

ESTATE PLANNING TECHNIQUES

Decanting: Eliminating Trust Sediment

By Sanford J. Schlesinger, Esq. and Martin R. Goodman, Esq.

The grantor or trustee of a trust may desire to change certain terms of the trust, if the trust ceases to effectively address the grantor's intentions due to changed circumstances, if the trust has a drafting error, or if the trust creates disadvantageous tax results. However, if an inter vivos trust is irrevocable and not amendable, then the grantor or trustee may be able to consider changing the terms of the trust by methods other than having the grantor amend it. Similarly, as a testamentary trust is always irrevocable and generally not amendable, the trustee may be able to consider what methods are available to change the terms of the trust.

Introduction

Two of the available methods of changing a trust that is irrevocable and not amendable are a judicial modification or a judicial reformation of the trust. However, these alternatives may be expensive and time consuming, and the accomplishment of the desired result may be uncertain. Another alternative, when permitted by applicable state law, is amending the trust with the consent of the grantor, the trustee, and all of the beneficiaries of the trust. However, this alternative may not be feasible, or may require judicial approval, if one or more of the trust's beneficiaries is a minor or a person not yet in being.

A third alternative, commonly referred to as "decanting," is the process by which a trustee, who has the discretion under the terms of the trust to

distribute the trust's principal to or for the benefit of one or more of the trust's beneficiaries, exercises such discretion by distributing the trust's principal to a new trust, which has all of the terms and conditions of the invaded trust, except as to those terms and conditions that the trustee desires to change.

This column will discuss decanting a trust, with particular emphasis on the recent amendment to the decanting statute in the State of New York.

The common law recognizes the concept of decanting a trust, where the trustee has the absolute and uncontrolled discretion to distribute the trust's principal to a beneficiary.¹ However, the scope of such common law power and the rules regarding its application have not been entirely free from doubt.

In order to eliminate any doubt as to the ability of a trustee to decant a trust, and in many cases to expand such authority, numerous states have enacted statutes that specifically authorize the decanting of a trust. As of this writing, Alaska, Arizona, Delaware, Florida, Indiana, Missouri, Nevada, New Hampshire, New York, North Carolina, Ohio, South Dakota and Tennessee have decanting statutes. In addition, proposed decanting statutes have been or will be introduced in Colorado, Illinois, Michigan and Virginia. The New York decanting statute, which is set forth in Section 10-6.6 of the New York Estates, Powers and Trusts Law, was amended on August 17, 2011, to expand the authority of a trustee to decant a trust.

New York Decanting Statute

Under the New York decanting statute, as recently amended, an "authorized trustee" with "unlimited discretion" to invade trust principal can distribute all or part of the principal to a new trust, which can

Mr. Schlesinger is the Founding and Managing Partner and **Mr. Goodman** is a partner at Schlesinger Gannon & Lazetera LLP, New York, New York. Mr. Schlesinger is a member of the CCH FINANCIAL AND ESTATE PLANNING Advisory Board.

be created for the benefit of one, more than one, or all of the current beneficiaries of the invaded trust. For this purpose, the term authorized trustee means any trustee of the invaded trust having authority to distribute trust principal to one or more of the current beneficiaries, except that the grantor of the trust, and present and future trust beneficiaries, cannot be an authorized trustee. In addition, unlimited discretion means the authority to distribute principal that is not modified in any manner. In this regard, the statute states that a power to pay principal that includes words such as “best interests,” “welfare,” “comfort,” or “happiness” is not considered to be a limitation on or modification of the right to distribute principal. If an authorized trustee has unlimited discretion to invade trust principal, and the same trustee or another trustee has discretion to invade trust principal that is not unlimited, the statute authorizes such authorized trustee having unlimited discretion to exercise such discretion. Importantly, the statute also states that although the new trust must be created for the benefit of any one or more of the current beneficiaries of the invaded trust, the new trust can exclude any one or more of the current beneficiaries of the invaded trust. Similarly, the statute provides that although the remainder beneficiaries of the new trust must be any one or more of the remainder beneficiaries of the invaded trust, the new trust may exclude any one or more of the remainder beneficiaries of the invaded trust.

If an authorized trustee has unlimited discretion, the New York decanting statute authorizes the new trust to give a power of appointment to one or more of the current beneficiaries of the invaded trust, if such beneficiary could receive principal outright under the terms of the invaded trust. Such power of appointment may only exclude as permissible appointees one or more of such beneficiary, the grantor, the grantor’s spouse, or any of the estates, creditors, or creditors of the estates of such beneficiary, the grantor or the grantor’s spouse. If the invaded trust grants a power of appointment to a beneficiary, the new trust may grant the same power to such beneficiary (i.e., such power must have the same class of the permissible appointees of the power in the invaded trust and must be exercisable in the same manner as the power in the invaded trust).

The New York decanting statute also provides that an authorized trustee who can invade trust

principal, but who does not have unlimited discretion, can distribute all or part of such trust principal to a new trust, if the current beneficiaries of the new trust are the same as the current beneficiaries of the former trust, and if the remainder beneficiaries of the new trust are the same as the remainder beneficiaries of the former trust. The new trust must include the same language authorizing the trustee to distribute the income or principal as existed in the invaded trust. If the new trust has a term beyond that of the invaded trust (as discussed below), then for any period after the invaded trust would have terminated the new trust may also give the trustee unlimited discretion to invade trust principal during such extended term. If the invaded trust gives a power of appointment to a trust beneficiary, the new trust must give the same power of appointment to such beneficiary, having the same class of permissible appointees that existed in the former trust.

The New York decanting statute also contains the following general rules:

1. The New York decanting statute does not create or imply a duty to decant a trust. However, a trust may be decanted unless doing so is expressly prohibited by the trust, but a general prohibition on amending or revoking a trust, or a spendthrift clause, does not preclude decanting a trust.
2. An existing trust can be decanted whether or not there is a current need to invade principal under the terms of the existing trust. Thus, a trust can be decanted even if the standard set forth in the trust for a discretionary invasion of trust principal could not be satisfied under the existing circumstances.
3. A trustee who decants a trust has a fiduciary duty to do so in the best interests of one or more of the beneficiaries to whom the trustee could make trust distributions and as a prudent person would do so under the prevailing circumstances.
 - a. A trust cannot be decanted if there is substantial evidence of a contrary intent of the creator of the trust and if it cannot be established that the creator would be likely to have changed such intention under the circumstances existing at the time of the decanting.
 - b. The provisions of the invaded trust, by themselves, are not to be viewed as substantial evidence of a contrary intent of the creator unless the

invaded trust expressly prohibits decanting in the manner intended by the authorized trustee.

4. Decanting all of the principal of the invaded trust includes subsequently discovered assets of the invaded trust and assets of the invaded trust acquired after the decanting. However, the distribution of only part of the principal of an invaded trust does not include the distribution of subsequently discovered assets of the invaded trust or subsequently acquired assets of the invaded trust.
5. The new trust can have a term that is longer than the term of the invaded trust.

Under the New York decanting statute, an authorized trustee can decant a trust without the consent of the trust's creator, the persons interested in the trust or court approval. Decanting is accomplished by a written instrument that is signed, dated and acknowledged by the authorized trustee. Such instrument and a copy of the invaded trust and the new trust must be delivered to the grantor of

Under the New York decanting statute, an authorized trustee can decant a trust without the consent of the trust's creator, the persons interested in the trust or court approval.

the invaded trust, if living, any person having the right, pursuant to the terms of the invaded trust, to remove or replace the authorized trustee exercising the discretion, and any persons interested in the invaded trust and the new trust. The exercise of the discretion is effective 30 days after the date of service of such notice. A person interested in the invaded trust may object to the trustee's decanting, but failure to object does not constitute consent. A beneficiary of the invaded trust retains the right to compel the authorized trustee who decanted the trust to account for doing so.

The New York decanting statute also contains the following limitations. Specifically, decanting cannot:

1. Reduce, limit, or modify any beneficiary's current right to a mandatory distribution of

income or principal, a mandatory annuity or unitrust interest, or a withdrawal power, except in the case of decanting to a supplemental needs trust.

2. Decrease or indemnify against a trustee's liability or exonerate a trustee from liability for failure to exercise reasonable care, diligence and prudence.
3. Eliminate a provision granting a person the right to remove or replace the authorized trustee exercising the power to decant.
4. Change the provisions regarding the compensation of any trustee.

The New York decanting statute applies to any trust governed by the laws of the State of New York, including a trust whose governing law has been changed to the laws of the State of New York, and to any trust that has a trustee who is an individual domiciled in the State of New York or a trustee which is an entity having an office in the State of New York, if

a majority of the trustees select the State of New York as the location for the primary administration of the trust by an instrument executed by a majority of the trustees.

Possible Federal Tax Consequences of Decanting

It is important to note that the Internal Revenue Service is studying the federal tax

implications of decanting a trust. On December 20, 2011, the IRS issued Notice 2011-101,² inviting comments regarding the possible tax consequences of decanting. The following is a list in the Notice of the facts and circumstances that may be involved in decanting and that may have possible tax consequences:

1. A beneficiary's right to or interest in trust principal or income is changed (including the right or interest of a charitable beneficiary).
2. Trust principal and/or income may be used to benefit new (additional) beneficiaries.
3. A beneficial interest (including any power to appoint income or corpus, whether general or limited, or other power) is added, deleted, or changed.

4. The transfer takes place from a trust treated as partially or wholly owned by a person under Code Secs. 671 through 678 (a grantor trust) to one which is not a grantor trust, or vice versa.
5. The situs or governing law of the new trust differs from that of the invaded trust, resulting in a termination date of the new trust that is subsequent to the termination date of the invaded trust.
6. A court order and/or approval of the state Attorney General is required for the transfer by the terms of the invaded trust and/or applicable law.
7. The beneficiaries are required to consent to the transfer by the terms of the invaded trust and/or applicable local law.
8. The beneficiaries are not required to consent to the transfer by the terms of the invaded trust and/or applicable local law.
9. Consent of the beneficiaries and/or a court order (or approval of the state Attorney General) is not required, but is obtained.
10. The effect of state law or the silence of state law on any of the above scenarios.
11. A change in the identity of a donor or transferor for gift tax and/or generation-skipping transfer (GST) tax purposes.
12. The invaded trust is exempt from GST tax under Reg. §26.2601-1, has an inclusion ratio of zero under Code Sec. 2632, or is exempt from GST tax under Code Sec. 2663.
13. None of the changes described above are made, but a future power to make any such changes is created.

The foregoing list in Notice 2011-101 indicates that a trustee who decants a trust before the IRS publishes the results of its study may inadvertently subject the trust and/or its beneficiaries to possible adverse tax consequences. Therefore, it may be prudent for a trustee who

is considering decanting a trust to refrain from doing so until the IRS publishes those results, so the trustee can determine whether or not the proposed decanting would cause adverse tax consequences. One possible exception to such cautionary note is decanting a trust solely for the purpose of changing the successor trustee(s) of the trust, which generally can be done without tax concerns, if the successor trustee(s) is not a beneficiary of the trust.

It is noted that the IRS has not announced a date by which its guidance regarding decanting will be released, thereby creating a dilemma for a trustee who wants to promptly decant a trust to address exigent circumstances.

Conclusion

Decanting a trust can be an effective and relatively inexpensive method for changing the terms of a trust to cope with changed circumstances, a drafting error or disadvantageous tax consequences. However, in some cases it may be prudent to refrain from decanting a trust until the IRS publishes the results of its study of the federal tax consequences of doing so, to avoid unintended adverse tax consequences that might result from decanting a trust.

ENDNOTES

¹ See *Wiedenmayer v. Johnson*, 106 N.J. Super. 161 (App. Div. 1969), 254 A.2d 534, aff'd on opinion, 55 N.J. 81 (1969), 259 A.2d 465, which is often cited by commentators as supporting the common law right to decant a trust, where the trustees had the discretion to distribute the trust's principal to the beneficiary for his "best interests." The court held that the trustees could distribute the entire trust to the beneficiary on the condition that he simultaneously create a new trust, having all of the terms of the original trust, except for the elimination of two of the remainder beneficiaries, to retain the distributed assets.

² IRB 2011-52, 932.

This article is reprinted with the publisher's permission from ESTATE PLANNING REVIEW-THE JOURNAL, a monthly publication of CCH, a Wolters Kluwer business.

Copying or distribution without the publisher's permission is prohibited.

To subscribe to ESTATE PLANNING REVIEW-THE JOURNAL or other CCH publications, please call 800-449-8114 or visit www.CCHGroup.com. All views expressed in the articles and columns are those of the author and not necessarily those of CCH.