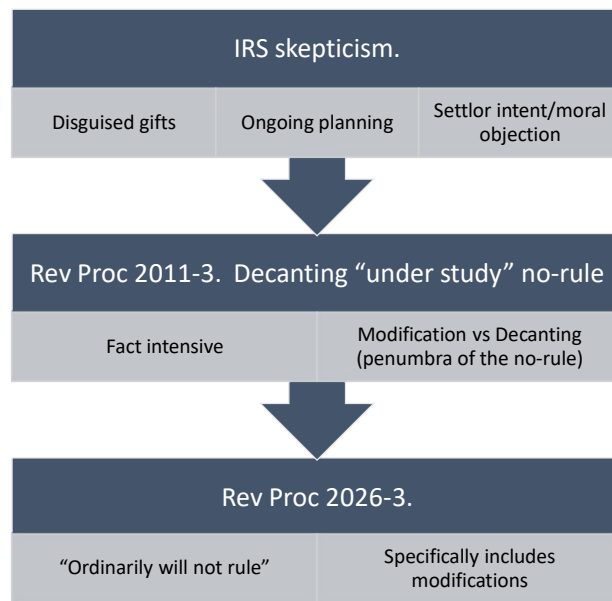
Modifications – Non-Judicial
Settlement Agreements

Difference between
decanting and modification

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History of Decanting

Very little actual decanting guidance



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CCA 202352018

- Year 1 – A establishes irrevocable grantor trust benefitting child and child’s descendants. No tax reimbursement authority under instrument or state law.
- Year 2 – Judicial modification to add in a provision allowing trustee to reimburse donor for income taxes at his discretion. Child and child’s children consent to the modification.
- Ruling – Child/Child’s children make taxable gifts of their interests in trust.
- Holding with huge implications: If beneficiaries consent to a modification of a trust, then those beneficiaries have made a gift.

Implications

- Ruling has implications far beyond the context of a tax reimbursement clause. Any modification or decanting that shifts a beneficial interest, even one that is ill-defined, contingent, or subject to divestment is potentially a taxable gift.
- Modification of a trust to expand or narrow distribution provisions?
- Addition or removal of a limited power of appointment?
- Addition or removal of beneficiary?
- Extension of perpetuities period? Could moving situs be a gift?
- Can anyone think of any others?
- Has the IRS taken away our god given right to decant and modify trusts?
- Should we consider a 28th amendment enshrining the right to decant?
- **People did not like this CCA.**

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Consent

- You need two things for a gift: Consent & shift of value
- A reaches into wallet and gives B \$1,000 – gift
- B reaches into A's wallet and takes \$1,000 – not a gift, shift of value but no consent
- CCA focused on the shift of value: the relinquishment of a portion of discretionary interest in trust has value and is a gift.
- Key fact: “Pursuant to State Statute, Child and Child's issue consent to the modification.”
- Key fact: “a trustee of Trust may distribute income and principal to or for the benefit of Child **in the trustee's absolute discretion.**”

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PLR 201647001

- Year 1 – A establishes irrevocable grantor trust benefitting child and child's descendants. No tax reimbursement authority under instrument or state law.
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Estate Inclusion Risk

- This is not a transfer with a retained interest—it's two sets of transfers.
- Transfer #1: donor makes transfer to trust benefitting child.
- Transfer #2: child makes a transfer of a portion of his interest in trust back to donor.
- Two sets of gifts: Father gives son \$100 Year 1.
- Son gives father \$100 in Year 2.
- Not 2036—two 2511 events.

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More on Consent

- Last sentence of the analysis: “The result would be the same if the modification was pursuant to a state statute that provides beneficiaries with a right to notice and a right to object to the modification and a beneficiary fails to exercise their right to object.”
- Failure to act can be a gift
 - Rev Rul 84-105 – failure to enforce rights to property under a Will is a gift
 - Rev Rul 81-264 – allowing SOL to run on a loan is a gift

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More on Consent

- Trust provides that trustee must distribute income to A for A's life, remainder to A's Child. Trustee informs A that that he intends to terminate trust and distribute to A's Child. A makes no objection. Who thinks A hasn't made a gift?
- Failure to object is not always a gift. It's only a gift if you had the ability to successfully object to the modification.
- Not a gift if modification/decanting clearly provided for under the terms of the instrument of state law.

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More on Consent

- Trust has \$2 million of property. Trustee has complete discretion to make distributions of principal to A & B. In Year, trustee distributes \$200,000 to A for a downpayment on a house and nothing to B. Gift from B?
- B consents to the distribution to A. Gift from B? From CCA “**Pursuant to State Statute**, Child and Child’s issue consent to the modification.”
- Trustee distributes \$2 million to A. Gift from B?
- Do you have to take every close call to court to avoid a gift?

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Value of Gift

- Footnote 1: “Although the determination of the values of the gifts requires complex calculations, Child and Child’s issue cannot escape gift tax on the basis that the value of the gift is difficult to calculate. See *Smith v. Shaughnessy*, 318 U.S. 176, 180 (1943) (“The language of the gift tax statute, ‘property . . . real or personal, tangible or intangible,’ is broad enough to include property, however conceptual or contingent.”)
- Two enormous valuation issues:
 - What is the value of a totally discretionary term interest? What is the value of a remainder interest following a discretionary term interest (or in *McDougall* following a POA).
 - What is the value of the donor’s discretionary reimbursement right?
- These values are functionally impossible to come up with

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Value of Gift

- Assume the term interest is worth X. Assume Donor's reimbursement is worth Y.
- Possible formula: $(X \text{ divided by value of trust}) - (Y \text{ times } (X \text{ divided by value of the trust}))$.
- Is this like what happens when the dog catches the car?
- There are two pieces of authority that can help in valuing the interest (but not in a good way).
 - Section 2702
 - Treas Reg. 25.2511-1(e)

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Section 2702

- Chapter 14 was enacted in 1990 and has four sections that each provides a special valuation rule that corresponds to a perceived abuse by Congress.
- Special valuation rule = a rule that departs from the traditional fair market value metric in section 2512
- Section 2702 – special rule that says retained interests in trust are disregarded unless they fall into specific enumerated exceptions that are easy to value (i.e. unitrust or annuity interest). GRATs, GRUTs, QPRTs.
- Meant to deal with interests in trust that have a technical FMV that don't correspond to actual value.
- GRIT – donor retains the right to income, remainder to children.
 - 2701 = dividends
 - 2703 = buy-sell agreements
 - 2704 = LP restrictions

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Section 2702

- Section 2702: “ for purposes of determining whether a transfer of an interest in trust to (or for the benefit of) a member of the transferor’s family is a gift (and the value of such transfer), the value of any interest in such trust retained by the transferor or any applicable family member...which is not a qualified interest shall be treated as being zero.”
- Transferor: Child
- Transferee: To donor in Trust that benefits donor and other family members
- Transferred interest: A portion of the value of donor’s discretionary reimbursement right
- Retained interest: The remaining portion of child’s interest, which is not a qualified interest.
- Is that remaining portion of child’s interest valued at zero?

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Chapter 14 – Section 2702



If child’s retained interest is valued at zero, then child has made a gift of his entire interest.



There is no need to determine value of donor’s reimbursement right



Still have to value child’s discretionary interest to determine what he gave away.

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Section 25.2511-1(e)

- 25.2511-1(e) if the donor's retained interest is not susceptible of measurement on the basis of generally accepted valuation principles, the gift tax is applicable to the entire value of the property subject to the gift.
- Because you can't value what was given away (the reimbursement right) based on valuation principals, you can't value what was retained.
- Probably less clear authority than section 2702.
- Geared toward this example in the regs: "Thus if a donor, aged 65 years, transfers a life estate in property to A, aged 25 years, with remainder to A's issue, or in default of issue, with reversion to the donor, the gift tax will normally be applicable to the entire value of the property."

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Valuation

- Assuming that the retained interest is disregarded, and beneficiary has given his entire interest, you still have to determine what that interest is.
- Interests
 - Child: right to receive distributions at the donor's discretion.
 - Grandchild: right to receive the remainder (or what's left of it if any) after the child's death.
- What is the value of the right to receive distributions at the donor's discretion? Depends perhaps on the child's individual situation? What his needs are—even though the trust doesn't require distributions for needs, there are still fiduciaries duties owed to the beneficiary.

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Types of IRS Guidance

- Law vs. Agency Decision
 - Statute, Constitution
 - Treasury regulation, Rev. Rul., Rev. Proc., Notice, Announcement
- Treasury reviewed vs. non-treasury reviewed
 - CCA, PLR, TAM, GLAM
 - Rev Rul, Rev Proc, Notice, Announcement
- Specific vs. Non-taxpayer Specific
 - PLR, TAM
 - Non-Taxpayer Specific CCA, GLAM
- IRS enforcement? When would this come up?
- *McDougall*.

Non-Taxpayer Specific Chief
Counsel Advice

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McDougall

- Decedent died in 2011, leaving residue of her estate to QTIP trust.
- QTIP trust provided mandatory income distributions to Husband and discretionary distributions for Husband's health, education, and support.
- Husband had testamentary limited power to appoint the principal to or among Decedent's descendants. If power is unexercised, remainder passes to children.
- In 2016, Husband and children signed a non-judicial settlement agreement in which they agreed to terminate the trust and distribute all assets to Husband.

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IRS Argument #1 Section 2519 Gift from Husband

- What is a QTIP trust?
- Section 2519: “any disposition of all or part of a qualifying income interest for life in any property to which this section applies shall be treated as a transfer of all interests in such property other than the qualifying income interest.”
- In other words, a “disposition” of a portion of you interest in a QTIP trust is a gift of the entire trust.
- IRS argued that husband’s agreement to terminate trust was a section 2519 disposition, and therefore, a gift of the entire thing.
- Court said no way.

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IRS Argument #2 Indirect Gift from Children

- Children made a gift of their remainder interests in the QTIP trust when they agreed to terminate the trust.
- They held remainder interests in the trust, they gave those interests up and allowed them to pass to Husband when he signed the NJSA. So, they made a gift of their remainder interests.
- Taxpayer’s counter arguments:
- Husband had a power of appointment so children were not guaranteed to get anything. How can you make a gift when you might end up getting nothing?
- It’s all still a QTIP trust. It was to be included in Husband’s estate, was the only beneficiary during his life, and had a guaranteed income interest. It was constructively already his so how can he make a gift of it?

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Taxpayer's Arguments

- Court: "Linda and Peter [the children] plainly made gratuitous transfers. Before the implementation of the NJA, they held valuable rights - the remainder interests in the QTIP. After the NJA, they had given up those valuable rights by agreeing that all Residuary Trust assets would be transferred to Bruce. And they received nothing in return. By giving up something for nothing, Linda and Peter engaged in quintessential gratuitous transfers and are therefore subject to gift tax under 2501 and 2511."
- Court: "Given the procedural posture of the case, we do not of course decide here the value of the gifts Linda and Peter made to Bruce. That factual issue remains open for decisions in future proceedings."
- Sound familiar? From CCA: "Although the determination of the values of the gifts requires complex calculations, Child and Child's issue cannot escape gift tax on the basis that the value of the gift is difficult to calculate."

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CCA vs. McDougall

In *McDougall*, the court did not buy the argument that the relinquishment of an ill-defined interest cannot be a gift. The decision supports the CCA's conclusion that you can make a gift of an interest in trust even though the interest is ill-defined and there is no guarantee that you will ever receive a distribution.

But the *McDougall* decision does not necessarily mean the Tax Court would agree with the conclusion of the CCA.

There are some major differences between the CCA and *McDougall*...

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Distribution Standard

- *McDougall*: Distributions to spouse limited to HEMS
- CCA: Distribution to child not limited to an ascertainable standard
- Might the Tax Court say that the HEMS limitation created a transferable property of the remainder in the way that full discretion doesn't?
- In that case, you could find a gift in *McDougall* but not in the CCA

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Nature of Gifted Interest in Trust

- *McDougall*: Trust terminates and Children (the remainder beneficiaries) are giving up all of their interests.
- CCA: Vast majority of the beneficial interests intact. The children (current beneficiary) and grandchildren (remainder beneficiaries) are giving up a small portion of their interest—The value of the Donor's right to receive reimbursement.
- Tax court could say that unlike in *McDougall*, the interest in the CCA is too speculative to be a property interest subject to transfer.
- Tax court could also agree with the 2016 PLR, that it is an "administrative change".
- Tax court could fail to find a gift in the CCA for these reasons without being inconsistent with *McDougall*.

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QTIP vs Non-QTIP Trusts

- *McDougall*: Trust was a QTIP trust, and taxpayer made the argument that it constructively already belonged to the Husband for tax purposes.
- CCA: Not a QTIP trust, so that issue is not at play here.
- If an appellate were to overturn *McDougall* on that basis, it would not directly affect the reasoning in the CCA.

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NJSA vs. Court Order

- *McDougall*: Termination the result of a non-judicial settlement agreement.
- CCA: Modification the result of a court order.
- Some have argued that one cannot make a gift if one is following a state court order. Since you're obligated to comply with that order, how can it be a gift?
- *Harris v Commissioner*: payment in accordance with a court ordered divorce settlement can't be a gift because it is pursuant to a court order.
- Argument probably fails if the person giving up the interest consented to the modification or the order which terminates his interest.
- NJSA vs. Judicial Modification unlikely to make a difference.

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Chapter 14 again

- Could Chapter 14 apply to *McDougall*?
- Section 2702 “a transfer of an interest in trust”
- Treas Reg. 25.2702-1(a) **Scope of section 2702.** Section 2702 provides special rules to determine the amount of the gift when an individual makes a transfer in trust to (or for the benefit of) a member of the individual's family and the individual or an applicable family member retains an interest in the trust.
- Transfer of an interest in trust = transfer of an interest **TO** a trust.
- Children are not making a transfer of an interest in trust—transfer is to Husband.
- No applicable family members are retaining any interests in trust (because trust is terminating).
- Compare to the CCA, where the children are retaining a portion of their interest.

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Where do we go from here?

- CCA 202352018 and *McDougall* present more questions than they answer.
- What should you do if you want to modify, decant, or terminate a trust?
- Don't be like the Cat i' th' adage from Macbeth:

Wouldst thou have that
Which thou esteem'st the ornament of life
And live a coward in thine own esteem,
Letting “I dare not” wait upon “I would,”
Like the poor cat i' th' adage?

William Shakespeare, *Macbeth*, Act I, Scene 7

- Don't pace around like Macbeth wringing his hands deciding whether to act.
- Don't claw at the water too scared to dip your paw in.

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Where do we go from here?

- Don't make an unforced error: modify the trust in a way where that is clearly within the sole discretion of the trustee if possible.
 - If trustee has power to make distributions and you want to terminate the trust and distribute to a beneficiary, have the trustee make the distribution. Don't do a NJSA terminating the trust.
 - If trust document or state law has a decanting provision use that if possible, don't do it with a NJSA with consenting beneficiaries.
 - If you want to change terms, consider moving situs if the other state's law gives you what you want.
 - If you want to add a tax reimbursement clause **MOVE SITUS TO SOUTH DAKOTA!!! (Starting July 1)**

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Where do we go from here?

- Next line of defense – don't have the beneficiaries consent if possible
 - Consent is clearly an indication that the consent was necessary to the modification
 - Consent however is not determinative that the consent was necessary
 - Some corporate trustees will not like this—they always want consent from beneficiaries to limit liability

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Where do we go from here?

- Scrivener's error? UTC 415
 - Donor intended for trust to say X but trust says Y
 - Donor intended to add tax reimbursement clause but attorney didn't put it in
- Ambiguity in the instrument?
 - As long as the ambiguity can be resolved in a way that comports with state law.
 - Trustee may make distributions to child at his discretion. Does that include the power to decant for his benefit?
- Bona fide dispute?
- Mistake of law UTC 415 "reformation to correct mistakes"
 - Donor didn't realize he was going to have to pay the tax.
 - Some conflicting authority about whether the reformation will be given retroactive effect. RR 93-79
- Reformation to achieve settlor's tax objectives UTC 416

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Private Letter Rulings

- What is a Private Letter Ruling?
 - Advance ruling about the interpretation of tax law.
 - Ruling from the IRS that a certain transaction will have a certain tax result.
 - If you modify the trust to provide X, the modification won't result in a gift from the beneficiaries.
- IRS has always ruled on modifications or decantings that do not shift a beneficial interest.
- Starting in 2026, IRS changed its ruling position.
- Before 2026 – Never rule on a modification or decanting that shifts a beneficial interest
- Starting in 2026 – "Ordinarily won't rule" on a modification or decanting that shifts a beneficial interest. We don't know yet how this will play out.

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