Section 678

Estate Planning with Section 678 of the Internal Revenue Code : Part Two

A continuation of a review of the drafting options available to preserve flexibility and avoid automatic trust distributions to beneficiaries for purposes of asset protection, estate tax protection, and divorce protection, along with general protection for young and/or spendthrift beneficiaries.

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Impact of the SECURE Act and the Proposed RMD Regulations

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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? **1** Many will argue it does not make sense anymore, because of the compressed trust income tax brackets combined with the compressed payout period for IRAs and

401Ks under the SECURE ACT. The "compressed trust tax brackets penalty" would become even greater if tax provisions similar to those included in last year's "Build Back Better Act," which would have imposed a 5% surtax on trust taxable income over $200,000 and 8% on trust taxable income over $500,000, eventually becomes law. **2** As discussed in Part One of this article (Part One), however, the drafter can handle the compressed trust tax brackets penalty by judiciously utilizing **Section 678** in the drafting of the trust. This allows the income of the trust to be taxed at the beneficiary's income tax rates and brackets, rather than at the trust's.

Thus far the discussion has focused on estate planning strategies applicable to so-called "accumulation trusts," or trusts which do not require that the trust's income be distributed currently. These same strategies will not be successful in the case of so-called "conduit trusts," however, because conduit trusts mandate that all IRA and plan distributions to the trust must in turn be distributed out to the designated beneficiary of the trust, upon receipt. Conduit trusts obviously help solve the compounded negative impact of compressed trust income tax brackets combined with the new compressed post-death RMD deferral period, but they do so at the expense of obviating the reasons estate planning attorneys use trusts in the first instance, e.g., asset protection, estate tax protection and divorce protection, along with general protection for young and/or spendthrift beneficiaries. Conduit trusts cannot solve all of clients' estate planning concerns the way incorporating **Section 678** into accumulation trusts can.

Existing trust documents which establish accumulation trusts may also 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 five-year default period. Because IRA, etc., payments will be

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20% or more per year under the five-year default rule (assuming level annual withdrawals), it will normally be important for 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 the new **Section 401(a)(9)(E)(i)** . **3** As discussed in Part One, in order to avoid large estate tax includible "hanging power" amounts in accumulation trusts funded with IRAs and/or 401Ks, with the added potential for lowering the overall income tax liability of the family, consideration should also be given to adding multiple **Section 678** withdrawal powers in accumulation trusts funded with these types of benefits.

Existing trust documents may also need to be modified to take advantage of situations where lifetime deferral may still be available, including especially trusts for minor beneficiaries, special needs and chronically ill beneficiaries, and beneficiaries who are less than 10 years younger than the account owner (i.e., eligible designated beneficiaries). Lifetime deferral is also available for trusts which benefit a surviving spouse, but the trust would need to be drafted as a conduit trust, with all of the deficiencies described in Part One.

The Proposed Regulations issued in late February 2022 **4** clarify that the life expectancy of the designated beneficiary and, in the case of an employee who was in pay status at the time of his or her death, the life expectancy of the employee, are relevant in that they will determine the minimum annual distributions during the 10 years after the account owner's death until, at the 10-year point, the balance of the account must be distributed. **5**

In the case of trusts, the Proposed Regulations also clarify that:

- Permissible appointees under a testamentary power of appointment are to be disregarded, for beneficiary designation purposes;
- Takers under a contingent gift clause are generally disregarded, for beneficiary designation purposes; and
- The first taker or takers after the death of the life beneficiary are relevant beneficiaries for beneficiary designation purposes, as are the taker or takers (presumably only the first taker or takers) in default of appointment. **6**

The Proposed Regulations provide generally that trust beneficiaries "are identifiable if it is possible to identify each person eligible to receive a portion of the employee's interest in the plan through the trust." **7** If the account owner "names a class of individuals as the beneficiary (such as grandchildren)," the preamble to the Proposed Regulations provides that "the addition of another member of that class (for example, the birth of another grandchild) will not cause the trust to fail to meet the identifiability requirements" - though it is somewhat difficult to find this language in the Proposed Regulations themselves.

Although the Proposed Regulations do not generally consider potential appointees under a power of appointment as being relevant beneficiaries under the identifiability requirements, for some reason they do focus on them (arguably exclusively), as relevant beneficiaries, if before September 30 of the year after the account owner's death, the class of potential appointees is narrowed or otherwise altered. **8** The Proposed Regulations understandably appear to only look at the actual appointees as being relevant under the identifiability requirement if the power is irrevocably exercised (or limited) prior to September 30 of the year after the account owner's death. Although it is not crystal clear in the Proposed Regulations and preamble, the implication in the Proposed Regulations appears to be that a revocable exercise of a power of appointment, e.g., under a power only exercisable under the beneficiary's will, where the beneficiary has not yet died, will be disregarded, because the power holder has not irrevocably exercised the power as of the date of the account owner's death, or by September 30 of the year after his or her death.

Takers in default of appointment are generally relevant under the SECURE Act, but for some reason the Proposed Regulations, as well as the preamble to the same, appear to imply that takers in default of appointment are disregarded if, by

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September 30 of the year after the account owner's death, the class of potential appointees is irrevocably restricted or otherwise altered. In that situation, the members of the restricted class of potential appointees, and not the takers in default of appointment, appear to be relevant beneficiaries for purpose of the identifiability requirements. Hopefully the reasoning behind this arguably inconsistent treatment will be clarified in the Final Regulations.

Prior to the issuance of the Proposed RMD Regulations earlier this year, special trust drafting language needed to be employed in order to maximize income tax deferral and achieve income tax basis step-up in trusts where the plan was to pay IRA and/or other defined contribution plan benefits to the trust after the account owner's death. **9** In general this special type of drafting will no longer be required if the above-referenced provisions of the Proposed Regulations are finalized. Because permissible appointees (including under a conditional general power of appointment included to achieve income tax basis step-up) are generally not considered relevant for beneficiary identification purposes under the Proposed Regulations, and because takers under a contingent gift clause are likewise generally not considered relevant for these purposes, it should no longer be necessary under the Proposed Regulations to address such situations in a special and restrictive manner.

Estate Planning for Married Couples' IRAs and 401ks

The rise in the stock market prior to this year, teamed with the passage of the SECURE Act three years ago, and the scheduled 50% reduction in the size of the federal estate tax exemption in the year 2026, has resulted in a renewed interest in estate planning for IRA and 401k accounts owned by married couples. For married couples owning such assets, 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 the other non-tax objectives outlined above.

In 2013 Congress permanently passed into law as the "portability election" for assets passing outright to a surviving spouse at the first spouse to die's death. The portability election 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 and future generations' 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 assets transferred to a bypass trust for a surviving spouse are avoided; 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.

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

In light of these limitations of the spousal portability election when compared to so-called "bypass trust planning," whereby married couples

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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 **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, since, as described in Part One, the trust is not even taxed to the extent the surviving spouse is taxed instead. What is more, utilizing **Section 678** 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, and again as discussed in Part One, 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.

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 income tax sense after the SECURE Act, given the demise of so-called "stretch IRA" treatment for 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 extending 10 years 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 "after tax" economic 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.

Trust Planning for S Corporations

25 years ago **Section 1361(e)** , commonly referred to as the Electing Small Business Trust (ESBT), 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 (QSST), 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.

Section 1361(c)(2)(A)(i) provides that a "trust all of which is treated (under subpart E of part I of subchapter J of this chapter) as owned

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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 **Section 1361(c)(2)(A)(i)** . Finally, **Section 1361(d)(1)(B)** provides that, for purposes of ection 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.

An ESBT is handled differently under the Code. With an 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)** and the regulations thereunder. **Reg. 1.641(c)-1** 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.

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 a 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;
> (2) 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.

In light of these 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 Part One, judicious use of **Section 678** in the drafting of the ESBT 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** . Utilizing **Section 678 of the Code** therefore will cause an estate or generation-skipping transfer tax-exempt ESBT to not only retain more transfer tax-exempt assets, but these trust assets will 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 **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.

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As described in Part One, 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 **Section 2514(e)** . Similar to the already-described analysis applicable in the case of accumulation trusts receiving substantial annual payments of IRA or 401k proceeds under the SECURE Act, multiple **Section 678** withdrawal powers (i.e., in the beneficiary's children, etc.) can be employed, if necessary, to lessen the potential of a significant **Section 2041** estate tax inclusion in any one beneficiary resulting from the "hanging amount," if the S corporation is expected to produce substantial annual income.

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, as described in Part One, the lapsed portions of the withdrawal rights generally will be so protected. 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,

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assuming the trustee in the first place 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."

There needs to be one word of caution when applying **Section 678** 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, **Reg. 1.671-2(b)** 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 an 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 **Reg. 1.678(a)-1** refers to Regs. "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."

Reg. 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)** . 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.

If a trustee feels that an existing irrevocable QSST would be better structured as an 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)**), 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

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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, an ESBT, read closely the statutes may actually permit this form of decanting to take place.

Epilogue

As alluded to at the conclusion of the preceding section of this article, 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 to the beneficiary, which may have the effect of interfering with 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 this is 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 which are already payable to the trust, nor can a "trust amendment" generally add beneficiaries to a 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.

1 As described in Part One, *Estate Planning with* ***Section 678 of the Internal Revenue Code*** *: Part One*, 49 ETPL 9 (September 2022), this is typically done for reasons of protection of trust assets against immaturity or a spendthrift beneficiary, lawsuits, divorce and estate taxes.

2 Compare to taxable income levels of $10 million and $25 million for individuals.

3 See **I.R.C. Section 401(a)(9)(H)(i)** .

4 The proposed regulations had not been finalized at the time this article was finalized, and are discussed herein according to the language proposed. The author anticipates the language of the final regulations will largely reflect that of the proposed.

5 See **Prop. Reg. 1.401(a)(9)-5(d)** .

6 See **Prop. Reg. 1.401(a)(9)-4(f)** .

7 **Prop. Reg. 1.401(a)(9)-4(f)(5)(i)** .

8 See **Prop. Reg. 1.401(a)(9)-4(f)(5)(ii)** .

9 See Blase, *6-7-8: Estate Planning with* ***Section 678 of the Internal Revenue Code*** (2022), at pp. 28-32.