THE TAX CONSEQUENCES OF DECANTING:

AN OVERVIEW OF THE GIFT, ESTATE, INCOME AND GENERATION-SKIPPING TRANSFER TAX ISSUES TO CONSIDER WHEN CONTEMPLATING A TRUST DECANTING

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The Tax and Non-Tax Aspects of Decanting Irrevocable Trusts

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The Tax Consequences of Decanting: An Overview of the Gift, Estate, Income and Generation-Skipping Transfer Tax Issues to Consider when Contemplating a Trust Decanting

By Michael M. Gordon, Todd A. Flubacher, Meryl G. Finkelstein and Cynthia D.M. Brown

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. Decanting has become one of the preferred mechanisms for amending irrevocable trusts. The purpose of this outline is to highlight the tax issues to consider when decanting a trust.

II. Concept Behind Decanting Statute.

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 who has the ability to distribute principal outright 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), In re: Estate of Spencer, 232 N.W.2d 491 (Iowa 1975). 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 the principal of one irrevocable trust into another trust. NY Estates, Powers & Trust Law § 10-6.6(b). Since then, at least sixteen other states have also enacted decanting statutes. These states include Alaska, Arizona, Delaware, Florida, Illinois, Indiana, Kentucky, Missouri, Nevada, New Hampshire, North Carolina, Ohio, Rhode Island, South Dakota, Tennessee and Virginia.

The various state statutes that permit a trustee to exercise a decanting power vary in their details but all operate off of 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 alter the beneficial interests in a trust.

III. Recent IRS Action.

The Internal Revenue Service has recognized that decanting is an emerging issue with tax consequences that are not entirely clear under current law. In 2011 decantings were added to the "no ruling list" pursuant to Rev. Proc. 2011-3.

The Internal Revenue Service recently issued a notice (IRS Notice 2011-101) requesting comments on the tax implications of trust decantings that result in a change in the beneficial interests in the trust. For purposes of the notice, a change in beneficial interests occurs when the interests of one or more beneficiaries of the first trust are changed or terminated under the second trust and/or when the second trust adds a beneficiary who did not have any interest under the first trust.

Several organizations, including the Delaware Bar Association, through the Estates & Trusts Section, and the Delaware Bankers Association, have filed responses to IRS Notice 2011-101. Provided below is a list of the tax issues the IRS is requesting comment on:

A. Income Tax Issues:

1. Whether the existence of a decanting power causes the trust to be treated as a grantor trust under Internal Revenue Code ("IRC" or "Code") § 671.

2. Whether the distribution of property from one trust to another trust through a decanting should be treated as a distribution requiring the calculation of distributable net income ("DNI").

3. Whether the distribution from one trust to another will cause the trust to recognize gain under IRC § 1001, if the trust holds appreciated assets.

4. Whether the distribution from one trust to another will cause any beneficiary of the distributing trust to recognize gain under IRC § 1001.

5. Whether a trust that receives all of the assets of the decanted trust receives the tax attributes of the first trust.

B. The Gift and Estate Tax Issues:

1. Whether a beneficiary whose interests are diminished as a result of the decanting has made a taxable gift.

2. Whether a beneficiary whose interests are diminished as a result of the decanting has made a transfer for purposes of IRC § 2036 or § 2038.

3. Whether the existence of a decanting power in a trust that otherwise qualifies for an estate or gift tax marital deduction under IRC § 2056(b)(7) will cause the trust to fail to qualify for the marital deduction.

4. Whether a beneficiary who consents to a decanting (either voluntarily or as a condition of the decanting) or acquiescences in the decanting has made a taxable gift.

C. The GST Tax Issues.

1. Whether a trust that has, by a decanting, received property from another trust that is a grandfathered trust for GST purposes continues to maintain its grandfathered trust status.

2. Whether decanted trust property that has an inclusion ratio of zero (0) or less than one (1), will have the same inclusion ratio in the trust receiving the decanted property.

3. Whether a trust that is not exempt from GST tax may be decanted so as to permit effective allocation of GST exemption to only a portion of the original trust.

The notice also seeks guidance (i) in how “decanting” should be defined, (ii) whether there should be additional tax consequences if the decanting is from a U.S. trust to a foreign trust or vice versa and (iii) whether a new Employer Identification Number should be required where all of the principal of the Trust is distributed to another trust.

IV. Income Tax Considerations.

A. Grantor Trust Issues.

IRC § 674(a) of the provides that a trust will be treated as a grantor trust for income tax purposes if the income or principal of the trust is subject to a power of disposition by any person without the consent of an adverse party. There are several exceptions to the adverse party rule. However, none of the exceptions apply if any person has the power to add a beneficiary to the trust.

A question that arises in a decanting is whether the new trust into which the assets of the old trust are decanted is considered a beneficiary. If so, the trust could fail to qualify for the exceptions under IRC § 674 because the trustee of the original trust would be treated as holding the power to add a beneficiary to the original trust.

The term beneficiary or beneficiaries for purposes of IRC §674 should be limited to the persons for whose benefit the trust is held and not the trust itself. The power to distribute trust property to another trust via the decanting should not disqualify the trust from the exceptions to IRC § 674(a) as long as the decanting power does not permit the new trust to include persons as beneficiaries that were not beneficiaries of the original trust.

Delaware's decanting statute specifically provides that the beneficiaries of the new trust must also be beneficiaries of the original trust. 12 Del. C. § 3528(a)(1). Therefore, Delaware's decanting statute prohibits beneficiaries to be directly added to the trust via the decanting. The addition of beneficiaries is also prohibited under the other state decanting statutes. Delaware's decanting statute does, however, permit the new trust to grant beneficiaries of the existing trust powers of appointment not otherwise set forth in the original trust, which can indirectly lead to the addition of new beneficiaries not present in either the original or the new trust pursuant to the beneficiary's exercise of the power of appointment. 12 Del. C. § 3528(a).

B. Identity of the Grantor of the Second Trust.

Another issue that may arise when property is decanted from one trust to another trust is determining who the "grantor" of the second trust is for income tax purposes. If the second trust is viewed as a continuation of the first trust, then the same person should be considered to be the grantor of both the first and the second trust.

The Illinois decanting statute specifically addresses the identity of the grantor of the second trust by providing that the grantor of the first trust is considered "for all purposes" to be the grantor of any second trust established pursuant to the statute. 760 ILCS 5/§ 16.4(t). If the second trust has other assets, then the grantor of the first trust is considered the grantor of the

second trust only with respect to the assets that are actually transferred from the first trust to the second trust. Id.

The Illinois statute is consistent with the Treasury Regulations. Treas. Reg. § 1.671-2(e)(5) provides that if a trust makes a gratuitous transfer of property to another trust, the grantor of the transferor trust generally will be treated as the grantor of the transferee trust.

An exception arises where property is distributed from the first trust to the second trust pursuant to the exercise of a general power of appointment. In such a case, the person exercising the power of appointment will be treated as the grantor of the second trust.

C. DNI and Transfer of Tax Attributes.

It is possible through a decanting to decant all of the assets of the original trust into the new trust or only a portion of the assets of the original trust into the new trust. There appears to be a difference of opinion as to whether in a complete decanting the new trust is a continuation of the old trust and should therefore continue to operate under the old trust's employer identification number or whether the new trust should obtain a new employer identification number. There are Private Letter Rulings which suggest that the new trust is merely a continuation of the old trust. PLR 200607015 and PLR 200736002.

IRC § 661 permits a trust to deduct in the calculation of its taxable income distributions the trust is required to make and distributions actually made that are permitted distributions. IRC §662 requires beneficiaries who receive distributions to include such amount in their gross incomes for the year.

The Code does not specifically include a trust which can receive distributions from another trust within the definition of beneficiary for purposes of IRC §§ 661 and 662. However, case law suggests that one trust can be a beneficiary of another trust for purposes of IRC §§ 661 and 662. Lynchburg Trust and Savings Bank v. Commissioner, 68 F.2d 356 (4th Cir. 1934); Duke v. Commissioner, 38 BTA 1265 (1938).

In a situation where all of the assets are decanted from the original trust to the new trust the tax attributes from the original trust should be carried over to the new trust. IRC § 642(h) provides that in the final year of a trust, its capital loss and net operating loss carry forward and its deductions in excess of gross income for the year will be allowed as deductions to the beneficiaries who receive the trust property. In either case, the tax attributes from the original trust should carry over to the new trust.

D. Recognition of Gain.

As a general rule the distribution of appreciated assets from one trust to another trust pursuant to a decanting should not result in recognition of gain to the trust or any of the trust beneficiaries. At the trust level, if a distribution of appreciated assets is made from one trust to another trust, IRC § 643(e) would protect the distributing trust from recognizing gain unless the trustee of the distributing trust elects to recognize the gain.

IRC § 662(a) provides that a beneficiary may experience income by reason of a trust distribution only to the extent of the trust DNI. In a decanting the DNI from the original trust is not being distributed to the beneficiary. If anything, the DNI is being distributed to the new trust.

One area of possible caution is where the decanted property includes negative basis assets, such as property with debt in excess of basis or is a partnership or limited liability company interest with a negative capital account. In such a case, gain may be triggered under the authority of Crane v. Commissioner, 331 U.S. 1 (1947. It is not clear if Crane applies to a distribution from a non-grantor trust. IRC § 643(e) provides that gain generally is not recognized on a distribution of appreciated property from a non-grantor trust.[1] Whether *Crane* trumps IRC § 643(e) is not clear. However, regardless of whether *Crane* trumps IRC § 643(e), if all of the assets of a first trust are distributed to a second trust that is considered to be a continuation of the first trust, or if both the first trust and the second trust are grantor trusts deemed owned by the same person, no gain should be recognized on the distribution.

V. Gift and Estate Tax Considerations.

A. Beneficiary's Consent to Decanting.

It is possible through a decanting to reduce, or in some cases eliminate, a beneficiary's interest in the original trust. 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. 12 Del. C. § 3528(a)(3). Delaware's decanting statute can also be used to eliminate a beneficiary's power to withdrawal trust assets provided such power is not presently exercisable. 12 Del. C. § 3528(a)(5). An issue that arises is whether a beneficiary has made a taxable gift to the new trust when the beneficiary's interest in the old trust is reduced pursuant to the decanting.

[1] Code § 643(e) does not apply where the first trust is a grantor trust. Where property encumbered with debt in excess of basis or a partnership or LLC interest with a negative capital account is transferred from a grantor trust to a non-grantor trust or to a grantor trust deemed owned by a different person, gain may be recognized under *Crane*.

In order for a gift to occur there must be an act of transfer. In the decanting context a beneficiary is not affecting the transfer of the assets from the original trust to the new trust. The trustee causes the transfer of the assets from the original trust to the new trust. The beneficiary therefore should not be treated as having made a taxable gift when a trustee exercises the decanting power to reduce the beneficiary's interest in the trust unless the beneficiary has a legal right to object to the exercise of the authority to decant. Under Delaware's decanting statute it is not necessary to obtain a beneficiary's consent to decant the trust assets or even to notify the beneficiary of the decanting. The beneficiary's mere acquiescence to the decanting should not rise to the level of a taxable gift.

A more difficult issue involves whether the beneficiary's consent to a decanting which eliminates or reduces a beneficiary's interest in the old 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 attaining the age of thirty-five (35) all of the assets are to be distributed outright and free of trust to A. Further assume that the trustee decants all of the assets to a new trust 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 a general power of appointment. This would result in the new trust becoming a self-settled trust with respect to A either upon the decanting or upon A attaining the age of thirty-five (35).

If the Grantor consents to the decanting, or provides the decanting trustee with a release and/or indemnification, the IRS could argue that the grantor retained substantial control over the trust assets under IRC §§ 2036 or 2038 of the , in an attempt to include the trust assets in the grantor's estate.

B. Trustee/Beneficiary.

In certain situations a beneficiary may be serving as a co-trustee of the trust and participate in the decanting. Typically if a beneficiary is serving as a trustee, the trustee will be restricted in how the trust assets may be distributed to the beneficiary. For instance, the trustee/beneficiary will only be permitted to distribute trust assets to the trustee/beneficiary for his or her health, education, maintenance and support. 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.

Delaware law makes it clear 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). If a trustee is constrained in making distributions pursuant to an ascertainable standard under the terms of the first trust, the new trust must also limit distributions pursuant to an ascertainable standard.

C. Marital Deduction Trusts.

Another question that arises in a decanting is whether a decanting power contained in a trust that qualifies for the marital deduction under IRC §§ 2523 or 2056 causes the trust to fail to qualify for the marital deduction. The question is whether the trustee could exercise the decanting power to distribute assets from the original trust that qualifies for the marital deduction into a new trust that would not qualify for the marital deduction.

If the authority to decant is held in a fiduciary capacity it would seem that the terms of the trust or applicable law governing the trust would prohibit the fiduciary from exercising a power over the original trust in a manner that would be adverse to the interest of the beneficiaries or violate a material purpose of the trust. It would seem that the fiduciary could not then exercise the power to decant into a trust that does not qualify for the marital deduction because doing so would not be in the best interest of the beneficiaries of the trust. Delaware's statute makes it clear that a trustee may not exercise its decanting power over a trust that qualifies for the marital deduction to distribute the assets of such trust into a new trust that reduces any income interest of any income beneficiary of such trust. 12 Del. C. § 3528(a)(3).

D. Estate Tax.

As a general matter, no adverse federal estate tax consequences should arise as a result of the decanting. As previously mentioned, Delaware's decanting statute permits a decanting to grant a beneficiary of the original trust with a power of appointment not otherwise contained in the original trust. This power of appointment may be a general power of appointment or a limited power of appointment. 12 Del. C. § 3528(a). To the extent the new trust grants a beneficiary of the original trust a general power of appointment, the assets would be includable in the beneficiary's estate upon his or her subsequent death.

E. The Delaware Tax Trap.

IRC § 2041(a)(3) and its gift tax counterpart, IRC § 2514(d), are known as "the Delaware Tax Trap." The Delaware Tax Trap applies where the holder of a limited power of appointment (the "first power") exercises the power by creating another power (the "second power") that under applicable local law can be validly exercised so as to postpone the vesting of the trust property or suspend the absolute ownership or power of alienation of such property for a period ascertainable without regard to the date of creation of the first power.

In such a case (i) the holder's exercise of the first power will be deemed a transfer subject to gift tax under IRC § 2514(d) (this is the case regardless of whether the second power is exercised) and (ii) the property subject to the decedent's exercise of the first power will be includible in the decedent's gross estate for estate tax purposes under IRC § 2041(a)(3) (which treats the decedent's exercise of a limited power of appointment as if it were the exercise of a general power of appointment).

The key to springing the Delaware Tax Trap is the exercise of the first power to create a second power that has the effect of postponing the period of the rule against perpetuities applicable to the trust that created the first power. This results in the conversion of the non-general power of appointment into a taxable general power.

As previously noted, a number of state decanting statutes, including Delaware's decanting statute, permit the second trust to grant a power of appointment to a trust beneficiary. The question is whether this will this trigger a taxable gift if the vesting period does not relate back to the perpetuities period applicable to the first trust. Most commentators believe the Delaware Tax Trap rules were designed to apply to beneficiary powers of appointment, not fiduciary powers of appointment.

Where the second trust grants a beneficiary a limited power of appointment and the beneficiary exercises that power in further trust during his lifetime to create another power that can extend the perpetuities period applicable to the second trust, the beneficiary's exercise of the power would constitute a taxable gift under IRC § 2514(d). Similarly, if the beneficiary of the second trust is granted a testamentary limited power of appointment and exercises that power, in further trust, by creating another power that can delay the vesting of trust property beyond the perpetuities period applicable to the second trust, the property subject to the exercise of the power will be included in the beneficiary's estate under IRC§ 2041(a) (3) .

To avoid the application of the Delaware Tax Trap in Delaware, the Delaware Legislature enacted 25 Del. C. § 504 in 2000. The statute provides that in the case of a limited power of appointment over property held in trust (the "first power"), if the trust is not subject to the generation-skipping transfer tax, or has an inclusion ratio of zero for purposes of the generation-skipping transfer tax, then every estate or interest in property, real or personal, created through the exercise, by Will, deed or other instrument, shall be deemed to have been created at the time of the creation of, and not at the time of the exercise of, the first power.

Delaware's decanting statute provides that the use of the statute to decant shall be considered the exercise of a limited power of appointment and shall be subject to the provisions of Chapter 5 of Title 25 of the Delaware Code concerning the time at which the permissible period of the rule against perpetuities begins and the law which determines the permissible

period of the rule against perpetuities. 12 Del. C. § 3528(c). Therefore, the trustees' exercise of their authority under Delaware's decanting statute to decant assets into new trusts is treated as the exercise of a limited power of appointment.

Delaware law would prevent a decanting which occurs in accordance with the Delaware statute from springing the Delaware Tax Trap. Under Delaware law a limited power of appointment over a generation-skipping transfer tax exempt trust cannot be exercised without relating back to the creation of the first power thereby prohibiting the application of the Delaware Tax Trap.

VI. GST Tax Considerations

A. GST Exempt Status of a Trust.

Trusts can be exempt from GST tax in two ways: (1) per Treas. Reg. 26.2601-1(b), a trust is exempt from GST tax if it is a "grandfathered trust" meaning, generally, that it became irrevocable on or before September 25, 1985 (which is the effective date of the GST Code sections); or (2) the transferor allocated GST exemption to the trust (such trusts are also sometimes referred to as "non-grandfathered trusts" or "zero inclusion ratio trusts") .

Treas. Reg. 26.2601-1(b)(1) provides that a trust can lose GST exempt status if an actual or constructive addition is made to the trust after the effective date. With respect to decanting, the concern is that the decanting may be viewed as an addition or modification to a trust that causes it to lose its GST exempt status.

Interestingly, the Treasury Regulations provide a set of rules and "safe harbors" for grandfathered trusts in order to ensure that a decanting or modification of a grandfathered trust does not jeopardize its GST exempt status, but currently there are no rules or safe harbors specifically relating to non-grandfathered trusts.

B. Decanting as the Exercise of a Limited Power of Appointment.

Many states that have adopted decanting statutes, treat the trustee's power to decant as the exercise of a limited power of appointment. Delaware's decanting statute specifically notes that the exercise of a trustee's decanting power shall be considered to be the exercise of a limited power of appointment. 12 Del. C. § 3528(c).

There is a specific Treasury Regulation that deals with the effect of the exercise of a limited power of appointment over the assets of a grandfathered trust. Treas. Reg. 26.2601-1(b)(1)(v)(B) provides that the exercise of a limited power of appointment over the assets of a

grandfathered trust will not cause a trust to lose its GST exempt status unless the exercise of the power of appointment violates the federal perpetuities period.

For purposes of this Treasury Regulation, the permissible perpetuities period under federal law will not be deemed to violated as long as the vesting or absolute ownership of an interest in trust property is not delayed beyond: (1) a life in being when the trust was created plus 21 years; or (2) 90 years from the date of the creation of the trust.

Thus, Treas. Reg. 26.2601-1(b)(1)(v)(B) would lead us to believe that if decanting is deemed to be the equivalent of exercising a limited power of appointment, then as long as the vesting of beneficial interests in the "decantee trust" (i.e., the trust to which the assets of the original trust are distributed) is within the proscribed perpetuities period, the decantee trust can differ substantively from the original trust without loss of GST exempt status.

Unfortunately, regardless of how Delaware (or other states) may treat the power to decant, the IRS concluded in PLRs 9848043 and 9849007 that Treas. Reg. 26-2601-1(b)(1)(v)(B) was not directly relevant when considering a trustee's decanting power under a state statute requiring the participation or concurrence by the court and/or the trust beneficiaries. This is unfortunate because, as we will see, Treas. Reg. 26-2601-1(b)(1)(v)(B) would allow for broader changes in the new trust than allowed under the safe harbors contained in the other relevant Treasury Regulations.

C. The "Discretionary Distribution" Safe Harbor for Grandfathered Trusts.

Treas. Reg. 26.2601-1(b)(4)(i)(A) is sometimes known as the "discretionary distribution" safe harbor and provides guidelines for determining when the distribution of trust assets from a grandfathered trust to a new trust could cause the loss of GST exempt status.

The discretionary distribution safe harbor essentially provides that decanting will not cause a grandfathered trust to lose GST exempt status if the following three requirements are met:

(1) When the trust became irrevocable, either the terms of the trust instrument or local law (i.e., a statute or common law) authorized the trustee to distribute trust property to a new trust;

(2) Neither beneficiary consent nor court approval is required for the trustee's exercise of such power; and

(3) The new trust will not delay the vesting of an interest in the trust beyond the permissible perpetuities period under federal law. For purposes of this Treasury Regulations, the federal perpetuities period is (1) a life in being when the trust became irrevocable plus 21 years; or (2) 90 years from the date the trust became irrevocable.

The first requirement of the discretionary distribution safe harbor is particularly interesting because no state had a decanting statute at the time of the effective date of the GST tax in 1985. As such, in order to comply with the discretionary distribution safe harbor, if the terms of the trust do not authorize distribution to a new trust, you would need to rely on the common law of the state in which the trust is located to authorize the decanting. Some commentators suggest that most, if not all, states authorize decanting via common law principles, but only the courts of Florida, New Jersey and Iowa have explicitly recognized a common law authority to decant.

The second requirement does not appear to prohibit a trustee from obtaining beneficiary consent or court approval of the decanting. Delaware’s decanting statute does not require beneficiary consent or court approval for the trustee’s exercise of its decanting power, although the trustee and other parties involved may choose to obtain beneficiary consent or court approval before decanting to a new trust.

With respect to the third requirement, when utilizing Delaware’s decanting statute to decant the assets of a grandfathered trust, the attorney drafting the decantee trust (or the trust officer reviewing such trust on behalf of the trustee) should be as careful as possible to ensure that the new trust contains a provision limiting the vesting period to comply with the federal perpetuities period described in the Treasury Regulations. I believe that best practice is to cite the Treasury Regulation itself in the decantee trust and provide that the intent is to comply with the aforementioned federal perpetuities period.

Under the discretionary distribution safe harbor, what changes can be made without jeopardizing the trust’s GST exempt status? If decanting only changes administrative terms of the trust, there should be no loss of GST exempt status (PLR 200607015). However, it is important to consider what provisions are merely administrative in nature and what changes may be viewed as affecting the substantive or beneficial terms of the trust.

D. The "Trust Modification" Safe Harbor for Grandfathered Trusts.

Treas. Reg. 26-2601-1(b)(4)(i)(D) is sometimes known as the "trust modification" safe harbor. The trust modification safe harbor is seen as a "catch-all" that applies when all of the requirements set forth in the discretionary distribution safe harbor cannot be met.

The trust modification safe harbor provides that a modification to a grandfathered trust will not cause loss of GST exempt status as long as:

(1) The modification will not shift a beneficial interest in the trust to a beneficiary occupying a lower generation than the persons holding the beneficial interest in the original trust; and

(2) The modification will not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust.

Regarding the first requirement, note that beneficial interests can be shifted across the same generational level or to a higher generational level than the persons holding the interest in the original trust. However, it is important to be extremely careful when shifting beneficial interests, because the Treasury Regulations and their attendant examples provide that if a trust modification results in either an increase in the amount of a GST transfer or creates a new GST transfer, there is deemed to be a shift in a beneficial interest to a lower generation beneficiary. Additionally, if the effect of a modification cannot be determined immediately after the modification is made, there is a deemed to be a shift in a beneficial interest to a lower generation.

E. Non-Grandfathered Trusts.

There are no Code sections or Treasury Regulations that deal directly with the decanting or modification of non-grandfathered trusts. However, the IRS suggested in PLR 200743028 that the Treasury Regulations applicable to grandfathered trusts should also apply to non-grandfathered trusts.

An interesting example would involve a trust to which the grantor allocated GST exemption after the state in which the trust is sitused enacted a decanting statute. If the Treasury Regulations that apply to grandfathered trusts also apply to this non-grandfathered trust, then presumably a Delaware trustee could decant pursuant to Delaware's decanting statute, and the decantee trust could shift beneficial interests in the trust to lower generations as long as no beneficiary consent or court approval is required (per the discretionary distribution safe harbor).

If the IRS ultimately decides that the GST Regulations for grandfathered trusts should not apply to non-grandfathered trusts (a result most commentators find unlikely), one could argue that Treas. Reg. 26-2601-1(b)(1)(v)(B) relating to limited powers of appointment should apply.

F. Effect of Loss of GST Exempt Status.

PLR 9522032 suggests that if a trust loses its GST exempt status, there are no immediate gift tax implications, but the grantor of the trust will become the transferor for GST tax purposes.

Logically, although there is no authority directly on point, the loss of GST exempt status should not result in all future distributions from the trust being subject to GST tax. A GST tax should only be imposed when a distribution is made to someone that could not have received a distribution from the original trust without being subject to GST tax.