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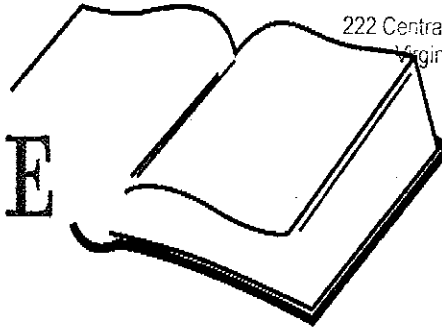

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Decanting Comes of Age

By Farhad Aghdami and Jeffrey D. Chadwick

On its face, the idea of modifying or changing an irrevocable trust seems difficult, if not impossible, and potentially contrary to the settlor's intent. In many cases, however, modifying or changing the terms of an irrevocable trust may be necessary to respond to unanticipated beneficiary needs and circumstances, to address changes in the law, to optimize the tax consequences of the trust, or to correct errors in the trust instrument. While trustees have a number of mechanisms available to modify an irrevocable trust, none may be more powerful or useful than decanting.

Decanting is the act of a trustee exercising its power to distribute trust principal to or for the benefit of a beneficiary by distributing the assets to a new trust. The best way to understand trust decanting is to visualize the physical act of decanting wine, which involves the pouring of wine from one vessel to another for the purpose of removing unwanted sediment. In the trust context, practitioners can view decanting as a trustee pouring the assets of an old trust into a new trust, with the less useful provisions — the so-called sediment — left behind.

The purpose of this article is to provide an overview of the decanting process and to explain how practitioners and trustees may utilize decanting statutes to modify impractical, inefficient,

incorrect, or outdated irrevocable trusts. Part I explores the common law origins of decanting, while Part II lists the situations in which decanting may be appropriate. Part III outlines the potential tax consequences of decanting and Part IV summarizes the eleven state decanting statutes currently in effect. Finally, Part V concludes by providing a list of best practices for trustees and practitioners when utilizing the decanting authority.

I. Common Law Origins

At first glance, decanting is a difficult concept to reconcile. It does, after all, permit a trustee to alter the terms — and arguably the beneficial interests — of an irrevocable trust. Not only does decanting seem to contradict the essence of irrevocability, it also seems to create an opportunity for trustees and beneficiaries to collude in contravention of a settlor's original intent. Despite these misgivings, a trustee's authority to decant is well-rooted in common law.

The common law rationale behind decanting is that, if a trustee has the discretionary power to distribute property to or for the benefit of a beneficiary, then the trustee has the power to distribute property to a second trust for the benefit of such beneficiary. The Restatement characterizes this power in the nature of a special power of appointment exercisable in a fiduciary capacity. *See generally* RESTATEMENT (SECOND) OF PROPERTY: DONATIVE TRANSFERS § 11.1 and RESTATEMENT (THIRD) OF PROPERTY: WILLS & OTHER DONATIVE TRANSFERS § 19.14.

The earliest reported case authorizing trust decanting is *Phipps v. Palm Beach Trust Co.*, 196 So. 299 (Fla. 1940). In *Phipps*, the Florida Supreme Court authorized a trustee with the power to distribute trust principal in his "sole and absolute discretion" to transfer the trust property to a second trust for the purpose of giving one of the settlor's children a special testamentary power of appointment to appoint trust income to that child's wife. The court determined that the trustee's power to distribute trust property to the limited class of persons designated as trust beneficiaries was a special power of appointment and that the trustee's ability to appoint property in further trust for members of the class depended upon the extent of the power authorized under the terms of the trust agreement. The court stated that "[t]he power vested in a trustee to create an estate in fee includes the power to create or appoint any estate less than a fee unless the donor clearly indicates a contrary intent." Consequently, if a trustee can distribute trust principal to a beneficiary outright, then the trustee should be able to distribute that same trust principal to a separate trust for the benefit of that beneficiary.

II. Reasons to Decant.

Once comfortable and familiar with the concept of

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decanting, a trustee may utilize its decanting authority in a wide variety of trust circumstances. While it would be both ambitious and unwieldy to provide a comprehensive list of the reasons to decant, a trustee may consider decanting to accomplish the following objectives.

A. To Change the Trust's Administrative Provisions. Decanting is not the only method by which a trustee may amend or modify an irrevocable trust. The Uniform Trust Code, for instance, contains provisions permitting modifications of trusts, reformations to correct mistakes, and combinations and divisions of trusts. A key advantage to decanting, however, is that it allows a trustee to change administrative provisions with minimal court or beneficiary interaction. Common administrative changes that may be accomplished by decanting include:

- changing trust situs or governing law;
- providing for the resignation, removal, and appointment of trustees without court approval;
- expanding the powers of a trustee to engage in sophisticated financial transactions, make or guarantee loans, adjust between income and principal, or participate in an initial public offering;
- providing for the division of trustee roles and responsibilities through the use of investment direction advisors, distribution advisors, trust protectors, or special asset direction advisors;
- addressing issues related to trustee compensation, which may be too high or too low;
- addressing trustee liability (and indemnification) for failure to diversify under the prudent investor rule with respect to an over-concentration of investment assets, such as closely held business interests;
- converting a foreign trust to a domestic trust or vice versa; and
- consolidating trusts for administrative efficiency.

B. To Address a Beneficiary-Related Change of Circumstances. A change in the grantor's family circumstances can complicate the purposes of an irrevocable trust. A trustee may utilize its decanting authority to respond to these changes by:

- limiting distributions to beneficiaries with substance abuse problems or those engaging in other unproductive behaviors;
- transferring assets to a special needs trust for a disabled beneficiary;
- limiting beneficiary rights to obtain information about the nature and extent of their trust interests by moving assets to a state, such as Delaware, where the trustee's duty to provide such information can be restricted;
- dividing single "pot" sprinkle trusts into separate trusts for each branch of the family;
- eliminating a beneficiary altogether; or
- transferring a self-settled irrevocable trust to a jurisdiction that recognizes asset protection in such circumstances.

C. To Respond to Changes in Federal or State Tax Law. When the tax laws change, the provisions of an irrevocable trust may become stale or inefficient. In these instances, a trustee may consider decanting to maximize tax efficiencies by:

- mitigating state income taxation by moving assets to a new trust in a jurisdiction that does not subject the trust to income taxation based on the trustee's or grantor's location;
- converting a non-grantor trust to a grantor trust or vice versa;

- maximizing GST planning for assets being distributed to a beneficiary outright (or over which the beneficiary has a general power) by decanting to another trust to make use of the beneficiary's and the grantor's available GST exemption; or
- dividing trusts for GST or marital deduction planning purposes.

D. To Correct Errors or Ambiguities in the Trust Instrument. When a trust document contains errors or is unclear on its face, a trustee may decant to correct a scrivener's error, address ambiguities in the original trust instrument, or add a spendthrift clause to a trust that does not contain such a provision.

III. Tax Consequences of Decanting.

Although decanting is analogous to a special power of appointment exercisable in a fiduciary capacity, the term "decant" does not appear anywhere in the Code or the Regulations. The Service, however, has recognized that decanting is an emerging issue with tax consequences that are not entirely clear under current law. For this reason, the Service placed decanting on its "no-ruling" list with respect to certain income, gift and GST tax matters. See *Rev. Proc. 2011-3*, which suggests that it is an area under study. Though it is expected that guidance may be forthcoming, to date, such guidance is not on the Service's Priority Guidance Plan. Despite this, by understanding the risks and taking the proper precautions, a trustee may decant the assets of an irrevocable trust to a new trust with minimal tax consequences.

A. Income Tax. In most circumstances, decanting will not generate any income tax consequences to the trusts or its beneficiaries. From a trust perspective, the old and new trusts will likely be treated as the same trust for income tax purposes. And from a beneficiary perspective, decanting will produce taxable gain only in limited and, more importantly, predictable circumstances.

1. *Trust Income Tax Consequences.* As a general matter, decanting assets from one domestic trust to another should not affect the income taxation of the trust because either (i) the old trust and the new trust are treated as the same trust for income tax purposes, or (ii) the transfer of assets merely carries out the original trust's distributable net income (DNI), resulting in income to the new trust with a corresponding distribution deduction for the old trust.

Under the first theory, when a trustee decants all the assets of an existing trust to a new trust, the new and existing trusts should be treated as the same trust for income tax purposes. *See Priv. Ltr. Rul. 200736002* (Oct. 26, 2007). Based on this "same trust theory," decanting should be viewed as a trust modification, and not the creation of an entirely new trust. *See, e.g., Priv. Ltr. Rul. 200723014* (Feb. 5, 2007) (ruling that a trust division would not cause a distribution under Code sections 661 or 662); *Priv. Ltr. Rul. 200607015* (Nov. 5, 2005) (ruling that a transfer of assets from existing trusts to new trusts for purposes of changing governing law and modifying administrative provisions would not cause the existing trusts, the new trusts, or the beneficiaries to realize income, gain, or loss under Code sections 661 or 662).

Even if the Service rejected the same trust theory and treated the old and new trusts as separate entities, non-recognition should still be the general rule. Under this "separate trust theory," the old trust would terminate and its DNI, including any capital gains for the year, would pour into the new trust. See Treas. Reg. § 1.643(a)-3(e), Example 7. In addition, all of the old trust's unused loss carryovers and excess deductions on termination would be transferred into

the new trust. This is because under Code section 642(h)(2), the new trust should be considered the beneficiary succeeding to the property of the old trust. The new trust would receive taxable income under Code section 662(a) to the extent of the old trust's DNI, and the old trust would be entitled to a corresponding deduction under Code section 661(a). While this should not produce a taxable event when viewed in the aggregate, it is important to consider any state income or property tax issues that may arise when transferring assets from one trust to another.

2. *Beneficiary Income Tax Consequences*. As a general rule, decanting should not cause the trust beneficiaries to realize any gain unless the trustee's appointment (i) converts a grantor trust to a non-grantor trust and (ii) the assets transferred include negative basis assets. As explained below, this general rule is a result of applying the Supreme Court's decisions in *Cottage Savings* and *Crane* to the decanting context.

a. *Cottage Savings*. A threshold issue is whether the mere act of decanting, which arguably involves the exchange of one property interest for another, causes the trust beneficiaries to realize gain or loss. The basic rule under Code section 1001 is that a taxpayer only realizes gain or loss when the taxpayer (i) sells or disposes of property (ii) in exchange for property that is materially different from the property the taxpayer sold or disposed. See Treas. Reg. § 1.1001-1(a). In *Cottage Savings Ass'n v. Comm'r*, 499 U.S. 554 (1991), the Supreme Court explained that two items of property are materially different if their owners possess legal entitlements that differ in kind or extent.

While earlier rulings called into question whether the Service would view decanting as the exchange of materially different interests in trust — see, for example, *Priv. Ltr. Rul. 199951028* and *Priv. Ltr. Rul. 200231011* — the Service clarified that decanting will not result in a beneficiary's realization of income or loss so long as the decanting is authorized by the trust instrument or governing state law. See *Priv. Ltr. Rul. 200743022*. The reason behind this treatment is the view that if a beneficiary's trust interest is subject to the trustee's discretion to decant—either under the terms of the trust or applicable state law — there is no change in the quality of the beneficiary's interest (i.e., it is not materially different under *Cottage Savings*) when the trustee actually exercises that discretion. Cf. Treas. Reg. § 1.1001-1(h) (prescribing similar rules for the severance of trusts). On the other hand, a decanting could result in a taxable exchange if the decanting is not authorized by the terms of the trust or applicable state law. See, for example, *Rev. Rul. 69-486*, 1969-2 C.B. 159 (finding that a non-pro-rata trust distribution will be treated as a taxable exchange if the trustee lacked authority to make such a distribution).

b. *Crane*. Although the mere act of decanting should not produce any taxable gain, a separate issue arises when decanting involves the transfer of negative basis assets, such as property with debt in excess of basis or an LLC or partnership interest with a negative capital account. In *Crane v. Comm'r*, 331 U.S. 1 (1947), the Court explained that, when a transferee assumes a transferor's liability in connection with a sale or exchange of property, the transferor must include in the amount realized under Code section 1001 the liability assumed by the transferee. In other words, a taxpayer's amount realized includes any debt discharged. See also Code section 752(d) (providing that a transferor's share of partnership liabilities are included in the transferor's amount realized).

Although it seems clear that the transfer of negative basis property should result in gain under

Crane, Code section 643(e) muddies the water in the trust context. Code section 643(e) provides that in the case of trust distributions of property, the beneficiary will receive a carryover basis in the property received, subject to the trustee's election to recognize any gain on the distribution. The question is whether Code section 643(e) overrides the gain recognition principles of *Crane*.

The interplay between Code section 643(e) and *Crane* causes the tax consequences of decanting negative basis property to be uncertain in several situations, including decanting from one complex trust to another complex trust or from a complex trust to a grantor trust. There is some certainty, however, when decanting between grantor trusts. First, because transactions between two grantor trusts (with the same grantor) are disregarded for income tax purposes — see *Rev. Rul. 85-13*, 195-1 C.B. 184 — no gain will be recognized on the decanting of negative basis assets from one grantor trust to another grantor trust. Second, gain will be recognized on the decanting of negative basis assets from a grantor trust to a non-grantor trust. This is because, when grantor trust status terminates during the grantor's lifetime, the grantor is deemed to realize an amount equal to any liabilities held as part of the trust property. See Treas. Reg. § 1.1001-2(c), Example 5; *Madorin v. Comm'r*, 84 T.C. 667 (1985). Code section 643(e) does not offer any protection in this context because it does not apply to grantor trusts.

B. Estate and Gift Taxes. Generally, decanting will not result in a beneficiary making a taxable gift to the decanted trust unless (i) the trustee exercising the decanting authority is also a beneficiary and the trustee's power of distribution is not limited by an ascertainable standard relating to health, education, maintenance, or support (see Treas. Reg. § 25.2511-1(g)(2)); (ii) the decanting requires beneficiary consent; or (iii) the Delaware tax trap applies.

Similarly, decanting will not result in estate inclusion for federal estate tax purposes unless (i) the new trust gives a beneficiary a general power of appointment causing estate inclusion under Code section 2041(a)(2); (ii) the new trust gives a beneficiary a testamentary limited power of appointment, resulting in the decanting being treated as an incomplete gift for gift tax purposes with the decanted assets included in the beneficiary's estate at his death pursuant to Code sections 2036 or 2038; (iii) a grantor's or beneficiary's involvement shows that the grantor had implied control over trust assets within the meaning of Code sections 2036 or 2038; or (iv) the Delaware tax trap applies. While the majority of these concepts are self-explanatory, the issues surrounding beneficiary consent and the Delaware tax trap merit further consideration.

1. *Beneficiary Consent.* If decanting shifts a beneficial interest in the trust or delays the vesting of a beneficiary's property interest in the trust, the Service could argue that when a beneficiary consents to decanting, the beneficiary exercises sufficient control over the trust assets to cause the beneficiary to make a taxable gift to the new trust. The most likely line of reasoning is that such consent would constitute the release of a general power of appointment pursuant to Code section 2514(b). While there is some argument that obtaining beneficiary consent to a decanting will result in a taxable gift, this argument should not be deemed to extend to beneficiary acquiescence, which does not involve a voluntary transfer. *See Estate of DiMarco v. Comm'r*, 87 T.C. 653 (1986), *acq. A.O.D.* 1990-26. For this reason, many state statutes require trustees to notify beneficiaries of decanting, but do not require beneficiary consent.

2. *Delaware Tax Trap.* Code section 2514(d),

commonly referred to as the "Delaware tax trap," provides that the exercise of a power of appointment will be considered a transfer for transfer tax purposes if (i) the powerholder, in exercising the power, grants another person the right to exercise a power of appointment, and (ii) under applicable local law, the new powerholder can exercise the power to postpone the vesting of any trust interest for a period ascertainable without regard to the date that the first power was created. The Delaware tax trap applies whether or not the second powerholder actually exercises the power in the prohibited manner. When a person exercises a power of appointment as provided in Code section 2514(d) during his or her lifetime, the exercise is treated as a taxable gift. If the power is exercised at death, the exercise will result in estate inclusion.

C. Generation Skipping Transfer (GST) Tax. From a GST tax perspective, a trustee's primary decanting concern is whether the decanting will cause a trust that is exempt from GST taxation—either by reason of the trust's grandfathered status or the transferor's allocation of GST exemption—to lose its GST exempt status. Although at common law and under many state statutes decanting is treated as the trustee's exercise of a special power of appointment, the GST Regulations contain explicitly different provisions for special powers of appointment (Treas. Reg. § 26.2601-1(b)(1)(v)(b)) and a trustee's distribution of trust principal from an exempt trust to a new or continuing trust (Treas. Reg. § 26.2601-1(b)(4)(i)(A)).

As a general matter, decanting will not cause an exempt trust to lose its GST exempt status if the decanting satisfies either (i) the discretionary test or (ii) the modification test. Importantly, even though the GST regulations only address the consequences of decanting the assets of grandfathered trusts, the Service has indicated that the GST regulations for grandfathered trusts should apply to trusts that are exempt by reason of the transferor's allocation of GST exemption. *See Priv. Ltr. Rul. 200743028* (May 29, 2007).

1. *The Discretionary Test.* Under the discretionary test of Regulations section 26.2601-1(b)(4)(i)(A), decanting will not taint GST-exempt status if the following conditions are satisfied:

- when the trust became irrevocable, either the terms of the trust instrument or local law (i.e., common law or state statute) authorizes the trustee to make distributions to a new trust;
- neither beneficiary consent nor court approval is required; and
- the new trust will not suspend or delay the vesting on an interest in trust beyond the federal perpetuities period, which is measured from the date the trust becomes irrevocable to the later of (i) some life in being plus twenty-one years or (ii) ninety years.

2. *The Modification Test.* In the event a decanting does not satisfy the discretionary test, it may still satisfy the modification test of Regulations section 26-2601-1(b)(4)(i)(D), which acts as a catch-all. Under the modification test, decanting will not taint GST-exempt status so long as the decanting:

- does not shift a beneficial interest in the trust to a beneficiary occupying a lower generation than the person holding the interest under the original trust; and
- does not extend the time for vesting of any beneficial interest in the trust beyond the period provided in the original trust.

Regulations section 26.2601-1(b)(4)(i)(E), Example 2 provides a good example of the interaction

between the discretionary and modification tests. Under the facts of the example, the grantor established an irrevocable trust for the benefit of the grantor's child A, A's spouse, and A's issue. When the trust was established, A had two children, B and C. The trust provided for discretionary distributions of income and principal to the beneficiaries. The trust terminated at A's death, with the principal distributed to A's issue, per stirpes. Pursuant to a decanting statute enacted after the creation of the trust, the trustee may appoint the assets to a new trust with either the consent of the beneficiaries or court approval. The trustee appointed one-half of the principal to a new trust that provided income to A for life, with the remainder passing one-half to B or B's issue and one-half to C or C's issue.

In the example provided by the regulations, the trustee's decanting does not satisfy the discretionary test because beneficiary consent or court approval is required. The decanting does satisfy the modification test, however, because it will not shift a beneficial interest in the trust and it will not extend the vesting period beyond the period prescribed in the original trust. As discussed above, though, requiring beneficiary consent could pose problems from a gift tax perspective.

3. *Consequences of Losing GST Exempt Status*. If decanting causes a trust to lose its GST exempt status, the tax consequences with respect to future trust distributions are unclear. When a trust loses its GST exempt status, the grantor becomes the transferor for purposes of Chapter 13. See *Priv. Ltr. Rul. 9522032* (June 2, 1995). The Service may argue that all future distributions from the trust are subject to GST tax (if otherwise applicable), though the better view is that a GST tax should be imposed only when a distribution is made to a person who would have been unable to receive that distribution under the terms of the original trust without being subject to GST tax.

IV. State Decanting Statutes.

Although the Florida Supreme Court first recognized a trustee's authority to decant in 1940, New York enacted the first state decanting statute in 1992. Since New York's inaugural enactment, ten other states (Alaska, Delaware, Tennessee, Florida, South Dakota, New Hampshire, Arizona, North Carolina, Nevada, and Indiana) have enacted decanting statutes. While each statute has its nuances and requires careful consideration (which exceeds the scope of this article), all enacting jurisdictions seek to balance the competing objectives of providing increased flexibility and honoring the settlor's original intent. The commonalities shared by the eleven state decanting statutes can best be explained by answering the following questions:

A. When Does the Trustee Possess the Authority to Decant? To exercise the decanting authority, (i) the trustee must have the power to decant under the terms of the trust instrument or applicable local law and (ii) the decanting must be consistent with the trustee's fiduciary duties, particularly the duty of loyalty. If the trust instrument does not explicitly grant decanting authority, a trustee may rely on a state decanting statute, which determines whether the trustee may decant based on the extent of a trustee's power of invasion. The least accessible statutes in this regard are Florida, New York, and Indiana, which require "absolute discretion" or "absolute power" to invade trust principal for a trustee to decant. The majority of states, however, require only that a trustee have some authority to invade trust principal, regardless of whether such authority is limited by an ascertainable standard.

B. Who Are the Permissible Appointees of the

Decanted Trust? All states require that the second trust name at least some of the beneficiaries named in the original trust. While this generally prohibits adding to the class of beneficiaries, it does not prevent the removal of beneficiaries. Moreover, some states, such as Delaware, Nevada, and North Carolina, permit beneficiaries of the second trust to have a limited or general power of appointment over the trust assets, which effectively allows the powerholders to add to the class of trust beneficiaries.

Older decanting statutes, such as Delaware, New York, and Tennessee, define permissible appointees to include those persons who are the "proper objects of the exercise of the power." More recent decanting statutes define the class of permissible appointees in terms of "beneficiaries," which more adequately addresses the issue of whether future or contingent beneficiaries, in addition to current beneficiaries, are permissible appointees.

C. Do the Statutes Place Any Limitations on a Trustee's Decanting Authority? With the exception of South Dakota, all states prohibit the acceleration of a remainderman's interest to a current right to receive trust distributions. Many states also prohibit decanting if it would reduce a beneficiary's fixed income, annuity, or unitrust interest in the trust. A recent trend is to include tax savings provisions designed to avoid violations of the state's rule against perpetuities, preserve marital and charitable deductions present in the original trust agreement, and prevent beneficiaries from making taxable gifts to the trust.

D. What Decanting Procedures Are Prescribed by Statute? To exercise the decanting authority, most states require a trustee to execute a decanting instrument that is (i) in writing, (ii) signed and acknowledged by the trustees, and (iii) kept with the original trust records. Some states, such as Florida and North Carolina, also impose an additional requirement that trustees provide notice of the decanting to the trust beneficiaries. And while no state makes beneficiary consent or court approval a prerequisite to decanting (due to adverse tax consequences), some states, such as Nevada and New York, permit a trustee or beneficiary to seek court approval by the trustee's or beneficiary's own initiative. Notably, Nevada also requires beneficiary consent if property designated for one beneficiary under the terms of the original trust will no longer be designated for that beneficiary under the terms of the decanted trust.

V. Conclusion

While the authority to decant vests a trustee with great power, it also vests a trustee—as well as the attorney advising the trustee—with great responsibility. If a trustee decants the assets of an irrevocable trust without due consideration of all relevant factors, the decanting could result in unintended tax consequences and even fiduciary liability.

To ensure a proper decanting, the first step is to determine that the trustee possesses the authority to decant, either by the terms of the trust or state statute. If the trust does not provide express decanting authority and the trust is being administered in a state without a decanting statute, the trustee may change the trust situs or governing law to a state that permits trust decanting. Once in a proper jurisdiction or having otherwise determined that decanting is permissible, trustees and practitioners should communicate openly and honestly with all appropriate parties, know and understand the potential tax consequences of the decanting, rely on independent trustees where appropriate, and draft a proper decanting instrument that complies with all state law requirements.

By engaging in these best practices, a trustee can utilize its decanting authority to provide flexibility to outdated documents, respond to unanticipated family circumstances, and increase tax efficiencies. Consequently, in contrast to the initial reaction of many practitioners, decanting an irrevocable trust may actually help promote the settlor's original intent by increasing benefits and advantages not otherwise available to the trust's deserving beneficiaries.

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