Office of Chief Counsel
Internal Revenue Service
memorandum

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subject: "Non-grantor, irrevocable, complex, discretionary, spendthrift trust"

This memorandum may not be used or cited as precedent.

SUMMARY: This memorandum discusses a marketed trust structure which mistakenly interprets § 643 of the Internal Revenue Code (the "Code") to remove certain trust income from current taxation. CC:PSI first discovered promotional material relating to the structure in March 2021, and subsequently informed SB/SE Division Counsel. This memorandum describes the structure and explains why it does not provide the claimed benefit. While we have reviewed the promoters' materials, we have not reviewed specific taxpayers' documents in relation to the structure. Therefore, this is a general discussion which does not rely on any facts unique to specific taxpayers and we do not include any taxpayer identifying information. Our legal conclusions are based on the summarized materials and may change if a particular case offers different facts.

For simplicity, this memorandum is limited to rebutting the promoters' misinterpretation of § 643. We do not address whether some or all of these structures could be recharacterized as grantor trusts under § 671, and, if needed, will issue a supplemental memorandum on that question. Similarly, we do not address the statements in the promoters' materials that appear to advise taxpayers to treat certain taxable trust distributions as deductible payments of trust expenses or the treatment of sales to the trust. In addition, we do not discuss the following questions:

1. The gift, estate, or generation-skipping transfer (GST) tax consequences of the structure. Specifically, we do not address whether transfers to or from the trust are “taxable gifts” as defined in § 2511.
2. The trust’s purported “asset protection” benefits, including whether state or federal courts will find that the terms of the trust provide protection from the claims of creditors including claims pertaining to federal tax debts.
3. Whether any of the gross income described in this structure constitutes an “extraordinary dividend” under § 643(b).
4. Whether, in any particular case, the existence of the trust might be challenged as a threshold matter under “sham trust” principles. We assume, solely for the sake of this memorandum, that the taxpayers are observing the formalities of their trust instruments and other relevant documents and contracts. To the extent that they are not, such that their control over the property transferred to the trust does not really change, the trust might be disregarded, with all the claimed tax benefits dependent on the trust’s validity being vitiated. See Zmuda v. Commissioner, 731 F.2d 1417 (1984), and Markosian v. Commissioner, 73 T.C. 1235 (1980), for the factors used to determine that a trust arrangement is a sham.
5. Whether the transaction in general or any particular instance of it might fall into any of the categories of “reportable transactions” provided in Treas. Reg. § 1.6011-4, such as a “confidential transaction” or “transaction with contractual protection.”

DESCRIPTION OF STRUCTURE: The structure claims to provide significant tax and asset protection advantages to individual taxpayers (described herein as the “Taxpayer”). The structure is being promoted by a combination of attorneys, accountants, enrolled agents, and unlicensed tax advisors. The promotional materials consist primarily of a series of presentations (some of which can be found on various social media platforms), informational websites, short documents, and short legal opinions. The materials state that the trust being offered complies with Scott on Trusts, the Uniform Trust Code, the Restatement of Trusts (Third), and the Code. Some materials specifically note that the trust is “section 643 compliant”. The materials describe the trust by its purported characteristics, typically a combination of the terms “non-grantor,” “irrevocable,” “discretionary,” “complex” (or “complex with simple provision”), “section 643,” and “spendthrift.”[1] In many variations, promotional materials refer to the trust structure as a “Non-Grantor, Irrevocable, Complex, Discretionary, Spendthrift Trust”. While there is some inconsistency among the materials, the basic form and mechanics of the structure are described here.

[1] In some iterations of the promotional materials, the trust is additionally described as “copyrighted.” This appears to be a reference to a specific model or form of trust instrument that is being sold or licensed, and not a tax or legal characteristic of the trust.

Formation and oversight

A third-party settlor, acting on behalf of Taxpayer, creates and nominally funds a trust with legal documents that are provided by the promoter. Taxpayer is appointed the "Compliance Overseer" with power to add and remove trustees and change beneficiaries of the trust. The promotional materials are inconsistent as to whether Taxpayer, a third-party, or both serve as trustee. In the case of a third-party serving as trustee, it is unclear whether the third-party would be an independent trustee.

Taxpayer is not a named beneficiary of the trust. In some variations, Taxpayer's spouse and/or children are specifically named as beneficiaries but are subject to change by the Taxpayer. The trust instrument gives the trustee sole discretion to make distributions of income or principal to beneficiaries ("discretionary distributions"). It is unclear whether the Taxpayer, serving in the role of Compliance Overseer, is given a power to direct the trustee to make or withhold discretionary distributions to beneficiaries. The trust is a self-styled "spendthrift" trust or "spendthrift trust organization." There are no provisions that allow any party to revoke the trust by distributing trust assets back to the donor in termination of the trust.

An accompanying letter described as a legal opinion ("legal opinion letter") states that the trust is in "in compliance with the IRC" and thereby must obtain an Employer Identification Number (EIN) and file Form 1041, "U.S. Income Tax Return for Estates and Trusts" (in addition to any other filing requirements) annually as a complex trust. A subsequently dated legal opinion letter from the same source notes that the trust is "not subject to turn over orders by any court. This limits the liability of Beneficiaries and Trustees of the Trust. It also makes the corpus of the Trust unreachable by creditors."

Funding

The trust is primarily funded by Taxpayer selling assets to the trust in exchange for a promissory note (styled as a "demand note" in certain materials).[2] The promotional materials do not discuss issues relating to the trust's initial capital, creditworthiness, or ability to make payments on the promissory note. Nor do the materials outline requirements related to the terms of the note, such as having a defined period for repayment. Certain materials do discuss the requirement for debt instruments of the trust to charge adequate interest (not specifically in relation to the demand note).

Certain materials claim that the sale of assets to the trust is a non-taxable event, noting that the trust's purchase price is the "book value" of the assets rather than their fair market value, such that the trust retains Taxpayer's basis in the assets. Further, there is a presumption that any of the Taxpayer's business assets (including real estate, equipment, or intangible property) sold to the trust will be leased back to Taxpayer or an

[2] Examples of assets appropriate for funding the trust by 'sale' include equipment, real estate, computers, websites, handbooks, copyrights, trademarks, and proprietary operating systems.

entity owned or controlled by Taxpayer. A few variations recommend that (1) Taxpayer transfer up to a 90% interest in a limited liability company ("LLC") (or another type of business entity) owned by Taxpayer to the trust, (2) the Taxpayer will cause the LLC to sell certain assets (including intellectual property (IP)) to the trust, and (3) Taxpayer will cause the LLC to lease back those assets and IP from the trust for a payment that is approximately equal to 70% of the monthly income of the LLC.

Income earned by the trust

The promotional materials claim that almost none of the income generated by the trust is subject to current federal income tax if the trustee allocates such income to corpus and refrains from making distributions to beneficiaries. The legal basis for these assertions regarding federal income taxation rely on § 643 of the Code.

To support the assertion that all income from the sale or exchange of capital assets ("capital gains") is excluded from federal income tax, the materials quote § 643(a)(3), without context (emphasis in original):

> "IRC Section 643(a)(3) Capital Gains and Losses – gains from the sale or exchange of capital assets shall be EXCLUDED to the extent that such gains are allocated to corpus and not (A) paid, credited, or required to be distributed to any beneficiary during the taxable year . . ."

Next, the materials claim that the trustee may characterize any remaining trust income as an "extraordinary dividend", which the materials claim is not subject to current taxation so long as the trustee allocates such income to corpus. The materials find support for this claim in § 643(a)(4):

> "if a fiduciary has the sole and absolute authority to designate something as extraordinary dividends or taxable stock dividends, and that designation is paid to the corpus of the trust and not subject to distribution, then it is not income to the trust according to Rule 643 [sic]."[3]

The accompanying legal opinion letters do not expound on this assertion, claiming only that the trust structure "provides the exclusion of extraordinary dividends and taxable stock dividends from items of gross income because the structure allows the Trustee to allocate these dividends to the corpus of the Trust." Another memorandum styled as a legal opinion letter simply states, "[c]apital gains, extraordinary dividends and taxable

[3] Several promoters rely on a private letter ruling issued by this office as support for their claim that extraordinary dividends described in § 643(a)(4) are not subject to current taxation. Some materials refer to this ruling as "Private Letter Ruling # PLR-133314-14 issued May 8, 2015" or "IRS Private Letter Ruling 133314-14" See PLR 201519012. This private letter ruling held that a certain distribution that a trust received from an LLC pursuant to a settlement agreement is considered an extraordinary dividend "excluded from the definition of "income" *within the meaning of § 643(b) (*emphasis added)."

stock dividends when allocated by the trustee to the corpus of the trust in good faith are not taxable income to the trust." That memorandum subsequently quotes from § 643 without explanation or context.

LAW:

Section 61(a) of the Code provides that, except as otherwise provided, "gross income" means all income from whatever source derived.

Section 63(a) generally defines the term "taxable income" as gross income minus the deductions allowed by Chapter 1 of the Code.

Section 641(a) generally provides that the tax imposed by § 1(e) applies to the taxable income of estates or of any kind of property held in trust including income which, at the discretion of the fiduciary, may be either distributed to the beneficiaries or accumulated.

Section 641(b) provides, in part, that the taxable income of a trust shall be computed in the same manner as in the case of an individual, except as otherwise provided in this part [§§ 641 through 685]. The tax shall be computed on such taxable income and shall be paid by the fiduciary.

Section 643(a) defines the term "distributable net income", for purposes of this part [§§ 641-685] as meaning, with respect to any taxable year, the taxable income of the estate or trust computed with certain modifications listed in §§ 643(a)(1) through (7).

Section 643(a)(3) provides that gains from the sale or exchange of capital assets shall be excluded [from "distributable net income"] to the extent that such gains are allocated to corpus and are not (A) paid, credited, or required to be distributed to any beneficiary during the taxable year, or (B) paid, permanently set aside, or to be used for the purposes specified in § 642(c).

Section 643(a)(4) provides that for purposes only of subpart B [§§ 651 and 652] (relating to trusts which are required to distribute current income only (i.e., "simple" trusts)) there shall be excluded [from "distributable net income"] those items of gross income constituting extraordinary dividends or taxable stock dividends which the fiduciary, acting in good faith, does not pay or credit to any beneficiary by reason of his determination that such dividends are allocable to corpus under the terms of the governing instrument and applicable local law.

Section 643(b) provides that for purposes of subparts A, B, C, and D [§§ 641-668], the term "income," when not preceded by the words "taxable," "distributable net," "undistributed net," or "gross," means the amount of the income of the estate or trust for the taxable year determined under the terms of the governing instrument and applicable local law. Items of gross income constituting extraordinary dividends or taxable stock dividends which the fiduciary, acting in good faith, determines to be allocable to corpus under the terms of the governing instrument and applicable local law shall not be considered income.

Section 1.643(a)-0 of the Income Tax Regulations provides that the term “distributable net income” has no application except in the taxation of estates and trusts and their beneficiaries. It limits the deductions allowable to estates and trusts for amounts paid, credited or required to be distributed to beneficiaries and is used to determine how much of an amount paid, credited, or required to be distributed to a beneficiary will be includible in that beneficiary’s gross income. It is also used to determine the character of distributions to the beneficiaries. Distributable net income means for any taxable year, the taxable income (as defined in § 63) of the estate or trust, computed with the modifications described in §§ 643(a)(1) through (7) and the regulations thereunder.

Section 651 provides in the case of any trust the terms of which provide that all of its income is required to be distributed currently, and do not provide that any amounts are to be paid, permanently set aside, or used for the purposes specified in § 642(c), there shall be allowed as a deduction in computing the taxable income of the trust the amount of the income for the taxable year which is required to be distributed currently.

Section 651(b) provides, in part, that if the amount of income required to be distributed currently exceeds the distributable net income of the trust for the taxable year, the deduction shall be limited to the amount of the distributable net income.

Section 661(a) provides that in any taxable year a deduction is allowed in computing the taxable income of a trust (other than a trust to which subpart B applies), for the sum of (1) the amount of income for such taxable year required to be distributed currently, and (2) any other amounts properly paid or credited or required to be distributed for such taxable year, but such deduction shall not exceed the distributable net income of the estate or trust.

ANALYSIS:

Contrary to the claims of the promotors, the trust will recognize income on its capital gains and dividends, except to the extent those amounts are distributed or deemed to be distributed to its beneficiaries.

The promotional materials support their claims about the tax benefits of their structure by reading subsections of § 643 out of context. The materials do not address § 641 which provides the basic rule that the trust’s taxable income is computed as it is for individuals, with certain modifications. Instead, the materials look to § 643(a) for guidance as to the definition of “taxable income”. In so doing, the materials fail to consider the beginning of that section, which expressly states that the section defines “distributable net income” rather than “taxable income.”

A non-grantor trust is considered a separate taxable entity for income tax purposes. A non-grantor trust computes its gross income in much the same manner as an individual. Most deductions and credits allowed to individuals are also allowed to estates and trusts. However, there is one primary distinction. A trust is allowed an income distribution deduction for distributions to beneficiaries. See §§ 651 and 661. A trust's deduction for distributions to beneficiaries is limited to the lesser of (1) amounts that the trust properly pays or credits to beneficiaries during the taxable year (or amounts that are required to be paid or credited to the beneficiaries during the taxable year under the trust instrument if not actually distributed) or (2) the "distributable net income" of the trust.

Section 643 defines the concept of the "distributable net income" (or "DNI") of the trust. DNI not only limits the amount that the trust can deduct for distributions to beneficiaries, but it also determines the amount on which the beneficiaries can be taxed as a result of those distributions. See §§ 652 and 662. The income distribution deduction of the trust coupled with the gross income inclusion to beneficiaries ensures the income of the trust is taxed either to the entity or to the beneficiaries, but not to both.

Under § 643(a), DNI is calculated by making certain modifications to the trust's taxable income. Some of these modifications include subtracting certain items of gross income from DNI that may not be distributable to beneficiaries who are entitled to receive trust "income". This, in turn, depends on the economic rights of trust beneficiaries determined under the trust instrument and applicable local law for the taxable year at issue. As background, a trustee apportions items of gross income or tax-exempt receipts of the trust between two different classes of beneficiaries, a class that is entitled to trust "income" as defined under the trust instrument and applicable local law (i.e., the "accounting income" of the trust), and a class of beneficiaries (sometimes referred to as "remainder beneficiaries") entitled to certain amounts of gross income allocated to trust "corpus" or "principal". Gross income that is allocated to trust principal can be accumulated by the trust for distribution in subsequent taxable years or at the time of the trust's termination. Gross income that is allocated to trust income is either distributed to beneficiaries in the current taxable year or, depending on the terms of the trust instrument, can be accumulated by the trust for distribution in subsequent taxable years.

If a trust excludes all capital gains and extraordinary dividends from income within the meaning of § 643(b), that simply means that the trust will subtract those capital gains and extraordinary dividends from DNI under § 643(a), so long as those amounts are not actually distributed to the beneficiaries. In turn, subtracting those amounts from DNI simply means that trust has a lower threshold for the deduction that it can take for distributions to beneficiaries authorized by § 651 (for simple trusts) or § 661 (for complex trusts). If a non-grantor trust does not make (and is not required to make) any distributions to its beneficiaries, then it is not entitled to any "income distribution deduction". Therefore, all of the income attributable to capital gains and extraordinary dividends must be reported by the non-grantor trust as income on Form 1041.

The promoters of this structure mistakenly assume that income in § 643(b) refers to the taxable income of the trust. However, the first sentence of § 643(b) provides that, within the parts of the Code encompassing §§ 641 through 668, any references to "income" without preface refers to the accounting income of the trust rather than another concept of income such as "taxable income". References to other types of income will be denoted by their full name, such as "distributable net income" or "taxable income". See e.g., § 641 describing rules related to the computation of "taxable income".

RECOMMENDATION:

In each case using this structure, as a threshold matter, the trust's income tax returns should be examined to ensure that (a) the trust is reporting all of its taxable income, including capital gains and any income that is described as an extraordinary dividend, and (b) ensure that the trust is disallowed any deduction claimed with respect to such income solely because the trustee, acting in good faith, has allocated such income to the corpus of the trust.[4]

Please call Jennifer N. Keeney or Darshan H. Chulani at (202) 317-6850 if you have any further questions.

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[4] Certain promotional materials include a description of tax reporting used in this structure as shown on the Form 1041. This sample From 1041 reflects that capital gains and other amounts of gross income characterized as extraordinary dividends are included as part of the trust's "total income", however, the sample Form 1041 shows that the trust claims a deduction on line 15a (other deductions not subject to 2% floor) in an amount that corresponds to the amount included in income. These promotional materials suggest that, in some variations, a statement is included with the return to explain this deduction.