HOW TO FIX A BROKEN TRUST THROUGH DECANTING

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I. Overview.

A typical estate plan often includes the use of one or more irrevocable trusts. However, as a result of the passage of time and change in circumstances, trustees and beneficiaries are often frustrated by the constraints imposed by the trust instrument. Trust law has greatly changed over time and the terms of an existing irrevocable trust agreement may lack the flexibility necessary to adjust to unforeseeable changes in law or other circumstances. Furthermore, the terms of the trust agreement may no longer satisfy the grantor's intent.

There are several tools that are available to practitioners to amend an irrevocable trust agreement to better fulfill the objectives of the grantor and the beneficiaries. The purpose of this outline is to highlight how the various states decanting statutes may be used to modify the terms of an irrevocable trust.

II. Decanting.

The word decant means to pour a liquid from one vessel to another. In the trust context, the liquid is the trust assets and the vessels are the trust instruments.

Under the common law of certain jurisdictions, a trustee that has the ability to distribute principal from a trust to or for a beneficiary may instead exercise such authority by distributing the assets in further trust for the beneficiary. Phipps v. Palm Beach Trust Company, 142 Fla. 782 (1940); Wiedenmayer v. Johnson, 254 A.2d 534 (N.J. Super. Ct. App. Div. 1969). Several states have codified the common law concept of decanting.

In 1992, New York became the first state to enact a decanting statute specifically authorizing a trustee in certain situations to pour assets of one irrevocable trust into another trust. NY Estates, Powers & Trust Law § 10-6.6(b). Since then at least ten other states have also enacted decanting statutes. These states include Alaska, Arizona, Delaware, Florida, Nevada, New Hampshire, North Carolina, Ohio, South Dakota and Tennessee.

A. Concept Behind Decanting Statute.

The various state statutes that permit a trustee to exercise a decanting power vary in their details but all operate off the same fundamental premise. If a trustee has the ability to invade principal for a beneficiary under the terms of a trust agreement, the trustee may, in the exercise of its principal invasion power, appoint the principal to a new trust for the benefit of some or all of the beneficiaries of the first trust. Although the concept behind the decanting statute is fairly simple, its implications are immense.

Decanting statutes can be used to update the terms of a governing instrument by pouring over all of the assets from a trust governed by an outdated instrument to a new trust that contains modern administrative provisions that will afford more flexibility to the trustee and beneficiaries. The decanting statute can also be used in certain situations to affect the beneficial interests in a trust. However, as explained later in this outline, care must be taken to avoid the imposition of any negative tax consequences as a result of the decanting.

B. Requirements for Use of Decanting Statute.

The various statutes all have different requirements that must be satisfied in order for a trustee to be able to avail itself of the benefit of the state's statute. However, there are common themes which run throughout the majority of the state's statute.

1. **Principal Invasion Right.**

As a starting point, the trustee of the first trust must have the ability to invade principal for the benefit of one or more of the beneficiaries of the trust. The various states differ in their requirements with respect to the principal invasion right. For instance, Delaware, Alaska, and Tennessee permit a trustee that has the authority to invade principal to decant the assets into a new trust even if the principal invasion power is limited by a standard. Florida on the other hand requires the trustee to have an absolute power to invade principal which is not limited pursuant to an ascertainable standard.

South Dakota appears to have the only decanting statute which does not require that a trustee have some principal invasion right in order to utilize the statute. Under South Dakota law, a trustee can decant income from one trust to another. S.D. CODIFIED LAWS § 55-2-15. The South Dakota statute therefore expressly authorizes distribution of income from one trust to another trust.

Delaware's decanting statue was recently amended to clarify that the trustee's exercise of the decanting power must comply with any standard imposed by the first trust. 12 Del. C. § 3528(a)(5). For example, if the first trust provides that the trustee may only distribute trust principal to the beneficiaries for their health, education, maintenance and support, the second trust must limit distributions to the beneficiaries only for their health, education, maintenance and support. Delaware's statute would allow the second trust to further restrict the purposes for which distributions could be made, but the distribution standard may not be broadened. For example, the second trust could provide that distributions shall only be made to the beneficiaries for their education, but it could not allow distributions to be made for any purpose not related to the standard contained in the first trust.

2. **Permissible Beneficiaries.**

The state decanting statutes impose limitations on a trustee's ability to exercise the decanting power. All of the statutes require that the trustee's exercise of the decanting power be in favor of one or more of the beneficiaries of the first trust. As such, the decanting statute cannot be used to add beneficiaries to the second trust that are not beneficiaries of the existing trust.

In certain states the decanting statute may be used to eliminate beneficiaries of the existing trust. For instance, assume trust one provides that the trustee can distribute trust principal to A, B and C in its sole and absolute discretion. The trustee may be able to utilize its decanting power to distribute the trust assets to trust two which only benefits B and C. This provision may be beneficial if a trustee desires to divide a pot trust into separate trusts for the beneficiaries of the first trust.

Some states decanting statutes permit the new trust to grant beneficiaries of the existing trust powers of appointment not otherwise set forth in the original trust. For instance, both Delaware and Nevada permit the new trust instrument to grant a beneficiary of the existing trust a general or limited power of appointment, thereby allowing the decanting to indirectly add beneficiaries to the first trust by granting beneficiaries of the second trust powers of appointment not otherwise contained in the first trust. This seems consistent with the basic concept behind decanting which is that if the trustee could distribute trust assets outright to the beneficiary, the trustee should be able to exercise such principal invasion power by distributing the assets in further trust which such further trust grants the beneficiary a power of disposition over the trust assets.

3. **Elimination of Beneficiaries' Rights in Trust.**

Some state decanting statutes prohibit the decanting from eliminating certain rights a beneficiary may have over the trust. For instance, New York, Alaska and Tennessee prohibit the decanting power from reducing any fixed income interest a beneficiary may have in the trust. Under Delaware law, the decanting power may not be used to eliminate a fixed income right with respect to a trust that qualifies for the marital deduction. 12 Del. C. § 3528(a)(5).

Delaware's decanting statute can be used to eliminate a fixed income right with respect to a trust that does not qualify for the marital deduction. For instance, assume the terms of trust one provide that all of the income is to be distributed to A during her lifetime and also gives the trustee the ability to distribute principal to A for her health, education, maintenance and support. Under Delaware's decanting statute, the trustee could decant all of the assets of trust one to trust two which eliminate A's mandatory income interest in the trust and instead allows the trustee to distribute income and principal to A in its sole and absolute discretion for her health, education, maintenance and support.

Another issue that often arises in a decanting is whether the decanting can eliminate a beneficiary's right of withdrawal over the trust property. Some states, such as North Carolina, provide that if a beneficiary has a power of withdrawal over trust property in trust one, the terms of trust two must provide the beneficiary with an identical right of withdrawal or sufficient property must remain in trust one to satisfy the outstanding power of withdrawal. N.C. Gen. Stat. § 36C-8-816.1.

Other states, such as Delaware, permit a decanting to eliminate a beneficiary's right of withdrawal over trust property as long as the right of withdrawal is not presently exercisable. 12 Del. C. § 3528(a)(4). For example, assume the terms of the first trust provide that the trustee may distribute income and principal of the trust to or for the benefit of A in its sole and absolute discretion and that upon attaining the age of thirty-five (35), A shall have the ability to withdraw all of the trust assets. As long as A has not attained the age of thirty-five (35) prior to the decanting, the decanting statute of certain states would permit trust two to eliminate A's right to withdraw the assets upon attaining the age of thirty-five (35).

4. **Notification to Beneficiaries.**

Most of the decanting statutes provide that the authority to decant is in the sole and absolute discretion of the trustee and that it is not necessary to obtain beneficiary consent in order for a trustee to exercise its decanting power. Some states such as Arizona, Nevada, New York and North Carolina permit a trustee to seek judicial approval for a decanting.

5. **Governing Law Considerations.**

Another issue that often arises in a decanting relates to whether the law of the particular jurisdiction must govern the first trust in order for the trustee to avail itself of the benefits of that particular jurisdiction's decanting statute. For instance, assume that trust one provides that Indiana law governs the validity, construction and administration of the trust and there is no mechanism contained in the trust instrument to transfer the situs of the trust or otherwise change the administrative laws governing the administration of the trust. Is it possible for a trustee to be appointed in another jurisdiction that has a decanting statute, such as New York, transfer all of the assets to the New York trustee and then have the New York trustee decant the trust assets under New York's decanting statute notwithstanding the fact that Indiana law continues to govern the validity, construction and administration of trust one?

Several state decanting statutes provide that the use of the statute to decant shall be considered the exercise of a limited power of appointment. For instance, Delaware's statute specifically states that the trustee's decanting power shall be considered the exercise of a limited power of appointment. 12 Del. C. § 3528(c).

Many states make it clear that the validity of the exercise of a limited power of appointment is governed by the law where the trust is sitused at the time the power is exercised. Therefore, if a trust is originally created outside of a state that has enacted decanting legislation, the trustee should be able to decant pursuant to the state's decanting statute once the trust is sitused in that particular state notwithstanding the fact that another jurisdiction's laws govern the validity, construction and the administration of the trust. Delaware recently clarified this concept by specifying in its decanting statute that the decanting power may be exercised notwithstanding the fact that another jurisdiction's laws govern the trust as long as the trust is sitused in Delaware and administered in Delaware.

C. Tax Consequences of Decanting.

There are several tax issues for a trustee to consider when deciding whether to decant the trust assets. The Internal Revenue Service recently issued a notice (Notice 2011-101) requesting comments on the tax implications of trust decantings that result in a change in the beneficial interest in the trust. The Estates and Trusts Section has formed a committee to draft a response to Notice 2011-101 on behalf of the Delaware State Bar Association.

1. **GST Tax Consequences.**

The Treasury Regulations provide certain safe harbors for determining whether a modification to an irrevocable trust will result in loss of GST grandfathered protection. As long as the following conditions are met, a decanting should not result in the loss of GST exempt status: (i) the exercise of a decanting power does not cause a beneficial interest in the trust property to be shifted to a beneficiary in a lower generational slot for GST purposes; and (ii) such distribution to a new trust does not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust. Treas. Reg. § 26.2601-1(b)(4)(i)(d)(1).

In certain situations it may be desirable to utilize a state's decanting statute to extend the duration of a GST exempt trust. The Treasury Regulations provide a safe harbor for the extension of an exempt trust pursuant to a decanting or other modification. The Regulations provide that such a decanting or modification will not result in loss of GST exempt status if (i) state law permitted a trustee to appoint in further trust without the consent or approval of any beneficiary or court at the time the trust became irrevocable, <u>or</u> (ii) the terms of the governing instrument of the exempt trust authorize distributions to the new trust without the consent or approval of any beneficiary or court <u>and</u> (iii) the terms of the governing instrument of the new trust do not extend the time for vesting of any beneficial interest beyond any life in being at the date the original trust became irrevocable plus a period of twenty-one years. Treas. Reg. §26.2601-1(b)(4)(i)(A).

As previously mentioned, the first decanting statute was enacted in 1992 seven years after the effective date of the GST tax. Therefore, grandfathered trusts cannot satisfy the first prong of the safe harbor in the Treasury Regulations which requires authority under state law permitting the trustee to appoint in further trust at the time when the trust became irrevocable. To come within the safe harbor the trustee must rely on the argument that the applicable state common law in existence on the date the trust became irrevocable permitted the appointment of assets in further trust. The second trust must also not extend the vesting of any beneficial interest in the trust beyond any life in being at the date trust one became irrevocable plus a period of twenty-one years.

2. **Gift Tax.**

There are two potential issues to be concerned with relating to the gift tax consequences of a decanting: (i) if a beneficiary is also serving as trustee, will the decanting have gift tax consequences and (ii) if a beneficiary consents or acquiesces to a decanting which eliminates a beneficial interest does the beneficiary make a taxable gift to the trust. In most situations if a beneficiary is serving as a trustee, the trust will be restricted in how the trust assets may be distributed to that beneficiary. For instance, the trustee/beneficiary will only be permitted to distribute trust assets to such trustee/beneficiary for his or her health, education, maintenance and support. Therefore a distribution in further trust which continues to restrict how the assets may be utilized for such beneficiary should not result in any negative gift tax consequences to the trustee/beneficiary.

A more difficult issue involves whether the beneficiary's consent or acquiescence to a decanting which eliminates or reduces a beneficiary's interest in the trust rises to the level of a taxable gift. For instance, assume the terms of the governing instrument permit the trustee to distribute income and principal to A for any purpose and provide that upon A attaining the age of thirty-five (35) all of the assets are to be distributed outright and free of trust to A. Further assume the trustee decants all of the assets to trust two which extinguishes the trustee's requirement to distribute the remaining trust assets to A upon her attaining the age of thirty-five (35) and instead provides that all of the trust assets shall remain in further trust for A's lifetime. If A consents to the decanting, the IRS could argue that A's right to receive the assets upon attaining the age of thirty-five (35) is equivalent to a general power of appointment and A's consent to the decanting is a lapse or release of the general power of appointment. This would result in trust two becoming a self-settled trust with respect to A either upon the decanting or upon A attaining the age of thirty-five (35).

3. **Estate Tax.**

As a general matter, no adverse federal estate tax consequences should arise as a result of the decanting. As previously mentioned, several states permit a decanting to grant a beneficiary of trust one with a power of appointment not otherwise contained in trust one. Many states allow the power of appointment to be a general power of appointment or a limited power of appointment. To the extent trust two grants a beneficiary of trust one a general power of appointment, the assets would be includible in the beneficiary's estate upon his or her subsequent death.

4. **Income Tax.**

In most situations a decanting will not give rise to a recognition event. However, the distribution may carry out a proportionate share of trust one's distributable net income under the tier system.

Typically when a decanting results in all of the trust assets being distributed from trust one to trust two, the trustee will file a final fiduciary income tax return for trust one and obtain a new taxpayer identification number for trust two. As such, trust two is treated as a separate taxpayer. There is at least one Private Letter Ruling which suggests that if all of the trust property is decanted from trust one into trust two, then trust two will be the same as trust one for income tax purposes. PLR 200736002.

D. Trustee Liability.

The decision to decant is typically in the sole and absolute discretion of the trustee. However, often it is the beneficiaries who have the desire to modify the terms of the governing instrument and who approach the trustee with a request to decant. This can put the trustee in a difficult position in that the trustee wants to accomplish the beneficiaries' goals but at the same time is concerned about the potential liability associated with the decanting.

For example, assume the beneficiaries approach the trustee with a request to decant all of the assets into a new trust which contains the same beneficial provisions but provides for an investment adviser to direct the trustee with respect to the investment of the trust assets. In the event the trust portfolio declines as a result of the investment performance by the investment adviser, the trustee could face a breach of fiduciary duty action from the beneficiaries as it was the trustee's sole discretion to decant the assets to a new trust which was no longer managed by the trustee.

Typically a trustee will require that all of the interested parties sign consent, release and indemnity agreements in connection with a decanting. However, there could be situations where it is not desirable from a tax standpoint to have a beneficiary consent to a particular decanting. The trustee must then decide whether it is willing to decant the assets as requested by the beneficiary in light of the potential liability.

III. Common Modification Desired by Beneficiaries.

Common modifications accomplished through decanting:

1. The transfer of situs of the trust to a particular jurisdiction and the reformation of the trust so such jurisdiction's laws thereafter govern the administration of the trust.

2. Bifurcation of trustee responsibilities through the appointment of advisers to direct the trustee with respect to particular functions.

3. Modification of other administrative provisions of the trust (i.e., succession of trustee provisions, accounting provisions, trustee powers, etc.).

4. Modification to beneficial terms of the trust (i.e., removing beneficiary withdraw rights at certain ages so trust assets may stay in further trust for a beneficiary's lifetime as opposed to being distributed at specified ages).

5. Conversion of grantor trusts to non-grantor trusts for income tax purposes.

6. Division of a pot trust into separate trusts for the benefit of a sole beneficiary.

7. Correction of a mistake or ambiguity contained in the trust agreement.