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Decanting a Trust: How to Aerate Your Assets

Trust decanting offers a way to alter the terms of an irrevocable trust to better suit the interests of the settlor or beneficiaries.

Much like your favorite aged Bordeaux, your trust, sealed up by its irrevocable terms, may contain unwanted or outdated terms, provisions or other impurities that prevent it from functioning as desired. By decanting, or pouring assets from one trust into another, a trustee may be able to cure these deficiencies.

Basis for Decanting

When looking to decant trust assets, it is generally because there is something that needs to be changed in the terms of the trust. Historically, changing an irrevocable trust typically required some form of judicial modification. Not surprisingly, judicial modification was usually undesirable due to the cost, time and other legal barriers associated with court involvement. As the law and the trust documents themselves evolved, to a limited extent, changing document provisions became less cumbersome. However, even with the easing of restrictions on modifying trusts, the determination of whether trust provisions could be changed often hinged on the level of trustee discretion to invade principal or income for beneficiaries. Unless a trustee had unlimited power to determine income and principal distributions, they were limited in what modifications could be made, if any.

To allow for flexibility, many states have enacted or modernized existing decanting statutes to allow for trust modification. To date, twenty-five states have some form of decanting statute. However, while these laws provide a means and guidance to making modifications, there are still several gray areas as to the impact of decanting, particular with respect to taxes.

Potential Uses for Decanting

The use of decanting is highly dependent on the laws under which a trust is governed. While it is beyond the scope of this article to review each state's decanting statute and which powers they may or may not grant, the following is a list of potential changes that can typically be made through decanting:

- Administrative change
- Protecting tax treatment of a trust
- Granting or changing powers of appointment
- Changing of trusteeship
- Dividing or consolidating trusts
- Correcting any error or ambiguity within the trust terms
- Adjusting withdrawal rights
- Adjusting distribution standards
- Adjusting the trust term
- Adding or eliminating a beneficiary
- Converting a trust's status to grantor or non-grantor
- Changing a trust's situs
- Adding or removing a spendthrift provision

As this list indicates, the changes that can be made run the gamut of trust reform. In addition to the types of modifications that can be made, state statutes can also differ as to who must consent to such changes. For example, some states place the power to decant solely in the hands of the trustees, while others may require beneficiary consent depending on the changes being made. Along with these considerations, trustees must also be cognizant of possible tax implications of decanting, which unfortunately, may be difficult to anticipate.

Tax Considerations

In most instances, it is believed that decanting is not a taxable event either for income tax or estate, gift and generations skipping tax purposes. However, because many of the tax issues with respect to decanting are unsettled, care must be taken when looking to decant a trust even if operating under the provisions of state statutes.

For income tax purposes, IRS has ruled that in general a decanting is not a recognition event with respect to capital gains. However, in certain circumstance a decanting could trigger gain. For example, if a trust with liabilities in excess of trust asset basis is decanted to convert from a grantor to a non-grantor trust, that decanting would likely trigger a gain.

In addition to gain issues, it remains an open question as to whether a decanting would be considered a distribution for fiduciary income tax purposes. If it is a distribution, a decanting from one trust to another would carry net taxable income from the old trust to the new trust. As a practical matter, whether the old or new trust is taxed on trust income may not make a difference. However, a distribution from a trust can impact trust tax attributes (passive activity loss carryovers, capital loss carryovers, investment interest expense carryovers, etc.), which could cause adverse tax results. The argument as to whether a decanting is a distribution could also turn on whether a trust is fully or partially decanted, which can lead to inconsistent tax results.

From a transfer tax standpoint there are also many unanswered questions. For example, if a trust is decanted to reduce or eliminate a beneficiary's interest in that trust and applicable state law requires that beneficiary's consent, is that consent a gift to the other beneficiaries? For generation-skipping transfer tax (GST) purposes, if a trust is GST exempt and is then decanted to extend the trust term or make that trust perpetual, could a gift be triggered, or could that trust lose its GST exemption?

In 2011, IRS issued Notice 2011-101 asking for comments on the potential federal tax consequences of decanting. The specific areas IRS sought to review include: shifts in beneficiary interests, rights, powers, and their ability or inability to consent, the conversion of a trust to grantor or non-grantor status, the change in trust situs, GST issues and the various effects of state law. In short, IRS has been reviewing everything about decanting. To date, IRS has not released additional guidance with respect to this Notice and it is possible they will hold off making further rulings until legislation has been enacted by the majority of states. Although there does exist a uniform trust statute, it has yet to receive wide support among state legislatures. As a result, many of the tax ramifications of decanting remain up for debate, and may continue to be for some time.

In Closing

In adding flexibility, decanting statutes are generally seen as a welcome development for trustees trying to implement a settlor's intent in the face of legal, economic or family changes. A trust flawless in its design when created may end up outdated or even potentially harmful with the passage of time. In allowing for simplified and efficient trust modification, these statutes provide a tool to correct for these issues. However, when taking advantage of this tool, trustees and their advisors must consider the ramifications of decanting, including possible hidden tax traps, particularly when the tax law with respect to decanting remains very much unsettled.

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Brexit and Its VAT and Customs Consequences

On June 23, 2016, a majority of the United Kingdom (UK) decided that their country should leave the European Union (EU), known as Brexit.

Both sides now look forward to possibly lengthy treaty negotiations before they can put their legal and economic relations on a new basis. Due to this impending exit, it is advisable for businesses to keep an eye on the development of the tax and legal issues and to make appropriate preparations.

British Prime Minister Theresa May outlined in her speech on January 17, 2017 a 12-point plan on what relationship Britain will seek to have with the EU once it leaves the Union. It is expected that in March 2017, the British government will formalize its request for exit to the European Commission. After that date, the negotiations regarding the new nature of the relations between the EU and UK will begin. Until that date, no legal changes will have taken place and general conditions remain unchanged.

On February 6, 2017 the Centre of European Reform estimated that Brexit would cost the UK approximately EUR 60 billion. Along with the cost itself, Brexit also affects all enterprises having their legal seat or a branch in an EU country, provided that they have some kind of business relations with UK. Further, it also affects enterprises having their legal seat outside the EU (for example, in the U.S.) that have special trade relations with the EU and sell goods or purchase goods from the UK. For this reason, it is essential for these enterprises to start considering the likely changes in the near-term, particularly because it is likely there will be serious implications in connection with VAT and customs duties with respect to the trading of goods and services with the UK. Changes will be required with regard to the processes (for example, amendment of supply chains), IT (in particular tax codes), price structuring and invoicing (including the price and the invoice text).

The EU single market and its fundamental freedoms

One of the cornerstones of the EU is free access to the single market. This means a common economic area that guarantees all EU citizens four basic freedoms:

- Free movement of persons: within the EU, all EU citizens can move freely and without border controls, reside and work.
- Free movement of goods: within the EU, goods can be freely imported and exported across state borders without customs controls.
- Freedom to provide services: services can be offered in all EU countries.
- Free movement of capital: EU citizens can decide freely where they would like to invest their money within the EU.

A country can only have free access to the single market if all four above-named basic freedoms can be guaranteed. The UK has decided that it no longer wants to guarantee the free movement of persons, i.e. unrestricted access of EU citizens to the British labour market. Therefore, the UK will no longer be able to participate in the single market.

VAT / customs duties and Brexit

It can be assumed that the UK VAT system will remain in force after Brexit given that it represents a share of around 20% of the entire fiscal revenue. However, when interpreting the corresponding regulations, the British authorities and courts would no longer be bound by European law and to the decisions by the EU Court of Justice. This calls into question how the VAT system is imposed in the UK after Brexit.

From a customs standpoint, European customs legislation is a central part of EU law and makes it possible to achieve the fundamental freedom of the free movement of goods. Since 1994, the customs legislation in the EU member states was no longer based on national and local provisions, but instead on the Union Customs Code. The basis for this is the EU Customs Union, which forbids the levying of customs duties and charges in connection with the trade in goods between member states, and which also introduced a uniform customs tariff in relations with third countries.

After Brexit, the UK will have the status of a third country. The UK would then be entitled to give itself its own national customs regulations, and to levy customs duties as it sees fit. Likewise, the EU will no doubt also levy customs duties on the import of British goods.

As a result, the shipment of goods from the EU to the UK must be declared as an export rather than intra-Community supply. Until Brexit, the corresponding regulations of an EU member state must consequently be complied with, in particular the burden of proof in the case of a supply that is exempt from tax. Once Brexit occurs however, it will no longer be necessary to make Intrastat declarations and recapitulative statements when shipping goods to UK.

When goods are purchased from the UK to the EU, these transactions will no longer be an intra-Community acquisition, but an import into the EU, with possible import VAT as well as customs duties levied. Until the UK and EU negotiate new trade and customs agreements, companies must deal with these uncertainties created by this post-Brexit reality.

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Know Your Sources: The Importance of the Weight of Authority in Tax Planning

Most individuals prefer simplicity over complexity. Not surprisingly, this premise extends to tax planning.

However, for many wealthy individuals complex tax planning is a reality, if not an outright necessity. As such, when dealing with more complex tax planning, the strength of a tax position or structure relies upon the sources or authorities on which that position or structure is based. It therefore becomes paramount to consider the weight of these authorities when determining a tax plan's likelihood of success.

The most impactful and binding types of authority are called primary sources. These primary sources are tax law authorities that must be followed and include: the Internal Revenue Code, U.S. Treasury Regulations, Revenue Rulings, and Revenue Procedures. Primary judicial sources include: the Supreme Court of the United States, Courts of Appeal, District Courts, and the U.S. Tax Court. It is important to note that some sources may be primary in some jurisdictions but not binding in others. For example, state law in New York is controlling in New York but not controlling in Florida, although Florida may choose to follow or find New York law persuasive in reaching its decision.

Internal Revenue Service and U.S. Treasury Department issue regulations to provide guidance for new legislation or to address issues that arise from existing Internal Revenue Code sections. Regulations interpret and illuminate direction on complete compliance with the law. The Federal Registrar also publishes these regulations for the guidance of the general public. Regulations can take the form of final regulations, proposed regulations or temporary regulations. Final regulations have the effect of law. Proposed regulations do not have the effect of law until they become finalized. When proposed regulations are published, IRS will solicit comments from practitioners, which they may or may not take into account. These regulations are then either finalized as originally proposed, finalized after changes based on those comments, or not at all. In fact, there are many instances of existing proposed regulations that have never been finalized. It should be noted, while not law, proposed regulations are illustrative of IRS line of thought on any given subject. In addition, there are times when IRS will allow (but not require) taxpayers to rely on proposed regulations at the taxpayer's discretion. Temporary regulations are effective upon publication; however, they expire after three years and are usually replaced by newly enacted final regulations.

A revenue ruling is an official interpretation by IRS of the Internal Revenue Code, related statutes, tax treaties and regulations. Revenue rulings are controlling law but secondary to subsequent legislation, regulations and court decisions. A revenue ruling embodies an IRS conclusion on how the law should be applied and construed in certain circumstances. *The Internal Revenue Bulletin* and the *Cumulative Bulletin* both publish revenue rulings for the information and guidance for taxpayers, tax professionals and IRS personnel.

A revenue procedure is an official statement of procedure that affects the rights or duties of taxpayers and other members of the public under the Internal Revenue Code, related statutes, tax treaties and regulations that should be a matter of public knowledge. Like revenue rulings, the *Internal Revenue Bulletin* also publishes revenue procedures. The most distinguishing difference between a revenue ruling and a revenue procedure is that while a revenue ruling generally states an IRS position, a revenue procedure provides return filing or other instructions concerning an IRS position. For example, a *revenue procedure* might specify how those entitled to deduct certain home mortgage interest on a vacation home may calculate the deduction, yet a *revenue ruling* may show a certain set of circumstances in which that home mortgage interest on the vacation home was deductible and other circumstances in which it was not.

If a primary source is unavailable or not fully illustrative, tax practitioners looks to secondary sources. Although never binding law, they can be quite helpful and persuasive when utilized correctly. Secondary sources include: private letter rulings (PLRs), technical advice memorandums (TAMs), journal and law review articles, treatises and IRS publications.

A PLR is a written statement issued to a taxpayer, which interprets and applies tax laws to the taxpayer's specific set of facts. IRS issues a PLR to establish with certainty the federal tax consequences of a particular transaction before the transaction is consummated or before the taxpayer's return is filed. IRS only issues a PLR upon a submitted written request by a taxpayer and is binding on IRS if the taxpayer fully and accurately described the proposed transaction in the request and carries out the described transaction accurately as well. Though a PLR may not be relied upon as precedent by other taxpayers or IRS personnel, it can be a highly persuasive tool when clients find themselves in similarly applicable circumstances. Moreover, due to its highly persuasive nature, it is one of the most utilized types of sources. PLRs are generally made public once personal information is removed that could in any way identify the taxpayer. For very complex transactions, PLRs are often the most useful guidance available.

TAMs are guidance furnished by the Office of Chief Counsel upon the request of an IRS director or an area director appeals in response to technical or procedural questions that develop during a taxpayer's proceeding. A request for a TAM generally stems from the examination of a taxpayer's return, consideration of a taxpayer's claim for a refund or credit or any other matter involving a specific taxpayer under the jurisdiction of the territory manager or the area directors appeals. As opposed to PLRs, TAMs are issued only on closed transactions and provide guidance on the proper interpretation and application of the tax laws. Additionally, TAMs represent the final determination of an IRS attitude concerning a matter but only with respect to that specific issue. Like PLRs, TAMs are highly persuasive in nature when employed correctly when a taxpayer's circumstances are similar to those at issue in the guidance. TAMs are also made available to the public once personally identifiable information has been removed.

Tax planning is often complicated and relies on what can be equally complicated rules. It is critical not just that these different rules are understood, but also that the weight of authority these different rules have are understood as well. When implemented correctly, the sources discussed provide the strong foundation upon which tax planning is built.

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What is Qualified Small Business Stock (QSBS)?

As business and business needs continue to emerge and change in this ever-evolving economic environment, tax practitioners must carefully assess how these changes impact or create planning opportunities.

Because of the considerable tax benefits, one such opportunity, Qualified Small Business Stock (QSBS), has become an integral part of planning for small and growing businesses and business owners. For practitioners advising these clients, one of the new questions of the day is if and how QSBS fits into in the new and growing FinTech industry.

What is Qualified Small Business Stock

QSBS is stock of a domestic C corporation whose gross assets at the actual issuance of the stock do not exceed $50 million. While QSBS has existed since August 11, 1993, more recent tax law passed in September 2010 has significantly enhanced the benefits. Specifically, for QSBS acquired after September 28, 2010 and held for five years, a taxpayer is able to exclude up to $10 million of the capital gains from taxation.

Holding the stock for five plus years as well as making sure the corporation has gross assets under $50 million dollars at the time of issuance is a relatively straightforward and quantifiable measurement. However, where determining the qualification for QSBS can be more subjective is the additional requirement that the company must be a *qualified trade or business*.

Qualified Trade or Business

The Internal Revenue Code defines qualified trade or business for purposes of QSBS as any trade or business other than:

- Any trade or business involving the performance of services (and the Internal Revenue Code lists a number of specific service businesses) or any trade or business where the principal asset of such trade or business is the reputation or skill of one or more employee
- Any banking, insurance, finance, leasing, investing or similar business
- Any farming business
- Any business involving the production or extraction of products where depletion is allowable

As noted above, companies that derive revenue from services or skilled labor will generally not qualify as QSBS. Even though some service industries will rarely ever change, others are constantly changing, even more so with the Information Revolution that is currently still taking place. In particular, one of the biggest industries to have recently appeared is *Fintech,* an industry which cannot simply be labeled either a *service* or *technology* company.

Rise of FinTech

FinTech is the term used for an economic industry composed of companies that use technology to provide or help financial services. It encompasses a wide range of companies from Credit Karma to Square. It has been coined as one of the most promising new industries by sites such as Forbes and The Economist and many in the start-up community have sought and are still seeking market share in this growing industry.

As an industry that is trying to disrupt incumbent financial systems and challenge traditional corporations that are less reliant on software, these small startups are one of the perfect places to begin investing in a world that has become more dependent on technology and less dependent on human skills. For those making early investments in start-ups in the FinTech industry, the ability to exclude the first $10 million of capital gain from federal taxation is certainly a welcome and added bonus to any return.

Does FinTech Qualify?

As defined, FinTech companies dabble in two sectors that were once seen to be wholly different. It is therefore not surprising that certain companies classified under FinTech lean more towards the Tech while others more towards the Fin. Certainly, those companies that lean more towards the Finance of the FinTech will find it more challenging to claim a QSBS position as any financing business is specifically stated as a disqualified business under the tax law. However, what about those companies that lean more towards Technology? Is it enough to overshadow their involvement in financing and qualify them for QSBS?

Diving Deep

By way of example, FinTech companies such as Square are immediately better known for their technological products such as the Square Reader. Yet their involvement with financials, such as Square Register, software that combines payment processing with point-of-sale functionality like itemization and inventory management, raises the question as to whether such activity defines them as a finance company for purposes of QSBS.

Breaking the rules down: the two biggest points of emphasis made for businesses excluded is 1) the company's dependence on the skill/reputation of one or more of its employees, and 2) whether the company performs legitimate services in the disqualified industry. A company such as Square is not so heavily dependent on its employees' skills to bring in revenue but rather in the functionality of their technological products, bypassing the first rule that would have effectively banned it from qualifying.

A part of Square's revenue, however, also comes from a percentage of each transaction when a card is swiped with its Square Reader. The question becomes, is Square effectively performing a service to its clients in the finance industry? At least some practitioners believe the answer to be no.

In one Tax Court case, IRS challenged an entity structured as a training facility for an insurance business, and denied QSBS status as a disqualified service business, relying on the reputation or skill of one or more employees. The court disagreed with the IRS argument and indicated that the principal asset of the company was the training and organization structure. As such, the reasoning in this case provides an understanding that a company with primary assets in something other than the skill or reputation of individuals such as technology, but functioning as a facilitator in a disqualified industry, does not necessarily disqualify that company from meeting QSBS requirements.

Square's main line of business is providing software and hardware products that help streamline financing for the client, but its actual business does not perform the financial services. As a result, Square shares could effectively qualify for QSBS treatment for those investors who acquired shares when the company's gross assets were still under $50 million.

Similar yet Unique

Although there are similarities, the question of whether a corporation in the FinTech industry can qualify for QSBS treatment must be determined on a case-by-case basis and with careful consideration and analysis to effectively come to a conclusion. While taxpayers can benefit greatly, it is advisable to work with a professional advisor familiar with the intricacies of QSBS to address all the requirements and avoid traps.

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