



The Act of Decanting: Amending Trusts Without Going to Court

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Trusts are, in the United States, one of the most important tools available for income, estate and financial planning. For reasons relating both to Federal and State tax law and the mortality of those who transfer their property into trust, those trusts are usually irrevocable by their terms.

However, sometimes, the terms of the trust do not permit that irrevocable trust to provide maximum advantage for planning, such as an opportunity to reduce income tax. Other times, circumstances change, and the trustee and beneficiaries wish the terms of the trust could be changed. In some cases, the trustee and beneficiaries wish the terms of the trust could be changed to reflect those changes. In some cases, the trustee and beneficiaries may petition a court to make changes or corrections. In that event, the courts may or may not make the desired changes.

The law with respect such judicial changes is **evolving**, and different standards may be found in various state laws, various provisions of the Restatement of Trusts, and the Uniform Trust Act. However, it is a universal truth that court proceedings, whether or not successful, can be expensive and time consuming.

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Often, a trust permits the trustees to pay trust principal over to one of more beneficiaries. That is often called a power to “invade” the trust. And now, statutes in nine states permit the trustee to invade the trust not just by paying trust principal directly to a beneficiary, but also by paying it over to a new trust for that beneficiary (or all of the beneficiaries).

The act of paying trust principal from one trust to another is commonly referred to as “**decanting**”.

Decanting in modern usage is usually viewed as the act of pouring liquid (such as wine) from one vessel or container to another. In this context, the decanting occurs by paying trust property from one trust to another trust. Decanting can often be used to allow the trust to achieve more desirable results.

Those states enacting decanting statutes are Alaska, Arizona, Delaware, Florida, Nevada, New Hampshire, New York, North Carolina, South Dakota and Tennessee. There is no “Uniform Decanting Act”, and some decanting statutes are broader and more flexible than others. For example, some states (such as Alaska and Delaware) permit decanting regardless of the standard for corpus invasion contained in the trust agreement. But others (such as New York) permit decanting only if the trustee’s invasion standard is absolute (that is, not restricted by a standard, such as the common “ascertainable standard” relating to health, support, maintenance and education).

While the above nine states have enacted specific decanting statutes, it should be noted that the Florida Supreme Court has ruled that, as a matter of common law, a trustee could invade a trust by paying the assets over for the beneficiaries to a new trust. *Phipps v. Palm Beach Trust Co.*, 196 So. 199 (Fl. 1940). Thus, decanting may also be available under the common law of those state which have not enacted an express statute. Of course, that result may not be certain, so it is often preferable to proceed under an explicit state statute.

Fortunately, Alaska’s decanting statute (AS 13.36.157), which is a relatively broad and flexible, can apply to a trust created outside of Alaska (i) if an Alaskan individual or trust company is made a co-trustee and (ii) the trustees agree that, at least for the time being, the primary place of the trust’s administration will be Alaska. Then, as long as the trust instrument permits the trustees to pay principal to the beneficiaries (even if only for specified reasons such as health, education, maintenance and support), the trustees may then **decant** (or pay) the trust assets to a new trust the terms of which are established by the trustees, which has terms more consistent with the goals sought to be achieved.

Reasons to Decant

Common reasons to consider decanting include (1) correcting a Crummey power of withdrawal to allow trust contributions to qualify for the gift tax annual exclusion under Code Sec. 2503(a) and, in some cases, the generation-skipping transfer tax “annual exclusion” under Code Sec. 2642(c) (which requires that the trust have only one “skip” beneficiary, such as a grandchild, and that the trust be included in the beneficiary’s gross estate), (2) making a trust a grantor trust for income tax purposes so the income is attributed to the trust’s grantor and so the existence of the trust is ignored for Federal income tax purposes (thereby, for example, permitting the grantor to sell appreciated assets to the trust without recognizing income), (3) allowing a trust to be a qualified subchapter S trust, (4) correcting drafting errors (such as, with respect to an irrevocable life insurance trust,

allowing any portion of the trust that is included in the grantor's estate to qualify for the estate tax marital deduction if the grantor is married at death), (5) trying to eliminate application of the so-called "reciprocal trust" doctrine, (6) granting a beneficiary a special power of appointment (which could be made exercisable only with the consent of a non-adverse trustee), and (7) extending the term of a trust so it will not terminate when the beneficiary reaches a certain age but made to last at least until the beneficiary's death.

New York was the first state to enact a decanting statute and it originally required either the consent of all beneficiaries or court approval. However, it often is extremely difficult to get the consent of all beneficiaries and there is a potential risk that the IRS might contend in some cases that beneficiary's consent to a trust "revision" is a gift by that beneficiary. Therefore, a considerable body of case law in New York developed as a framework for the type of action a trustee may take pursuant to decanting laws. That body of law is useful in all states, since all decanting statutes are derived from the original New York statute. (No court approval is now required, including in New York, for decanting).

Specifically, Approved Decanting Action

Courts have held that decanting can be used to (1) extend the terms of the trust such as providing for a trust that was to terminate when the beneficiary reached a certain age instead to last at least until the beneficiary dies (*In re Hazen*, NYLJ 12/20/97), (2) modify the administrative terms of the trust to grant greater flexibility and reduce costs of administration such as by consolidating trusts (*Matter of Vetlesen*, NYLJ 6/19/99), (3) change the location and governing law of the trust (*Matter of Riese*, 627 NYS2d 1028 (Surr. Ct. NY Cty 1995), *Matter of Kaskel*, 620 NYS2d 217 (Surr. Ct. NY Cty 1994) and *Estate of Grosjean*, NYLJ 12/20/97) which may be used to avoid a local tax, (4) make the interests in the trust "spendthrift" so they are not subject to attachment by the creditors of a trust beneficiary or eliminating a spendthrift provision so interests in the trust may be assigned (*In re Rockefeller*, NYLJ 8/24/99), (5) permit beneficiaries to remove a trustee (*Estate of Klingenstein*, NYLJ 4/20/2000), (6) convert the trust to a supplemental needs trust so as to prevent a disabled trust beneficiary from being denied governmental benefits (*Estate of Grosjean*).

Tax Effects of Decanting

To date, the IRS has issued several private letter rulings (not precedent) that indicates that there are no adverse effects of decanting as a general rule. See, e.g., PLR 200013025, 9804046, 9737024, 9438023 and 9332004. However, decanting may cause "grand-parenting" from generation-skipping transfer tax for certain pre-1986 trusts to be lost. The exercise of a special power of appointment by a beneficiary under a grand-parented trust will not cause the grand-parenting to be lost as long as the exercise does not extend the trust beyond the "normal" common law rule against perpetuities (lives in being plus 21 years). And even though, as reflected in *Phipps*, the trustee's power of invasion may be viewed as a power of appointment, Reg. §26.2601-1(b)(4)(A) provides that extension of the term of a pre-1986 trust through a decanting by a trustee will cause grand-parenting to be lost unless the power to decant was contained in the original instrument or state law when the trust was created conferred the decanting power on the trustee. All nine state decanting statutes were enacted after 1986. Hence, using them to extent the terms of a pre-1986 trust may cause grand-parenting to be lost unless, again as reflected in *Phipps*, the power existed under state common law and the decanting occurs under it rather than the newly enacted statute.

There is no regulation specifying what the consequences would be of extending the term of a trust that is exempt from generation-skipping transfer tax by reason of allocation of GST exemption as opposed to grandparenting. Hence, using decanting to accomplish that should be approached with caution. On the other hand, if the trust is not exempt from the tax, it presumably could be decanting without generation-skipping transfer tax concerns.

Of course, there may be a concern that a decanting might be viewed by the IRS as a gift by beneficiary. But case law suggests that only a voluntary transfer of property by an individual may constitute a gift for Federal gift tax purposes. Cf. *Harris v. Commissioner*, 340 US 106 (1950); *Estate of DiMarco v. Commissioner*, 87 TC 653 (1986), acq. In result only 1990-2 CB 1. The result might be different, however, if the beneficiary is the trustee. See Gans, Blattmachr & Heilborn, "Gifts by Fiduciaries by Tax Options and Elections", *Probate & Property*, November/December 2004, Vol. 18 No. 6; republished in *Digest of Tax Articles* (March 2005). In any case, the gift issue likely can be avoided by granting the beneficiary in the "new" trust a special power of appointment (which could be made exercisable only with the consent of a non-adverse party, such as a non-adverse trustee).

Put Decanting in Your Documents

Although applicable state law may provide a decanting statute, it may not be as broad as desirable. Hence, it is appropriate to consider putting a decanting power in the instrument itself. The ILS system has long offer that by checking the question "Check if trustee may create trusts." Now, we have expanded the decanting language to read as follows, which is a substantial expansion of the trustee's power:

The Trustees (other than any Interested Trustee with respect to any trust which provides that principal of the trust may be invaded for any reason other than support, maintenance, health and education within the meaning of Code Sec. 2041(b)) of any trust hereunder (referred to as the "invaded trust") may exercise any power to invade the principal of the invaded trust by appointing (whether or not there is a current need to invade principal under any standard for invasion of principal set forth in the invaded trust) part or all of the principal of the invaded trust in favor of a trustee of another trust (referred to as the "appointed trust") for the benefit of one, or more or all of those beneficiaries for whom the principal of the invaded trust may be currently paid to the exclusion of any one or more of such beneficiaries.

Unless the Trustees who so appoint the principal of the invaded trust provide otherwise in writing at the time of appointment, if all of the assets of the invaded trust are paid to appointed trust, the exercise of the power by the Trustees under this paragraph shall apply to all of the assets comprising the principal of the invaded trust, undistributed accumulated income and assets subsequently paid to or acquired by the trust that in being so invaded after the payment to the other trust. Unless the Trustees who so appoint the principal of the invaded trust provide otherwise in writing at the time of appointment, to the extent that only a portion of trust assets of the invaded trust are paid over to the appointed trust, subsequently discovered assets or assets subsequently paid to or acquired by the invaded trust shall remain assets of the invaded trust.

The exercise of the power to invade the principal of a trust under this paragraph shall be by an instrument in writing, signed, and acknowledged by the authorized Trustees. The instrument exercising the power shall be maintained with the records of the invaded trust and may be filed in any court having jurisdiction over the invaded trust.

The exercise of the power to invade the principal of a trust under this paragraph shall not be treated as being prohibited by any provision in the invaded trust instrument that prohibits amendment or revocation of the trust or that constitutes a spendthrift clause. The provisions of this paragraph shall not be construed to abridge the right of any Trustee to appoint property in further trust that arises under any statutory law or under common law, or as directed by any court having jurisdiction over the invaded trust. Nothing in this paragraph shall be construed as creating or implying a duty on any Trustee acting hereunder to exercise a power to invade principal, and no inference of impropriety shall be made as a result of a Trustee not exercising the power conferred under this paragraph.

The Trustees acting pursuant to the authority granted by this paragraph may not exercise a power to decrease or indemnify against a Trustee's liability or exonerate a trustee from liability for failure to exercise the duty of care, diligence and prudence otherwise applicable to the Trustees or to make a binding and conclusive fixation of the value of any asset for purposes of distribution, allocation or otherwise.

The Trustees acting pursuant to the authority granted by this paragraph may not exercise a power to change the provisions regarding the determination of compensation of any trustee of the appointed trust; compensation of the trustees of the appointed trust may continue and shall be determined in the same manner as in the invaded trust.

No trustee shall receive any paying commission with respect to property transferred pursuant to this paragraph. If any contribution to the invaded trust qualified for the annual exclusion under Code Sec. 2503(b), the marital deduction under Code Sec. 2056(a) or 2523(a), or the charitable deduction under Code Sec. 170(a), 642(c), 2055(a) or 2522(a), is a direct skip whether or not a nontaxable gift under Code Sec. 2642(c), or qualified for any other specific tax benefit that would be lost by the existence of the authorized trustee's authority under this section for income, gift, estate, or generation-skipping transfer tax purposes under the Code, then the Trustees shall not (1) have the power to invade the principal of a trust pursuant to this paragraph in a manner that would prevent the invaded trust from qualifying for or would reduce the exclusion, deduction, nontaxable gift or other tax benefit which was originally claimed with respect to that contribution, (2) have the power to make a change, including the grant of a power of appointment, that will result in (a) a change or modification of any standard of payment to or for one or more of the beneficiaries of the invaded trust or (b) a reduction, limitation or other change in any beneficiary's right to a mandatory distribution of income, a mandatory annuity or unitrust interest, a right annually to withdraw a percentage of the value of the trust or a right annually to withdraw a specified dollar amount provided that such mandatory or annual right has come into effect with respect to the beneficiary.

Notwithstanding the foregoing (2) but subject to (1), the Trustees may pay to an appointed trust that is a supplemental needs trust. The Trustees exercising the authority granted by this paragraph may not make a change that will violate any rule against perpetuities or similar rule limiting the duration of trusts applicable to the invaded trust and may not make a change that will disqualify a trust which owns S corporation stock and is a permitted shareholder under Code Sec. 1361(c) (2) from being a permitted shareholder.

The current beneficiaries of the appointed trust shall be one, more than one or all of the current beneficiaries of the invaded trust and the successor and remainder beneficiaries of the appointed trust shall be one, more than one or all of the successor or remainder beneficiaries of the invaded trust. If a beneficiary includes a class of persons, such class shall include any person who falls within the class of persons after the payment to the appointed trust. The appointed trust may grant to one or more of the beneficiaries of the appointed trust a power of appointment. The term "appointed trust" shall mean an irrevocable trust other than the invaded trust

to which principal is appointed under this section including but not limited to a new trust created by the Trustees (other than any Interested Trustee with respect to any trust which provides for principal of the trust may be invaded for any reason other than support, maintenance, health and education within the meaning of Code Sec. 2041(b)) on {my} behalf.”

Of course, the drafter may amend the language for his or her own documents on a case by case basis.

Summary and Conclusions

Decanting is powerful. It may correct drafting errors, “fix” potential tax problems (at least on a prospective basis), extend the time a trust may last and grant a beneficiary a power of appointment. However, there are some limits. The trustee must have the power to pay trust principal to one or more of the beneficiaries and, under the law of some states, the standard for invading cannot be changed. The beneficiaries of the new trust must include at least one or more of the beneficiaries of the original trust. Although new beneficiaries cannot be added, that result usually may be achieved by granting a beneficiary the power to add new beneficiaries.

In this time of complexity of Federal and state tax law, constantly changing family and economic circumstances, and the number of irrevocable documents that have one or more provisions that, in hindsight, are not optimal, many believe that the enactment and use of decanting statutes may be the **single greatest tool** available to the modern estate planning attorney.



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