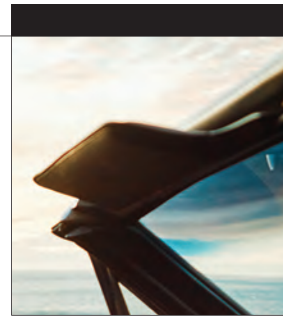

# Decanting from a QSST to a ESBT

Considering the intersection of the newer laws on decanting with a desire to change the vehicle holding a subchapter S ownership interest.

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Decanting an existing qualified subchapter S trust (QSST) to an electing small business trust (ESBT), which ESBT includes a Section 678 current income withdrawal power in the trust beneficiary, may be highly beneficial because, unlike a ESBT which includes a Section 678 withdrawal power over current income, all of the ordinary income of a QSST must be distributed to the beneficiary currently, regardless of need. This mandatory income distribution requirement in turn causes potentially 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, (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 (iv) in the case of underaged or spendthrift beneficiaries, a potentially unhealthy full access to trust income, access which may be suspended by utilizing a ESBT, even a ESBT which includes a Section 678 current income withdrawal power.[1]

Due to the above-described benefits of a ESBT (when it includes a Section 678 current income withdrawal right in the beneficiary) over a QSST, and because the ordinary income of this form of ESBT will not be taxed at the maximum income tax rate applicable to ESBTs generally, in many instances the trustee of an existing QSST may wish to decant the same to a ESBT for the same beneficiary.[2] The problem is that, when it comes to QSSTs, decanting is often thought to be restricted by some states' trust decanting statutes, including the laws of states which have adopted the Uniform Trust Decanting Act (UTDA). This problem is further compounded by the fact that, in the eyes of the Internal Revenue Service, the mere existence of most trust decanting statutes may be viewed as causing QSST qualification issues under the Internal Revenue Code.

## State Law Restrictions on Decanting QSSTs

Missouri, for example, which has *not* adopted the UTDA, provides in its decanting statute that the exercise

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of the trustee's decanting authority may not reduce any income interest of any income beneficiary of a trust which has been qualified as a QSST under Section 1361(d).[3] This statutory restriction does not necessarily prohibit decanting a QSST to a ESBT, however. It merely means that the ESBT may only have the same single income beneficiary which the existing QSST had, and that the same income beneficiary must enjoy the same rights to the trust's income that he or she enjoyed under the QSST. If the current income beneficiary is granted a current Section 678 withdrawal power over all of the ordinary income of the new trust, for example, the beneficiary is in no different position than he or she was under the QSST. In each situation the beneficiary is entitled to all of the ordinary income of the trust, currently.

The "Missouri-style" trust decanting statute therefore permits decanting from a QSST to a ESBT, as long as the current beneficiary of the trust remains the same, and possesses a current right to receive all of the trust's ordinary income, whether that right be exercisable by means of a Section 678 withdrawal power over all of the trust's current income, or otherwise. Therefore, a "Missouri-style" trust decanting statute positions the attorney to convert a QSST, with all of its above-outlined inherent disadvantages, into a ESBT which includes none of the same disadvantages.

Decanting to a ESBT under the UTDA, on the other hand, is more problematic - at least at first blush. Section 19(b)(4) of the UTDA provides:

> If the property of the first trust includes shares of stock in an S corporation, as defined in 26 U.S.C Section 1361, and the first trust is, or but for provisions of this Act other than this section would be, a permitted shareholder under any provision of 26 U.S.C. Section 1361, an authorized fiduciary may exercise the power with respect to part or all of the S corporation stock only if any second trust receiving the stock is a permitted shareholder under 26 U.S.C. Section 1361(c)(2) [which includes a ESBT]. If the property of the first trust includes shares of stock in an S corporation and the first trust is, or but for provisions of the Act other than this section would be, a qualified subchapter S trust within the meaning of 26. U.S.C. Section 1361(d), *the second trust instrument must not include or omit a term that prevents the second trust from qualifying as a qualified subchapter S trust.* [Emphasis supplied]

Decanting under the UTDA from a QSST to a ESBT, which ESBT includes a Section 678 withdrawal power over all of the current income of the trust, would seem to be permissible under the first sentence of the above paragraph, but at first glance would not seem to be permissible under the second sentence, which requires that "the second trust instrument must not include or omit a term that prevents the second trust from qualifying as a" QSST. By emphasizing the word "term," however, the second sentence actually does not prevent the new trust from being a ESBT, at least one which includes a Section 678 withdrawal power over all of the current income of the trust.

The only "trust terms" which are required under Section 1361(d)(3) of the Code are included in subparagraph (A) thereof. Although clause (i) of subparagraph (A) requires that, during the life of the current income beneficiary, there shall be only one beneficiary of the trust, subparagraph (A) does not require that the trust include a clause mandating that the ordinary income of the trust be paid to the one beneficiary currently. Instead, clause (i) only requires that the trust terms direct that there be only one income beneficiary of the trust during the life of the current income beneficiary.

Subparagraph (B) provides that all of the income of the trust must be distributed currently to one individual who is a citizen or resident of the United States, but it never states the "trust terms" must direct this. Furthermore, a ESBT containing a Section 678 power to withdraw current income from the trust does not "include or omit a term that prevents the second trust from qualifying as a qualified subchapter S trust." Quite to the contrary, it satisfies the (A)(i) "trust term" requirement that, "during the life of the current income beneficiary, there shall be only 1 income beneficiary of the trust." A single trust beneficiary having a current and full power to withdraw all of the trust's ordinary income is still an "income beneficiary," nevertheless.

Again, to be clear, there is no question that Section 1361(d)(3) of the Code requires that all of the income of the trust must be distributed currently, and to only one beneficiary; it is just that this requirement is not one of the mandatory trust terms of a QSST, which is relevant for UTDA construction purposes. Provided all of the other Section 1361(d)(3)(A) requirements are satisfied, the second trust instrument satisfies the UTDA requirement that "the second trust instrument must not include or omit a term that prevents the second trust from qualifying as a qualified subchapter S trust," because the single beneficiary's Section 678 withdrawal power is over all of the current ordinary income of the trust, and because nothing in the second trust instrument prevents all of the ordinary income of the trust from being distributed, currently, to one beneficiary.

1 See Blase, "The Electing Small Business Trust: 25 Years Later," 49 Estate Planning 18 (March, 2022). See also J. Blase, *6-7-8: Estate Planning with Section 678 of the Internal Revenue Code* (2022).

2 *Ibid.*

3 Rev. Mo. Stat. section 456.4-419.2(5)(d).

## Reining in the Treasury Regulations

As described above, Section 1361(d)(3)(A) of the Code provides that the "terms of the trust" must include certain requirements, and Section 1361(d)(3)(B) of the Code requires that, as long as an existing trust is intended to qualify as a QSST, all of the ordinary income of the trust must be distributed currently to one beneficiary. Neither of these Code sections mentions the impact of local law on the trust's qualification. Nevertheless, the regulations issued by the Internal Revenue Service do discuss the impact of local law on the trust's qualification. Section 1.1361-1(j)(1)(iii) of the regulations, for example, provides:

> *If the terms of the trust do not preclude the possibility that any requirements stated in paragraph (j)(1)(ii) of this section [i.e., Section 1361(d)(3)A) of the Code] will not be met, the trust will not qualify as a QSST.* For example, if the terms of the trust are silent with respect to corpus distributions, and distributions of corpus to a person other than the current income beneficiary are permitted *under local law* during the life of the current income beneficiary, then *the terms of the trust* do not preclude the possibility that the corpus may be distributed to a person other than the current income beneficiary and, therefore, the trust is not a QSST. [Emphasis supplied]

Section 1.1361-1(j)(2)(ii)(A) of the regulations adds:

> (A) Terms of the trust and applicable local law. The determination of whether *the terms of a trust* meet all of the requirements under paragraph (j)(1)(ii) of this section [i.e., Section 1361(d)(3)(A) of the Code] depends upon *the terms of the trust instrument and the applicable local law.* For example, a trust whose governing instrument provides that A is the sole income beneficiary of the trust is, nevertheless, considered to have two income beneficiaries if, under the applicable local law, A and B are considered to be the income beneficiaries of the trust. [Emphasis supplied]

Assuming the above regulations constitute valid interpretations of the Code by the Internal Revenue Service, and given the subsequent questions raised by the Internal Revenue Service relative to the new trust decanting statutes, in Notice 2011-101, it would appear that the UTDA requirement that "the second trust instrument must not include or omit a term that prevents the second trust from qualifying as a qualified subchapter S trust," is appropriate. The question is, does the UTDA extend far enough in its restrictions?

By its very nature, a trustee's ability to decant to a new trust arguably violates the Section 1361(d)(3)(A)(ii) mandate that the terms of the trust instrument require that "any corpus distributed during the life of the current income beneficiary may be distributed only to such beneficiary." Distributions by the existing QSST to a second trust, with terms obviously not identical to the first trust, do not constitute distributions "to such beneficiary." Arguably, then, the cautious approach would be for states not to permit existing QSSTs to decant in favor of an entirely new trust, but instead only permit existing QSSTs to be modified. Under the same theory, "Missouri style" decanting laws, which unlike the UTDA do not appear to authorize an existing trust to be modified, should be amended to not only authorize trust decanting by modification, but to require the same in the case of an existing QSST, as the only form of permissible decanting.

Two significant questions remain, however, relative to (i) whether the above-set-out regulations promulgated by the Internal Revenue Service constitute a valid interpretation of the Internal Revenue Code, and (ii) assuming they do, exactly how should these regulations be construed.

**Validity of the Regulations.** As alluded to above, despite the fact that the Code only mentions the "terms of the trust," and never utilizes the phrase "terms of local law," the regulations nevertheless manage to incorporate the latter phrase into Section 1361(d)(3)(A). Does this incorporation constitute a valid interpretation of the Code?

Take, for example, Section 2041(a)(3), which reads as follows:

> (3) Creation of another power in certain cases. To the extent of any property with respect to which the decedent (A) *by will* . . . exercises a power of appointment created after October 21, 1942, by creating another power of appointment which *under the applicable local law* can be validly 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. [Emphasis supplied]

Notice how Congress was able to employ the phrases "by will" and "under the applicable local law," in the same sentence of Section 2041(a)(3). Now compare this to Section 1361(d)(3)(A), where Congress employs the phrase "a trust the terms of which" without also employing the phrase "and the applicable local law." There is a serious question of potential overreaching by the Internal Revenue Service when it chooses to expand the express Code language to include local law provisions which are not part of the terms of the trust, and do not even purport to constitute terms of the trust under the applicable decanting statutes. Also, and as alluded to above, there is no reason then why these regulations would not also apply to other forms of judicial and nonju-

4 T.D. 8600, 60 FR 37578 (July 21, 1995).

dicial modification of trusts under applicable local law.

**Construction of the Regulations.** Assuming, for the sake of argument, that the above-set-out regulations are valid, there is still the question of what do these regulations mean, as applied to decanting and other forms of trust modification. One very supportable reading of these regulations is that only the *existing* trust document need address all the QSST "trust terms" requirements, and not be inconsistent with clear, existing state law to the contrary. In other words, the regulations are not intended to address a "hypothetical" trust document which does not currently exist. This position is supported by the fact that the regulations make no mention of potential future amendments to the terms of an existing trust agreement, as being a potential QSST qualification problem.

Put another way, neither the "Missouri-style" decanting statute nor the UTDA directly authorize the trustee of an existing trust to make trust distributions other than pursuant to the terms of the existing trust document. They authorize the creation of modified trust documents or new trust documents, but they do not authorize the trustee to unilaterally depart from the terms of an existing trust document, *without first modifying the same or creating an entirely new trust document.* Thus, the only distributions permitted under the *existing* trust document are those which are also permitted under Section 1361(d)(3). Once a new or modified trust document actually exists, the regulations should then test the same under the Section 1361(d)(3) standards, assuming the intent of the new trust is to qualify as a QSST, and not as a ESBT, in which latter case the requirements under Section 1361(e)(1) of the Code would need to be satisfied.

This position is supported later in the regulations themselves, which regulations, significantly, were promulgated in 1995,[4] or prior to

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the existence of trust decanting statutes. Observe the below-cited regulations move successively from (1) a situation where a second beneficiary currently exists, under the terms of the trust instrument, to (2) a situation where a second beneficiary is not precluded under the terms of the trust instrument or under local law, but does not currently exist, to (3) a situation where a second beneficiary derives exclusively under local law, is not precluded under the terms of the trust instrument, but does not currently exist. The second two scenarios will not disqualify the trust as a QSST, but the first scenario, will.

**Situation 1.** Section 1.1361-1(j)(2)(iii) of the regulations provides: "If, under the terms of the trust, a person (including the income beneficiary) has a special power to appoint, during the life income beneficiary, trust income or corpus to any person other than the current income beneficiary, the trust *will not qualify as a QSST.*" [Emphasis supplied.] According to the Preamble to the 1995 final regulations, this is "because the statute clearly requires that the terms of the trust instrument provide that, during the life of the current income beneficiary, there be only one income beneficiary, and that any corpus distributed may be distributed only to such beneficiary."

**Situation 2.** Section 1.l361-1(j)(2)(iv) of the regulations next provides: "If the terms of a trust or local law do not preclude the current income beneficiary from transferring the beneficiary's interest in the trust . . ., the trust will still qualify as a QSST. However, if the income beneficiary transfers or assigns the income interest or a portion of the income interest to another, the trust may no longer qualify as a QSST, depending on the facts and circumstances, because any transferee of the current income beneficiary's income interest . . . will be treated as a current income beneficiary for purposes of paragraph (j)(1)(ii) of this section [i.e., Section 1361(d)(3)(B)] and the trust may no longer meet the QSST requirements."

**Situation 3.** Finally, Section 1.1361-1(j)(2)(v) of the regulations provides: "If the terms of the trust do not preclude a person other than the current income beneficiary named in the trust instrument from being awarded an interest in the trust by the order of a court, the trust *will qualify as a QSST* assuming the trust meets the requirements of paragraphs (j)(1)(i) and (ii) of this section [i.e., Section 1361(d)(3)(A) and (B)]." [Emphasis supplied.] Subparagraph (v) continues: "However, if as a result of such court order, the trust no longer meets the QSST requirements, the trust no longer qualifies as a QSST and the corporation's S election will terminate." The Preamble to the 1995 final regulations adds that, "because of the concern expressed that a trust instrument could not feasibly preclude the addition to a trust of a beneficiary that is mandated by a court of law, the final regulations provide for this exception to the general rule."

State trust decanting statutes situations appear to result in a hybrid of Situations 2 and 3, neither of which would disqualify the trust for QSST treatment. Decanting is not court-imposed (as in Situation 3), but it is also not imposed under the terms of the trust document, as in Situation 1. State decanting statutes constitute a grant of "local law" authority on the trustee which is not generally "precluded" under a trust document. Because 30 years or more worth of qualified subchapter S trust instruments were actually executed previous to the advent of state trust decanting statutes generally, it can also be argued that the Preamble comment that "a trust instrument could not feasibly preclude the addition to a trust of a beneficiary that is mandated by a court of law" applies equally to the addition to a trust of a beneficiary by a decanting trustee, at least in the case of a trust which became irrevocable prior to the existence of trust decanting statutes.

In Situation 1, the additional beneficiary (or permissible beneficiary) is named in the trust document. In Situations 2 and 3, he is not. In Situations 2 and 3 the additional beneficiary (or permissible beneficiary) is not precluded from being named, but he is also not currently named. This subtle distinction between Situations 1 and Situations 2 and 3 applies similarly in the state trust decanting statute situation. Similar to Situation 2, most trust instruments do not preclude trust decanting, but unlike Situation 1, they also do not direct that a second beneficiary (or permissible beneficiary), including a trust, exist. In other words, the failure to "preclude" trust decanting is not fatal to the qualification of a trust as a QSST because, similar to Situation 2, above, additional action by the trustee is required in order to create the existence of a second beneficiary, including a trust.

The above construction of the regulations is supported later in the regulations themselves, in the following example found in Section 1.1361-1(k):

> **Example 5: QSST when current income beneficiary assigns the income interest to a person not named in the trust.** On January 1, 1996, stock of Corporation R, a calendar year S corporation, is transferred to a trust that satisfies all of the requirements to be a QSST. Neither the terms of the trust nor local law preclude the current income beneficiary, K, from assigning K's interest in the trust. K files a timely QSST election that is effective January 1, 1996. On July 1, 1996, K assigns the income interest in the trust to N. Under applicable state law, the trustee is bound as a result of the assignment to distribute the trust income to N. Thus, the QSST will cease to qualify as a QSST under section 1361(d)(3)(A)(iii) because N's interest will terminate on K's death (rather than on N's death). Accordingly, *as of the date of the assignment,* the trust ceases to be a QSST and Corporation R ceases to be an S corporation. [Emphasis supplied]

Notice that, in this example, K always possessed the ability to disqualify the trust as a QSST (i.e., K was not "precluded" from disqualifying the trust), but until K actually did assign K's interest to N, the QSST was not disqualified.

A trustee may possess the ability to decant to a trust, or to modify an existing trust, which new or modified trust may or may not qualify as a QSST. The Treasury regulations nevertheless direct that the existing trust will only (and potentially) be disqualified as a QSST when and if the trustee actually decants. When and if the trustee does decant, the new or modified trust will need to stand on its own footing, and qualify as a permissible shareholder in an S corporation either as a QSST, as a ESBT, or as another permissible trust under Section 1361(c)(2)(A).

## Transfer Tax Issues

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)), 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.

## Moving Forward

Under a literal reading of the applicable Sections of the Code, and based upon a clear and studied reading of the Internal Revenue Service's regulations, the mere ability of a trustee of an existing trust to decant to another trust should not disqualify the existing trust for QSST treatment. Furthermore, and under a literal reading of the UTDA and "Missouri-style" trust decanting statutes, estate planners in most states are currently able to decant an existing QSST to a ESBT, including a ESBT which includes appropriate Section 678 current income withdrawal powers. Finally, and under this same line of reasoning, state legislatures and the Uniform Law Commission should consider amending their existing trust decanting rules to remove any restrictions which would arguably prohibit decanting an existing QSST to any other form of trust, including a ESBT. ■