Presenting a live 90-minute webinar with interactive Q&A

Modifying Irrevocable Trusts: Changing the Unchangeable?
Navigating Modification Methods, Governing Law, Consent Requirements, and Tax Considerations

WEDNESDAY, MAY 21, 2014
1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

Today’s faculty features:

Meryl G. Finkelstein, Sr. Counsel, Norton Rose Fulbright, New York
Jaclyn G. Feffer, Senior Vice President & Fiduciary Counsel, Bessemer Trust, New York

The audio portion of the conference may be accessed via the telephone or by using your computer's speakers. Please refer to the instructions emailed to registrants for additional information. If you have any questions, please contact Customer Service at 1-800-926-7926 ext. 10.
**Tips for Optimal Quality**

*Sound Quality*
If you are listening via your computer speakers, please note that the quality of your sound will vary depending on the speed and quality of your internet connection.

If the sound quality is not satisfactory, you may listen via the phone: dial 1-866-961-9091 and enter your PIN when prompted. Otherwise, please send us a chat or e-mail sound@straffordpub.com immediately so we can address the problem.

If you dialed in and have any difficulties during the call, press *0 for assistance.

*Viewing Quality*
To maximize your screen, press the F11 key on your keyboard. To exit full screen, press the F11 key again.
Continuing Education Credits

For CLE purposes, please let us know how many people are listening at your location by completing each of the following steps:

- In the chat box, type (1) your company name and (2) the number of attendees at your location
- Click the SEND button beside the box

If you have purchased Strafford CLE processing services, you must confirm your participation by completing and submitting an Official Record of Attendance (CLE Form).

You may obtain your CLE form by going to the program page and selecting the appropriate form in the PROGRAM MATERIALS box at the top right corner.

If you'd like to purchase CLE credit processing, it is available for a fee. For additional information about CLE credit processing, go to our website or call us at 1-800-926-7926 ext. 35.
Program Materials

If you have not printed the conference materials for this program, please complete the following steps:

• Click on the ^ symbol next to “Conference Materials” in the middle of the left-hand column on your screen.

• Click on the tab labeled “Handouts” that appears, and there you will see a PDF of the slides for today’s program.

• Double click on the PDF and a separate page will open.

• Print the slides by clicking on the printer icon.
Modifying Irrevocable Trusts: Changing the Unchangeable?

May 21, 2014

Meryl G. Finkelstein
Sr. Counsel
Norton Rose Fulbright
666 Fifth Avenue
New York, New York 10103
meryl.finkelstein@nortonrosefulbright.com
+1 212 318 3301

Jaclyn G. Feffer
Sr. Vice President & Fiduciary Counsel
Bessemer Trust
630 Fifth Avenue
New York, New York 10111
feffer@bessemer.com
+1 212 708 9385
INTRODUCTION

• **Why modify or terminate a Will or trust?**
  – Change of law
  – Change of circumstance (i.e., family structure and location, investment objectives, types and amounts of assets)
  – Mistake – by draftsperson or by settlor/decedent (as to law or facts)

• **Types of modifications available**
  – Construction
  – Reformation
  – Amendment
  – Division
  – Disclaimer
  – Nonjudicial Settlement Agreements
  – Nonjudicial Consent Agreements
  – Decanting
  – Others
STATE LAW CONSIDERATIONS

• **Importance of state law**
  – Wills and Trusts are primarily creatures of state law.
  – Accordingly, state law dictates how their terms can be changed either (i) after the death of a testator or (ii) after a trust becomes irrevocable.
  – State laws – both statutory and common law – govern modification techniques such as construction, reformation, amendment, division, decanting, disclaimers.
  – Requirements for each modification technique vary from state to state.

• **Determining which state law applies**
  – Because different states have different tools for modification (i.e., some states allow decanting and others do not), a threshold question should always be what state law applies to my document?
  – In some cases, only one jurisdiction governs all aspects of a Will or trust.
  – In other cases, there are multiple jurisdictions to consider – perhaps one state law controls administration while another controls validity and construction.
STATE LAW CONSIDERATIONS (Cont’d)

• **Which state law controls construction of instrument?**
  – What types of things are considered “construction”?
    – When heirs are determined
    – Whether a spouse of the beneficiary is included as a next of kin
    – Effect of class gifts
    – Meaning of *per capita* and *per stirpes*
    – Whether a disposition is vested or contingent
    – Effect if a beneficiary dies without issue
    – Effect of spousal election rights
    – Rules governing powers of appointment

• **UTC §107 and Restatement (Second) Conflicts of Law Approach**
  – If the Will or trust sets forth the law governing construction, this will likely control.
  – The “meaning and effect” of the terms of an instrument are governed by law designated in the instrument unless the designation of that jurisdiction’s law is “contrary to a strong public policy of the jurisdiction having the most significant relationship to the matter at issue.”
STATE LAW CONSIDERATIONS (Cont’d)

• What if instrument is silent as to which state law controls construction?
  – If question of construction is related to trust administration, look to laws of the trust’s principal place of administration.
  – If question of construction is related to dispositive matters, look to laws of the state that the settler or testator would probably have desired to be applicable (in UTC §107 this is referred to as “place having the most significant relationship” to the matter at issue).
STATE LAW CONSIDERATIONS (Cont’d)

- **Which state law controls administration of instrument?**
  - What types of things are considered “administration”?  
    - Changing trustees (removal and appointment)  
    - Trustee powers and duties  
    - Principal-income determinations  
    - Liability of the trustee  
    - Trustee compensation  
    - Creditor’s rights  
    - Notice requirements  
    - Dividing trusts  
    - Termination or modification of trusts  
  - There is a difference between “governed by” and “administered.”
  - If you change situs of a trust, generally the laws concerning the validity and construction of a trust would not change, but the law governing administration would change to the new situs (see UTC §107).
STATE LAW CONSIDERATIONS (Cont’d)

• **Identifying necessary parties – who are they?**
  – These vary depending on which tool you are using, but consist of some combination of (i) the settlor, (ii) the trustee, and (iii) the beneficiaries (or under the UTC, the qualified beneficiaries).

• **Representation of parties – who can bind others?**
  – There are rules governing who represents minors, unborns, incapacitated beneficiaries, beneficiaries whose identity and/or location are unknown, permissible appointees under a power of appointment, and takers in default under powers of appointment.
  – Actual vs. Virtual Representation
    – Actual representation: Based upon the individual’s relationship to the represented party.
    – Virtual representation: Based upon an individual holding substantially identical interests in the trust as the represented beneficiary (UTC §304).
STATE LAW CONSIDERATIONS (Cont’d)

• **Limitations on representation**
  – Representative must not have a conflict of interest with respect to a particular question at issue in the modification.
  – A settlor can never represent a beneficiary in a non-judicial consent modification.
  – Parent can represent his minor or unborn child unless guardian has been appointed by court.
  – Some states provide priority between parents who both want to represent a minor child – generally, the parent who is a beneficiary of the trust or whose ancestors created the trust has priority.
  – Certain fiduciaries can be actual representatives (i.e., conservator, guardian, agent under power of attorney, trustee with respect to trust beneficiaries, and personal representative with respect to persons interested in the decedent’s estate).
  – Holders of inter vivos or testamentary general powers of appointment can bind potential appointees.
CONSTRUCTION PROCEEDINGS

• **Definition**
  – Judicial proceeding to determine settlor’s (or testator’s) intent, when the instrument is ambiguous or does not provide for a particular contingency.

• **Types of ambiguities**
  – Patent = obvious from the text of the document (i.e., “I give twenty (20) shares of my estate to my sister. Said fifty (50) shares shall be held in trust…”).
  – Latent = not obvious from the text, only apparent after considering facts not set forth in the instrument (i.e., classic example is “I give my real property located at 1600 Pennsylvania Avenue” when testator clearly does not own such property).

• **Process by court to determine intent of settlor/testator**
  – Look to the “four corners” of the document.
  – Use rules of construction and constructional preferences (refer to Restatement (Third) of the Law of Property (Wills & Other Donative Transfers) §11.3(c)).
  – Look to extrinsic evidence.
CONSTRUCTION PROCEEDINGS (Cont’d)

• **Examples of constructional preferences**
  – The construction that is more in accord with common intention than other plausible constructions.
  – The construction that is more in accord with the donor’s general dispositive plan than other plausible constructions.
  – The construction that renders the document more effective than other plausible constructions, including the construction that favors completeness of disposition and the construction that avoids illegality.
  – The construction that gives more favorable tax consequences than other plausible constructions.
  – The construction that accords with the transferor’s contractual obligations.

• **Extrinsic evidence**
  – Historically, courts have been more reluctant to look at extrinsic evidence in the Will context (except for latent ambiguities).
  – Types of extrinsic evidence: testimony of drafter or settlor, list of assets of particular settlor/testator, relevant associated documents (i.e., contract).
CONSTRUCTION PROCEEDINGS (Cont’d)

• **Tax Consequences and Timing**
  – Since construction is simply deciding the meaning of the document as drafted, construction applies retroactive to date of instrument.
  – Because construction is retroactive to date of the instrument, the tax consequences will be determined as of that date.

• **Gift Tax**
  – Likely there is no gift tax consequence – beneficiaries who may have consented to the construction decree (or failed to object to it) will not be deemed to have surrendered rights in a manner that might subject them to a gift tax.

• **GST Tax**
  – If the instrument is grandfathered or otherwise exempt from GST tax, that should not be lost by the construction decree.
  – Treas Reg 26.2601-1(b)(4)(i)(C): “A judicial construction of a governing instrument to resolve an ambiguity in the terms of the instrument or to correct a scrivener’s error will not cause an exempt trust to be subject to the provisions of chapter 13 if (1) the judicial action involves a bona fide issue; and (2) the construction is consistent with applicable state law that would be applied by the highest court of the state.”
CONSTRUCTION PROCEEDINGS (Cont’d)

• Income Tax

  – *Grantor trust qualification*: Under IRC 671 and 674, if settlor has power to control beneficial enjoyment of a trust (unless such power can be exercised only by trustees no more than half of whom are related or subordinate parties), trust is a grantor trust. If a settlor can remove and replace a trustee with himself, he is treated as holding the power of the trustee, and there will be a grantor trust, but beware of estate tax inclusion. Where a trust was ambiguous as to whether settlor could have removed the trustee and replaced with herself, the court construed the language narrowly to exclude the settlor from appointing herself as trustee. See PLR 200006027.

  – *QSST qualification*: A QSST can only have a single beneficiary and must prohibit distributions to any person other than that beneficiary during the beneficiary’s life. Where a trust was ambiguous as to whether invasion powers could be exercised in favor of others, in addition to the beneficiary, it was construed that it was only permitted to be invaded for the beneficiary. See PLR 9729036.
CONSTRUCTION PROCEEDINGS (Cont’d)

• **Marital Deduction**
  - Courts have construed Wills and trusts to allow the marital deduction.
  - **Estate of Mittelman, 522 F2d 132 (DC Cir 1975):** Although QTIP trust did not require all income to be paid to spouse, court construed it to include this provision and qualified it for the marital deduction.
  - **Sawyer v. Sawyer, 374 NE 2d 166 (Ohio 1977):** Wife’s share of the residuary estate was not required, per instrument, to contribute to taxes; this reduced overall taxes b/c larger marital deduction; court relied on the constructional preference of lowering taxes.
  - **PLR 9834027:** Decedent left assets to a credit shelter trust (non-marital) with the balance to a marital trust. The bequest to the credit shelter trust was inadvertently drafted to be larger than the federal exemption amount, and would thus cause a tax. Court reduced the bequest to the CST to only that amount that would pass free of federal estate tax, so the estate would incur no federal estate tax.
  - **PLR 200045004:** Court construed a Will and Codicil to redirect a bequest to a marital trust – instead of to a non-marital trust which was scrivener’s error.
REFORMATION PROCEEDINGS

• **Definition**
  – A court proceeding to determine the settlor’s intent when the language in the document is unambiguous, but does not accomplish the settlor’s intent.

• **Scope**
  – Reformation goes further than construction – here the court is rewriting the instrument in some respect, maybe adding missing language to or deleting language from the instrument.
  – Historically viewed by courts with skepticism, but now courts are more comfortable, especially considering UTC takes broader approach.
Types of reformations

- Scrivener’s error
- Mistake of facts or law – either:
  - settlor was unaware of facts or law at the time the instrument was created, or
  - settlor could not have predicted a change in facts or law after instrument was created.

Availability for Wills

- Historically not available for Wills (because to change the language of a Will would be inconsistent with the statutory formalities required for the execution of a Will).
- This distinction is gradually disappearing – e.g., in 2011 FL enacted a statute allowing a Will to be reformed to correct mistakes or to achieve the testator’s tax objectives.
• UTC approach and importance of extrinsic evidence
  – UTC § 411(b): non-charitable irrevocable trust can be terminated or modified by court as long as the termination or modification is “not inconsistent with a material purpose of the trust.”
  – Caution: Courts do take reform actions seriously, so it is important to have your proof together – the liberalization of the UTC is helpful but extrinsic evidence is essential here. There is a concern regarding unreliable or contrived evidence, so the higher standard of clear and convincing proof is required.

• Restatement (Third) of the Law of Property (Wills & Other Donative Transfers) §12.1
  – “A donative document, though unambiguous, may be reformed to conform the text to the donor’s intention if it is established by clear and convincing evidence:
    – That a mistake of fact or law, whether in expression or inducement, affected specific terms of the document; and
    – What the donor’s intention was.
  – In determining whether these elements have been established by clear and convincing evidence, direct evidence of intention contradicting the plain meaning of the text as well as other evidence of intention may be considered.”
• **Reformation to correct scrivener’s error**
  – Accomplished through addition or replacement of language instead of interpretation of existing language.
  – If the reformation decree is consistent with state law, the IRS would agree the decree is retroactive to the date of the original instrument (the same as construction decree).
  – GST tax (Treas Reg 26.2601-1(b)(4)(i)(C)):
    – Reformation to correct a scrivener’s error will not cause an exempt trust to lose its GST exempt status if (i) the judicial action involves a bona fide issue and (ii) the construction is consistent with applicable state law that would be applied by the highest court in the state.
    – Many PLRs in this area provide comfort to practitioners (i.e., PLR 200040012 stated that reformation to change trust termination from “settlor’s grandchildren” to “settlor’s child’s living issue” was allowed and exempt status not lost).
Ref ormation to correct scrivener’s error (cont’d)

- Gift tax
  - As a general rule, if a beneficiary consents to or fails to object to a change that has an adverse impact on his rights, he could be treated as making a taxable gift.
  - In PLRs, the IRS has conceded that there should not be a gift tax implication for a reformation proceeding if it’s based on scrivener’s error and consistent with state law.
  - This has come up in the context of reforming a GPOA to an LPOA where IRS found no release of a power for gift tax purposes (e.g., PLR 200144018 and PLR 200201017).

- Impact on Charitable Remainder Trusts
  - Key here is to make changes without loss of charitable remainder trust status and without triggering self-dealing rules.
  - IRS has allowed reformations without changing CRT status to: change payout percentage; change remaindermen to private instead of public foundation.
• **Reformation to correct mistake of facts or law** – to achieve result settlor would have wanted if settlor had been aware of facts or law
  
  – There are two ways that mistake of facts or law play into reformation proceedings – (1) where settlor would have intended a different result if he was aware of certain facts or law and (2) where settlor would have intended a different result if he could have predicted a change of facts or law.
  
  – Example: This comes up in the disclaimer context – if disclaimer turns out not to be qualified disclaimer, there is a gift; taxpayer could seek reformation (rescission) claiming he would not have effected a disclaimer if he knew it would not have been qualified.
Reformation to correct mistake of facts or law – to achieve result settlor would have wanted if settlor had been aware of facts or law (cont’d)

Gift Tax
- If the reformation is consistent with applicable state law, and it can be made without the consent of beneficiaries whose rights might be reduced by the change, the reformation should not cause adverse gift tax consequences.

GST Tax
- Caution: A reformation for this purpose (where settlor was not aware of facts or law at time of instrument) may cause a trust to lose GST exempt status.

Treas Regs:
- Treas Reg 26.2601-1(b)(4)(i)(C) only protects for scrivener’s errors, and the settlor’s mistake as to facts or law is not a scrivener’s error and thus there is no protection under the Regs.
- Can look to Treas Reg 26.2601-1(b)(4)(i)(D) which protects a modification to an exempt trust if the modification is (1) valid under state law, (2) does not shift a beneficial interest to a lower generation, and (3) does not extend the time for vesting of a beneficial interest beyond the time originally set out in the instrument.
• Reformation to correct mistake of facts or law – to achieve result settlor would have wanted if settlor had been able to predict change of facts or law
  – UTC §415 (Reformation to Correct Mistakes)
    – “The court may reform the terms of a trust, even if unambiguous, to conform the terms to the settlor’s intention if it is proved by clear and convincing evidence what the settlor’s intention was and that the terms of the trust were affected by a mistake of fact or law, whether in expression or inducement.”
    – This mirrors the Restatement (Third) of Property: Donative Transfers §12.1.
  – Tax consequences should be the same as the mistake of facts or law that settlor was unaware of.
  – Gift Tax
    – If the reformation decree is consistent with applicable state law and can be made without the consent of beneficiaries whose interest is reduced as a result, no gift tax consequence.
  – GST Tax
    – Caution: May cause the trust to lose the GST effective date protection (same as above).

  – Facts: Under his revocable trust, settlor created trusts for his children. Upon a child’s death, the trust would pass to the child’s descendants, or if none, to his other children. Trust terms included adopted persons as trust beneficiaries. There were two adopted children in his family line – one minor child adopted before the settlor’s death (who the settlor knew), and one adult adopted thirteen years after his death (who the settlor never knew and who was 27 years old at time of adoption).

  – One of settlor’s children sued to exclude the 27 year old. She argued the settlor’s intent was to keep the assets in his family and there was no evidence the settlor anticipated an adult adoption 13 years after his death. (So, this goes to facts settlor could not have anticipated.)

  – The trial court granted summary judgment and agreed to exclude the child but the court of appeals reversed on the grounds that (i) Florida public policy permits adult adoption and there’s no statutory basis for excluding an adult adoptee, (ii) there was no fraud in the adoption itself, (iii) the trust terms did not exclude a legally adopted person as a beneficiary, (iv) there was no evidence that the settlor opposed adult adoptions, and (v) whether the adult adoption impairs a material purpose of the trust is an issue in appropriate for resolution on summary judgment.
REFORMATION PROCEEDINGS (Cont’d)

- **Clairmont v. Larson**, 2013 ND 85 (2013) – Court allowed reformation to exclude descendants of child’s ex-husband as trust beneficiaries.
  - Facts: Settlors created various trusts for their four grandchildren, using different lawyers for each set. The trust for one grandson provided that at the grandson’s death, the trust assets were to be distributed to his descendants, or if none, to his “brothers and sisters.” The grandson’s parents subsequently divorced and his father remarried and had two children with his second wife. The grandson died in 2011, unmarried, intestate and without descendants.
  - This seems to apply to both facts settlor could not have anticipated – i.e., that there would be half-siblings – and settlor being mistaken about the law – i.e., that “brothers and sisters” could include half-siblings.
  - The trial court determined that “brothers and sisters” included the half siblings, but the ND Supreme Court reversed, holding that “brothers and sisters” excluded the half siblings. The Supreme Court looked at the extrinsic evidence and found that it supported reformation – the settlors never discussed half-blood relatives with the drafting attorney and the drafting attorney understood it to include only the direct lineal descendants (or he would have used different language). There was no evidence that the half-siblings were intended to be included.
• **Bellamy v. Langfitt et al.**, 2012 Fla. App. LEXIS 1543 (Feb. 8, 2012) – Court did not allow reformation to eliminate corporate trustee role.

  – Facts: Inter vivos trust mandated that there be a corporate trustee at all times. After grantor’s death, the corporate trustee and a few beneficiaries agreed that corporate trustee would resign in favor of a corporate custodian. (There were other individual trustees acting.) One beneficiary (who did not agree to the settlement) brought a petition to appoint a corporate trustee (instead of a corporate custodian).

  – Trial court held that corporate custodian was permissible b/c the purpose of the corporate trustee had been served b/c the trust was substantially administered.

  – Court of Appeals reversed and remanded holding that the clear language of the trust required a corporate trustee and a corporate custodian would not serve the same role and there were more than ministerial functions remaining.
AMENDMENT

The power to amend a trust can be granted under the trust instrument or by state statute.

It is possible to draft an irrevocable trust that gives one or more parties other than the settlor the power to amend the trust in limited circumstances. For example, it is common to give the trustee of a QPRT or a GRAT the limited power to amend the trust to conform to any statutory changes in the QPRT or GRAT rules under the Code and related Treasury Regulations.

Under New York EPTL § 7-1.9, the settlor of a trust may amend (or revoke) a trust without judicial approval provided that all of the beneficiaries consent (although the consent of living contingent remainder beneficiaries is required, the consent of unborn beneficiaries is not). The New York amendment statute is not available if the settlor is deceased or if the trust has a beneficiary who is under a legal disability, although case law in New York has permitted an amendment where the trust had minor beneficiaries but the proposed amendment was favorable to them (Matter of Cord, 58 N.Y.2d 539 (NY Court of Appeals, 1983).

The Attorney General may consent on behalf of charitable beneficiaries and a recent case held that an attorney-in-fact could revoke or amend a trust for the settlor under this section (Perosi v. LiGreci, 98 A.D.3d 230, N.YS.2d 629 (2d Dep’t 2012).
AMENDMENT (cont’d)

The possibility that a settlor can revoke an irrevocable trust under New York EPTL § 7-1.9 does not cause the assets of the trust to be included in the settlor’s gross estate for federal estate tax purposes (i.e., the trust is still deemed to be irrevocable). However, if a settlor amends a trust in a manner that changes beneficial interests, this could have adverse tax consequences to the grantor.

A similar problem can arise with respect to a beneficiary who consents to an amendment that reduces or eliminates the beneficiary’s interest in the trust. In such case, the beneficiary may be treated as having made a gift of that interest.

Although the Treasury Regulations do not contain provisions that protect a GST grandfathered trust that is amended, even where the amendment is authorized under the original trust agreement, the Regulations do protect the exercise of a trustee discretionary power in favor of a new trust if authorized under the trust instrument.
Division is the power to divide a single trust into two or more trusts. A trust division can be desirable in order to achieve both tax and non-tax benefits.

- **Divisions for Tax Purposes:**
  - Dividing a single sprinkle trust with a fractional inclusion ratio for generation-skipping transfer tax ("GST Tax") purposes into two separate trusts, one with a zero inclusion ratio and one with an inclusion ratio of one. If the trust is a sprinkle trust for the benefit of descendants, distributions to children can be made from the resulting trust with an inclusion ratio of one and distributions to the grandchildren or more remote descendants can be made from the resulting trust with a zero inclusion ratio.
  - Dividing a single QTIP marital deduction trust into separate trusts in order to make a reverse QTIP election under IRC §2652(a)(3) to utilize the deceased spouse’s GST exemption. The division of the single QTIP trust into separate trusts is necessary as partial reverse QTIP elections are not permitted and the creation of a QTIP trust with a fractional inclusion ratio may have other adverse GST Tax consequences.
DIVISION (Cont’d)

– Dividing a single trust intended to be treated as a QTIP marital deduction trust into separate trusts in order to have separate and distinct credit and marital trusts. Although partial QTIP elections are permitted, having separate and distinct credit and marital trusts will be more tax efficient.

– Dividing a single grantor trust with multiple transferors into separate trusts which are wholly grantor trusts with respect to each transferor.

– Dividing a single non-grantor trust that holds sub-S stock and other assets into two separate trusts in order to qualify the trust holding the sub-S stock as a QSST or other sub-S eligible shareholder.

– Dividing a single grantor trust into two separate trusts so that grantor trust status can be relinquished with respect to one of the new resulting trusts.
DIVISION (Cont’d)

• **Divisions for Non-tax Purposes:**
  – Dividing a single trust into two separate trusts in order to segregate problematic assets, such as real estate with environmental problems, from financial assets in order to limit the exposure of the financial assets to potential creditor claims.
  – Dividing a single trust into two separate trusts in order to pursue different investment objectives for trust assets.
  – Dividing a single trust into two or more separate trusts in order to address differing needs of trust beneficiaries (or family lines) for distributions from the trust.
  – Dividing a single trust into two trusts, one of which will have a statutory unitrust election made. If there are difficult to value assets, those assets can remain outside of the unitrust to avoid revaluing them annually.
  – Dividing a single trust into two separate trusts in order to have different persons serve as trustees. For example, it might be beneficial in a family dynasty trust to purchase life insurance on certain trust beneficiaries. If the proposed insured is also a trustee, the trust can be severed and the insurance policies held by a trust in which the insured is not a trustee and holds no incidents of ownership with respect to the policies.
DIVISION (Cont’d)

• **Methods for Dividing a Trust:**

  Trust divisions can be achieved under common law, certain state statutes or the terms of the governing instrument.

• **Common Law:**

  At common law, courts in New York, New Jersey and Massachusetts have permitted trust divisions for both tax and non-tax purposes.


  In re Joseph Heller Inter Vivos Trust, 161 Misc. 2d 369 (N.Y. Co. Surr. Ct. 1994) (allowed a trust division to segregate real estate assets in order to insulate the trust’s financial assets from potential creditor claims with respect to the real estate assets).

• **State Statutes:**

  – New York has a broad division statute under Estates, Powers & Trusts Law (“E.P.T.L.”) Section 7-1.13(a)(1), which permits divisions without court approval or beneficiary consent in order to create (i) separate trusts, one of which qualifies for the marital deduction or charitable deduction and one of which does not, (ii) separate exempt and non-exempt trusts for GST tax purposes, (iii) separate trusts, one of which is a qualified subchapter S trust, and (iv) separate trusts for property transferred by different grantors.
DIVISION (Cont’d)

– Under E.P.T.L. § 7-1.13(a)(2), a trust may be divided with the consent of the trust beneficiaries (but without court approval) for any reason which is not directly contrary to the primary purpose of the trust.

– Under E.P.T.L. § 7-1.13(a)(3), the court having jurisdiction over a trust, on the petition of the trustee or any beneficiary, and on notice to all interested persons, may direct the division of a single trust into 2 or more trusts for any reason not directly contrary to the primary purpose of the trust.

– When a trust is divided under E.P.T.L. § 7-1.13, the terms of the resulting trusts will continue to be governed by the terms of the original trust instrument.

– California – Probate Code § 15412 allows a court, on petition of a trustee or a beneficiary, to order the division of a single trust into 2 or more separate trusts if the division will not defeat or substantially impair the accomplishment of the trust’s purposes or the interests of the beneficiaries. Beneficiary consent is not required.
DIVISION (Cont’d)

- **UTC Jurisdictions** -- Broad trust division powers also exist in states that have adopted the Uniform Trust Code. Under UTC § 417, a trustee can divide a single trust into two or more separate trusts for any reason provided “the result does not impair the rights of any beneficiary or adversely affect the achievement of the purposes of the trust.” Thus, under the UTC, a trustee does not have to obtain court approval or beneficiary consent prior to dividing a trust. The trustee must, however, give the beneficiaries prior written notice of a proposed division.

  - The UTC provides for greater flexibility in trust divisions since it does not require that the resulting trusts have identical terms or identical beneficiaries. The comments to the UTC specifically contemplate the use of division to resolve conflicts between beneficiaries, including establishing separate trusts for different beneficiaries. Thus, for example, a single sprinkle trust could be divided into separate trusts for different beneficiaries with different investment philosophies or different requirements for discretionary trust distributions.

  - The following jurisdictions have adopted the UTC: Alabama, Arizona, Arkansas, District of Columbia, Florida, Kansas, Maine, Massachusetts, Michigan, Missouri, Montana, Nebraska, New Hampshire, New Mexico, North Carolina, North Dakota, Ohio, Oregon, Pennsylvania, South Carolina, Tennessee, Utah, Vermont, Virginia, West Virginia, Wisconsin and Wyoming.
DIVISION (Cont’d)

• **Division Under the Trust Instrument:**
  The terms of the governing instrument may also allow trust division. Such a provision may give the trustee powers that are more expansive than what is permitted under any applicable state statute or, in some cases, may limit what could otherwise be achieved under state law. It is thus important to fully review the trust instrument before taking any action. Where beneficiary consent or notice is required under applicable state law, the trust instrument may dispense with consent or notice.

• **Tax Consequences of Trust Divisions**
  – **Income Tax Consequences**
    – A trust division generally should not result in the recognition of any gain (See PLR 200607015, 2/17/06), PLR 200723014 (6/8/07), PLR 200527007 (7/8/05)). However, where the trust division results in the creation of a second trust funded with assets encumbered with debt in excess of basis or a partnership interest with a negative capital account, gain may be recognized under Crane v. Comm’r if the second trust is not viewed as the same taxpayer as the original trust.
    – A trust division should not carry out any DNI under the Subchapter J rules of the Code. (See PLR 200607015, 2/17/06), PLR 200723014 (6/8/07), PLR 200527007 (7/8/05))
DIVISION (Cont’d)

• **Gift Tax Consequences**
  – A trust division, even where beneficiary consent is required, should not result in any adverse gift tax consequences. The UTC prohibits the “impairment” of beneficiary rights, which means that a trust division under the UTC cannot diminish or eliminate beneficial interests. Most non-UTC division statutes require that the resulting trusts have identical terms, including beneficial interests, so no gift tax consequences should result.

• **Estate Tax Consequences**
  – A trust division should not have any estate tax consequences. One caveat is that a specific division provision under a trust instrument should not be drafted to require the consent of the settlor as a condition to the division. This is recommended in order to avoid any potential argument that the settlor has retained interests or rights with respect to the disposition of the trust property.
DIVISION (Cont’d)

• **GST Tax Consequences**
  – §2642(a)(3) of the Code specifically permits the division of a trust for GST Tax purposes. A division for GST Tax purposes (a “qualified severance”) can be accomplished under the terms of the governing instrument or local law, and must comply with the requirements of Treas. Reg. §26.2642-6(d), including:
    – the trust must be severed on a fractional basis;
    – the severance cannot shift a beneficial interest to any beneficiary in a lower generation;
    – the severance cannot extend the time for vesting of any beneficial interest beyond the period provided for in (or applicable to) the original trust; and
    – the terms of the resulting trusts must provide, in the aggregate, for the same succession of interests of beneficiaries as are provided in the original trust. This last requirement may be satisfied in certain cases where a trust for multiple beneficiaries is divided into separate trusts along family lines.
  – Example: A discretionary sprinkle trust is created for the grantor’s 3 children and their descendants. The remainder of the trust is divided equally among the 3 families. The trust can be divided into 3 separate equal trusts, one for each family line.
DISCLAIMERS

- A disclaimer is a denial or refusal of a right or power. Disclaimers can relate to direct interests in property (such as bequests under Wills or beneficial interests in trusts), beneficiary powers (such as powers of appointment) and fiduciary powers (such as the power to distribute property among a class of beneficiaries).

- Disclaimers can be qualified or nonqualified.

- The requirements for a qualified disclaimer are set forth in Code §2518. Whether a disclaimer is a qualified disclaimer is important because of its potential gift tax consequences. With a qualified disclaimer, no adverse gift tax consequences with arise as a result of the disclaimant’s refusal to accept interests in or rights with respect to the disclaimed property.
DISCLAIMERS (Cont’d)

• In general, in order to be a **qualified disclaimer**:
  – the disclaimer must be irrevocable and unqualified;
  – the disclaimer must be made in writing and signed by the disclaimant or his legal representative;
  – The instrument must identify the property being disclaimed and be delivered to the transferor of the interest, the transferor's legal representative, the holder of the legal title to the property to which the interest relates, or the person in possession of such property;
  – The disclaimer must be delivered no later than the date which is 9 months after the later of:
    • the date on which the transfer creating the interest in the disclaimant is made, or
    • the day on which the disclaimant attains age 21;
  – The disclaimant must not have accepted the interest disclaimed or any of its benefits; and
  – The interest disclaimed must pass either to the spouse of the decedent or to a person other than the disclaimant without any direction on the part of the disclaimant.
DISCLAIMERS (Cont’d)

– Wills and trust instruments should be reviewed carefully to determine each and every interest, power or right that must be relinquished in connection with a particular disclaimer.

Example: H’s Will provides for $1,000,000 to be held in trust for his children, with the balance of his estate to pass to W, if she survives or, if not, to be added to the children’s trust. W is appointed to serve as the sole trustee of the children’s trust and has the power to make discretionary distributions of trust principal to her children. W plans to disclaim a portion of her residuary inheritance in order to increase the amount passing to the children’s trust in order to fully utilize H’s federal credit amount. In order for W’s disclaimer to be a qualified disclaimer, W must also disclaim her right to serve as trustee of the trust since she controls distributions from the trust.

– In addition to using disclaimers to correct flaws in documents, practitioners can incorporate disclaimer provisions into their estate plans. Example: Client has 3 children, one of whom is extremely wealthy (“X”). Client insists on treating all of her children equally, even though X and his family do not need or want an inheritance. The Will can be drafted to provide that if X disclaims his interest in the estate, his share will instead be distributed to his siblings.
DISCLAIMERS (Cont’d)

– A non-qualified disclaimer is a disclaimer that does not meet the requirements of Code § 2518. A non-qualified disclaimer will be treated as a taxable gift by the disclaimant. A non-qualified disclaimer is effective as a refusal to accept property or interests in property, but it is treated as a gift to the persons who benefit from the disclaimer.

– Many states also have statutes relating to disclaimers or renunciations of interests, so in addition to satisfying the requirements of Code § 2518, care must be taken to make sure that all state law requirements are satisfied.

• Uses for disclaimers:

– To fix drafting errors in wills and trust instruments. Example – a trust that is intended to qualify for an estate tax marital deduction inadvertently gives testator’s child a current beneficial interest. Child can disclaim the current interest in the trust so that the surviving spouse becomes the sole beneficiary during her life.

– To utilize a decedent’s available credit amount. Example – testator, H, leaves his entire estate to his wife, W, outright. W could disclaim a portion her outright inheritance to utilize all or a portion of W’s remaining credit amount.

– To avoid accepting bequests that would otherwise become subject to claims of creditors.

– To eliminate a retirement plan beneficiary in order to maximize deferral for the younger designated beneficiaries.
NONJUDICIAL SETTLEMENT AGREEMENTS

• **Applicability**
  – Governed by UTC §111.
  – Comment to UTC states that resolutions by nonjudicial means are “encouraged” – however, a nonjudicial settlement cannot be used to produce a result not authorized by law. These are extremely useful tools, because there is a lot of flexibility in changes that can be made and settlor consent is not required.

• **Requirements under UTC §111**
  – Agreement between “interested persons,”
    – “Interested persons” are those whose consent would be required if the settlement were approved by the court (virtual representation and appointment of a guardian ad litem should be acceptable under UTC)
    – Settlor’s consent is not needed (thus, living settlor is not required)
  – With respect to “any matter” involving a trust, as long as it does not violate a “material purpose” of the trust, and
  – Includes terms and conditions that could be approved by a court.
    – This third concept merges with the second concept since a court would likely not approve anything that violated a “material purpose” of the trust.
• **Scope of Modification.** UTC § 111 gives examples of matters that can be resolved by nonjudicial settlement – this is a nonexclusive list:
  – Interpretation or construction of the terms of the trust;
  – Approval of a trustee’s report or accounting;
  – Direction to a trustee to refrain from performing a particular act or the grant to a trustee of any necessary or desirable power;
  – Resignation or appointment of a trustee and the determination of a trustee’s compensation;
  – Transfer of a trust’s principal place of administration; or
  – Liability of a trustee for an action relating to the trust.
  – Note: Some states have an exclusive list of permitted modifications (to avoid potential abuse).
**Court approval**
- Interested persons may request the court to approve the settlement agreement (to determine if representation was adequate and to determine whether the agreement contains terms and conditions the court could have approved).
- This highlights the necessity of having consent from all interested persons because essentially an interested person can turn a nonjudicial settlement into a judicial settlement.

**Testamentary trusts**
- Nonjudicial settlements can be used for testamentary trusts.
NONJUDICIAL SETTLEMENT AGREEMENTS (Cont’d)

• **NJSA as alternative to directed trust**
  - Nonjudicial settlement agreement (NJSA) wrapper may be used in lieu of decanting or merger to create a directed trust.
  - How it works: The NJSA wrapper carves out a certain role while releasing the current trustee from liability for that role.
  - Examples – an NJSA wrapper may be used to:
    - Appoint “investment trustee,” “distribution trustee” or other “special purpose trustee” with certain exclusive powers;
    - Create administrative nexus to a particular state (appoint “administrative trustee”);
    - Hold a concentrated position in a single asset;
    - Hold a portion of a limited liability company;
    - To open and fund a discretionary management account with an investment manager; or
    - To overcome traditional common law rules against self-dealing.
  - Benefits: May eliminate tax concerns about creating/modifying a trust, faster, less expensive and more predictable (than judicial modification).
NONJUDICIAL CONSENT MODIFICATIONS

• Comparison to Nonjudicial Settlements
  – Governed by UTC §411(a)
  – The major difference between the nonjudicial consent modification and the nonjudicial settlement agreement is that a consent modification requires the consent of the settlor and all beneficiaries.
  – If your settlor is alive but not legally competent, then the modification can be accomplished through a power of attorney or by a court appointed guardian.
  – Generally trustee consent is not required.
  – Basically, this section of the UTC allows a trust to be modified or terminated over a trustee’s objection – however, under UTC §410(b) the trustee would have standing to object. (Beneficiaries also have standing to object under UTC §410(b).)

• Broad scope
  – The consent modification is broader than the settlement agreement – here, the modification or termination can be completed even if it is inconsistent with a material purpose of the trust; theory here is that the settlor is consenting.
  – For these purposes, a spendthrift provision is explicitly not considered a material purpose.
• **Distribution if consent to terminate**
  – If the trust is terminated by a nonjudicial consent modification, the trustee distributes the property as agreed upon by the beneficiaries.

• **Lack of Beneficiary Consent**
  – If not all beneficiaries consent, you will likely have to go to court.

• **Court approval**
  – The modification or termination may be approved by the court if the court is satisfied that:
    - If all of the beneficiaries had consented, the trust could have been modified or terminated under UTC §411(a); and
    - The interests of a beneficiary who does not consent will be adequately protected.
• **Gift Tax Consequences**
  – There is no gift by settlor or beneficiary.
  – The fact that the settlor is joining the beneficiaries in the termination or modification does not cause this to be a gift by the settlor. Treas Reg 20.2038-1(a)(2).
  – If this is a termination, as long as the beneficiaries agree to distribute the trust property in accordance with their proportionate interests, there is no gift by a beneficiary either.

• **Estate Tax Inclusion**
  – There should not be estate tax inclusion.
  – Some practitioners were concerned this would cause inclusion under 2036 or 2038 (i.e., has the settlor retained the power to modify trust in conjunction with others). In response, the UTC was revised to require that the settlor cannot represent any beneficiaries.
  – Some states have specifically provided that the settlor has a mere “veto power” – thus the settlor’s power is more passive and should not cause inclusion.
  – PLR 201233008 – settlor’s consent to a trust modification pursuant to state statute did not cause the trust assets to be included in the settlor’s gross estate under IRC 2036 or 2038.
TRUST DECANTING

A decanting statute permits a trustee who has the discretion or authority to invade the principal of a trust (and in some cases trust income) for the benefit of one or more trust beneficiaries to exercise that authority by transferring some or all of the assets of the trust in further trust.

The rationale underlying a trust decanting is that a trustee who has the discretion to make an outright distribution of trust property to or for the benefit of one or more current beneficiaries of the trust has a special power of appointment over the trust property that allows the trustee to distribute the property to another trust for the benefit of one or more beneficiaries of the trust.

Twenty-one states have enacted specific decanting legislation. Only two statutes (Indiana and New Hampshire) actually use the word “decanting” in their titles. Most refer to the trustee’s invasion or distribution power or the trustee’s power to appoint to another trust.
# State decanting statutes

<table>
<thead>
<tr>
<th>STATE</th>
<th>DECANTING STATUTE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Delaware</td>
<td>12 Del. C. §3528 (2003, various amendments)</td>
</tr>
<tr>
<td>Illinois</td>
<td>760 ILCS 5/§16.4 (1/1/2013)</td>
</tr>
<tr>
<td>Indiana</td>
<td>Ind. Code §30-4-3-36 (2010)</td>
</tr>
<tr>
<td>Kentucky</td>
<td>KRS §386.175 (2012)</td>
</tr>
<tr>
<td>Michigan</td>
<td>MCLA §§ 556.115a, 700.7820a and 700.7103 (2012)</td>
</tr>
<tr>
<td>Missouri</td>
<td>Missouri Rev. Stat. §456.4-419 (2011)</td>
</tr>
<tr>
<td>New York</td>
<td>N.Y. Estates, Powers &amp; Trusts Law §10-6.6(b) (1992, amended 2011)</td>
</tr>
<tr>
<td>Texas</td>
<td>Tx. Property Code §112.071 (2013)</td>
</tr>
<tr>
<td>Wyoming</td>
<td>W.S. 4-10-816(a)(xxviii) (2013)</td>
</tr>
</tbody>
</table>
REASONS TO DECANT A TRUST

• A trust decanting can be used to achieve a number of objectives. Common uses include:
  – Modifying and/or modernizing a trust’s administrative provisions (including converting a trust to a directed trust).
  – Changing a trust’s dispositive provisions (to the extent permitted by state law or the trust instrument) in order to address unforeseen circumstances of the beneficiaries of the trust (including eliminating beneficial interests).
  – Changing a trust’s governing law and/or situs.
  – Changing a trust’s provisions in order to achieve certain tax benefits, including turning grantor trust status on or off.
  – Correcting ambiguities and drafting errors in a trust.
  – Stripping out or segregating problem assets held by a trust.
  – Separating trust assets in order to employ different investment strategies or combining the assets of multiple trusts to take advantage of increased investment opportunities and/or reduce investment costs.
TRUST DECANTINGS -- THRESHOLD CONSIDERATIONS FOR THE TRUSTEE

- Does the trustee have the requisite power to make distributions under the trust?
- Is the proposed decanting consistent with the trustee’s fiduciary duties of loyalty and impartiality?
- Before decanting a trust, the trustee must thoroughly review the governing instrument.
  - Does the trust instrument prohibit decanting? If it does, then the trustee cannot act (or perhaps court authorization can be obtained).
  - If the trust instrument gives the trustee a specific power to decant, the trustee should confirm that the proposed decanting is consistent with what the trust instrument allows.
- If the trust instrument creating the first trust is silent, the trustee must confirm whether he has the requisite power under the applicable state decanting statute.
- If the decanting will be effectuated under the applicable state decanting statute, the trustee must confirm that the exercise of the decanting power complies with all statutory requirements and does not violate any limitations under the statute.
- Can the trust be moved to a new jurisdiction that permits decanting?
- Issues may arise in determining which state’s law applies to the first trust, particularly if its situs or governing law was changed prior to the decanting.
STATUTORY DIFFERENCES

All of the state decanting statutes are intended to allow the trustee to appoint the assets of an existing trust to a second trust – but the operative provisions of the statutes can differ in a variety of ways, including:

• The level of discretion that the trustee must have with respect to the power to invade the first trust (i.e., trusts where the trustee has absolute or unlimited discretion to make distributions versus trusts with distribution standards).
• Whether a decanting may be based solely on a power to invade trust income.
• The persons for whose benefit the power to invade the first trust may be exercised and the persons who are permissible beneficiaries under the second trust.
• Whether powers of appointment not granted under the first trust may be granted to a beneficiary under the second trust.
STATUTORY DIFFERENCES (Cont’d)

• Limitations on the trustee’s exercise of the decanting power that are intended to preserve tax benefits of the first trust such as marital and charitable deductions, gift tax annual exclusions, sub-S elections and allocations of GST exemption.

• Restrictions on the ability of a beneficiary-trustee to participate in a decanting.

• The procedural aspects of the trustee’s exercise of the decanting power, including:
  – Method of exercise;
  – Notice to beneficiaries, contents of the notice and waivers of notice itself or the notice period;
  – Beneficiary consent; and
  – Court approval and/or court filing requirements.
SCOPE OF THE TRUSTEE’S INVASION POWER UNDER STATE LAW

• Florida and Indiana’s decanting statutes require that the trustee have the absolute discretion or power to distribute trust principal in order to decant an existing trust.

  – Absolute discretion or power is one that is not limited to specific or ascertainable purposes such as HEMS. Under the Florida statute, a power to invade for the best interests, welfare, comfort or happiness of a beneficiary does not constitute a standard.

• All of the other state decanting statutes permit a decanting where the trustee’s distribution or invasion power under the existing trust is limited by a standard, but a distribution standard often limits the scope of the changes that the decanting can effectuate (i.e., changes in beneficial interests versus administrative changes).
SCOPE OF THE TRUSTEE’S INVASION POWER UNDER STATE LAW (Cont’d)

• If the trustee’s discretion under the first trust is limited by a standard, the decanting statute must be reviewed to determine if the same standard must be included in the second trust or if there are limitations on permitted changes.
  – Example: Some statutes require that the same standard be included in the second trust and some also require that it be exercisable in favor of the same beneficiaries as provided under the first trust (Alaska, Illinois, Missouri, New York, North Carolina and Texas).
  – Example: Other statutes require that the same or a more restrictive standard be included in the second trust where the trustee exercising the distribution power is a possible beneficiary under the standard (Arizona and Kentucky).
  – Example: Under the Ohio statute, the second trust cannot materially change the interests of the beneficiaries of the first trust (which means that a decanting can only be undertaken to make administrative changes to the first trust).
  – Under the Delaware statute, the trustee’s exercise of the invasion power must comply with any standard that limits the trustee’s authority to make distributions from the first trust (example – if the first trust has a 5% annual distribution limit, then only 5% of the assets can be decanted annually).
SCOPE OF THE TRUSTEE’S INVASION POWER UNDER STATE LAW (Cont’d)

In a number of states, a decanting may be based on a trustee’s discretionary power to distribute trust income, not just principal.

- The Kentucky, Michigan, Missouri, Nevada, North Carolina, South Carolina, South Dakota and Virginia statutes all apply to a trustee’s power to distribute trust income or principal.
- The Arizona and New Hampshire statutes refer to the power to make distributions, which includes both principal and income.
- Under the Texas statute, where the trustee has the discretion to distribute principal of the first trust, that power may be exercised in favor of beneficiaries of the first trust who are eligible to receive income or principal from the first trust.
PERMISSIBLE BENEFICIARIES OF THE SECOND TRUST

One of most difficult issues arising with respect to trust decantings is determining the identity of the permissible beneficiaries of the second trust and to what extent the beneficiary provisions of the first trust may be varied in the second trust.

• Can current beneficiaries of the first trust be eliminated in the second trust:
  – Under all of the statutes, the answer appears to be yes where the trustee has an unlimited distribution power or absolute discretion.
  – Where the trustee does not have absolute or unlimited discretion, then many statutes prohibit the elimination of the interests of current beneficiaries of the first trust in the second trust (See Alaska, Illinois, Michigan, New York, North Carolina, Ohio and Virginia.
  – Under the Texas statute, if the trustee does not have full discretion, then the current, successor and presumptive remainder beneficiaries of the second trust must be the same as the current, successor and presumptive remainder beneficiaries of the first trust.
PERMISSIBLE BENEFICIARIES OF THE SECOND TRUST (Cont’d)

• Can remainder beneficiaries of the first trust be eliminated in the second trust:
  – This is not explicitly addressed under most of the statutes, but most commentators take the position that if the interest of a current beneficiary can be eliminated under the statute, the interest of a future or remainder beneficiary also can be eliminated.
  – The Alaska, Illinois, Michigan, New York, Ohio and Texas statutes all specifically provide that remainder interests (and in some cases successor interests) can be eliminated only where the trustee of the first trust has absolute or unlimited discretion.
  – In Delaware, the interests of remainder beneficiaries under the first cannot be eliminated in the second trust (regardless of the level of the trustee’s discretion to make distributions).
PERMISSIBLE BENEFICIARIES OF THE SECOND TRUST (Cont’d)

• Can the interests of remainder beneficiaries of the first trust be accelerated to present interests in the second trust.
  – The Missouri and South Dakota statutes specifically permit the acceleration of remainder interests.
  – Although most of the statutes are silent, if the power to invade the principal of the first trust must be exercised in favor of one or more current beneficiaries of first trust, it follows that the acceleration of remainder interests should not be permitted.
  – The Kentucky, North Carolina and Virginia statutes all specifically prohibit the acceleration of remainder interests. This is also implied under other statutes (such as Delaware).

• Can the second trust add as beneficiaries persons who are not beneficiaries under the first trust.
  – None of the statutes permit the addition of beneficiaries in the second trust and the majority specifically state that the beneficiaries of the second trust may include only persons who are beneficiaries of the first trust.
Some statutes allow the second trust to grant a power of appointment not provided for under the first trust, effectively allowing the “back-door” addition of beneficiaries through the exercise of the power of appointment.

- The Alaska, Delaware, Illinois, Kentucky, Michigan, Nevada, New York, North Carolina, Ohio, South Dakota, Tennessee, Texas and Virginia statutes permit the second trust to grant a power of appointment (usually including a general power of appointment) not provided for in the first trust to a beneficiary of the second trust. The potential appointees under the power do not have to be beneficiaries of either the first trust or the second trust, thus providing a method for adding beneficiaries.

- Some statutes (Illinois, Ohio and Texas) require that the trustee have absolute discretion to distribute trust principal in order to add a power of appointment under the second trust.

- In New York, a beneficiary under the first trust can be granted a power of appointment in the second trust that is not in the first trust where the trustee has absolute discretion and the beneficiary could have received the entire principal of the first trust outright. However, the potential donees of the power must be unlimited (i.e., the power must be exercisable in favor of anyone in the world except where the beneficiary, the grantor or grantor’s spouse would have a general power of appointment).
Most decanting statutes seek to preserve certain provisions contained in the first trust, particularly as they relate to maintaining the tax benefits of the first trust and/or protecting certain fixed or mandatory interests of the beneficiaries of the first trust such as income interests and rights of withdrawal.

- All of the state decanting statutes prohibit the reduction (or elimination) of fixed or mandatory income interests under the first trust, but in some cases the scope of the prohibition is limited:
  - Example: In Delaware and South Dakota, this restriction applies only where the first trust is a marital trust.
  - Example: In Alaska, Illinois, Nevada, New Hampshire, New York, Ohio and Texas, only current income interests, not future income interests, are specifically protected. This is implied under the Missouri statute.
  - Example: The Kentucky statute protects both current and future fixed income interests.
STATUTORY LIMITATIONS ON EXERCISE OF TRUSTEE’S INVASION POWER (Cont’d)

Many decanting statutes also prohibit the reduction or elimination of annuity and/or unitrust interests (i.e. Alaska, Arizona, Florida, Indiana, Illinois, Michigan, Nevada, Kentucky, New Hampshire, New York, North Carolina, Ohio, Rhode Island, Texas and Virginia). In some states, only marital trusts and/or charitable trusts are protected (Delaware, Michigan, Missouri, South Dakota). Other states also protect GRAT interests (Missouri, South Dakota).

- Many statutes seek to preserve specific tax benefits of the first trust including:
  - Contributions that qualified for the gift tax annual exclusion under IRC 2503(b) based on the first trust’s qualification as a 2503(c) trust – in such a case, the second trust cannot extend the age for vesting and distribution of the beneficiary’s interest beyond the age set forth in the first trust (Delaware, Illinois, Kentucky, Michigan, Missouri, Nevada, North Carolina, Ohio, South Dakota and Virginia).
  - Trusts for which sub-chapter S elections have been made (Alaska, Illinois, Kentucky, Ohio, Tennessee and Texas).
STATUTORY LIMITATIONS ON EXERCISE OF TRUSTEE’S INVASION POWER (Cont’d)

• Many statutes also protect property subject to presently exercisable rights or powers of withdrawal.
  – Under some statutes, the decanting power does not apply to such property (New Hampshire).
  – Under other statutes, the decanting power does not apply unless the beneficiary’s power of withdrawal under the first trust is unchanged in the second trust (Missouri, Nevada and South Dakota).
  – Under some statutes, the second trust must provide an identical power of withdrawal or sufficient assets to satisfy the right of withdrawal must remain in the first trust (Kentucky, North Carolina and Virginia).
  – Some statutes also prohibit the elimination of the current right to withdraw a specified dollar amount or percentage of trust principal and a beneficiary’s right to receive mandatory principal distributions under the first trust (Alaska, Illinois, New York, Ohio and Texas).
STATUTORY LIMITATIONS ON EXERCISE OF TRUSTEE’S INVASION POWER (Cont’d)

• Many of the statutes contain provisions prohibiting the extension of the permissible period of the rule against perpetuities applicable to the first trust.

Attempts to extend the duration of a trust can have varying consequences depending on whether the trust is grandfathered from the GST tax, exempt from the GST tax or non-exempt. Care should be taken when a trust is decanted from a state that has a rule against perpetuities to a state that has repealed the rule against perpetuities or has a longer rule than the rule applicable to the first trust.
LIMITATIONS WHERE TRUSTEE IS A BENEFICIARY OR WHERE BENEFICIARIES POSSESS CERTAIN POWERS

Some statutes also limit the ability of a beneficiary-trustee to decant. Concerns include the potential for a taxable gift being made by the beneficiary-trustee or the beneficiary-trustee being deemed to hold a general power of appointment.

- In Alaska, New York, North Carolina and Virginia, a beneficiary-trustee is not authorized to act.
- In Arizona, the beneficiary-trustee cannot act if it would have an adverse tax impact on the beneficiary-trustee.
- Where absolute discretion is required and the action of a beneficiary-trustee would be tantamount to the exercise of a general power of appointment, the beneficiary-trustee cannot act.
- Missouri, Michigan Nevada, New Hampshire and South Dakota also limit the rights of a beneficiary trustee to act where the trust does not contain certain safeguards that would prevent adverse tax consequences to the beneficiary, or where beneficiaries have the right to remove and replace trustees or are not prohibited from using trust assets to discharge their legal support obligations.
Do the decanting statutes specify a manner of exercise?
- Most of the statutes require a written instrument that is signed and acknowledged by the trustee and filed with the records of the first trust (and in some cases the second trust).
- The Arizona, Missouri and New Hampshire statutes are silent on the method of exercise.

Can the second trust be established under the first trust or is a new trust required?
- Some statutes specifically require that a new governing instrument be created (Alaska and South Dakota).
- Other statutes specifically authorize the trustee to establish the second trust under the first trust or to create a new governing instrument (Arizona, Delaware, Florida, Indiana, Michigan, Missouri, North Carolina, Ohio and Tennessee).
MECHANICS OF THE TRUSTEE’S EXERCISE OF THE POWER TO APPOINT IN FURTHER TRUST (Cont’d)

• Is advance notice of the decanting required?
  – Most statutes require some amount of advance notice to the beneficiaries of the first trust (the statutes range from 20 to 63 days).
  – In some states, only current beneficiaries must receive notice. In others, both current beneficiaries and presumptive remaindermen must receive notice.
  – Some states also require notice to the state’s attorney general where the trust has a current or future charitable beneficiary.
  – The Nevada statute authorizes but does not require notice and interestingly, the Delaware statute does not require any notice.
  – **What constitutes notice?** In some, states serving a copy of the decanting instrument plus both trust instruments (Alaska, New York and Texas). In others, serving a copy of the proposed instrument exercising the decanting power is sufficient (Florida, Indiana, Kentucky, Michigan, North Carolina and Rhode Island).
MECHANICS OF THE TRUSTEE’S EXERCISE OF THE POWER TO APPOINT IN FURTHER TRUST (Cont’d)

• Can beneficiaries waive notice?
  – Many statutes permit the beneficiaries to waive the notice period in which case the decanting will be effective prior to the expiration of the notice period (Florida, Indiana, Kentucky, Michigan, Nevada, North Carolina, Ohio, Rhode Island and South Dakota).
  – Some statutes permit the beneficiaries to waive notice itself (Missouri, Texas and Virginia).

• Is beneficiary consent required?
  – Beneficiary consent generally is not required in any state and there are both gift and GST tax reasons for this. There are some limited exceptions in Nevada, Michigan and Ohio (such as where the trustee’s compensation is being altered by the decanting).

• Is court approval required or are there court filing requirements?
  – Only Ohio requires court approval and only in cases where the first trust is a testamentary trust created by an Ohio domiciliary. New York has a court filing requirement for testamentary trusts and inter vivos trusts that were the subject of prior court proceeding (but court approval is not required).
ADDITIONAL STATUTORY PROVISIONS

- Some statutes permit the term of the first trust to be extended in the second trust (Alaska, New York, Illinois, Michigan, and Ohio).

- Some statutes prohibit a decanting to change the trustee’s commissions (Alaska, Illinois, New York, Ohio, and Texas).

- Some statutes also prohibit a trustee from decanting a trust in order to reduce the trustee’s standard of care or to exonerate or indemnify the trustee from liability under the second trust (Illinois, New York, Ohio, Texas).

- Spendthrift clauses and provisions prohibiting amendment or revocation of the first trust do not bar a decanting.

- Many statutes provide that a trustee does not have a duty to decant and some also provide that a trustee’s failure to decant does not give rise to an inference of impropriety (Alaska, Delaware, Florida, Indiana, Illinois, Kentucky, Michigan, Missouri, Nevada, New Hampshire, New York, North Carolina, Ohio, Rhode Island, Texas, and Virginia).

- Many statutes provide that a decanting is subject to the trustee’s fiduciary duties and standards as they would apply in making a discretionary outright distribution and some statutes set forth guidelines that the trustee must consider before exercising a decanting power.
IRS NOTICE 2011-101

• IRS Notice 2011-101 (the “Notice”) requested comments regarding the income, gift, estate and GST Tax issues and consequences of a decanting that changes beneficial interests of the first trust.

• For purposes of the Notice, a change in beneficial interests occurs when the interests of beneficiaries of the first trust are changed or terminated under the second trust and/or when the second trust adds a new beneficiary.

• The Notice identifies thirteen facts and circumstances as potentially having tax consequences. These include situations where:
  – A beneficiary’s right to or interest in trust property is changed;
  – Trust beneficiaries are added;
  – Beneficial interests are added, deleted, or changed;
  – Assets are transferred from a grantor trust to a non-grantor trust or vice versa;
  – Beneficiaries of the first trust are required to consent, are not required to consent or actually do consent even though consent is not required;
  – The identity of the transferor for gift and/or GST Tax purposes changes; and
  – The first trust is a GST grandfathered trust or is exempt from GST Tax.
The Notice also seeks guidance on (a) how “decanting” should be defined, (b) whether there are additional tax consequences if the decanting is from a U.S. trust to a foreign trust or vice versa and (c) whether a new employer identification number should be required where all of the principal of the first trust is distributed to another trust.

While this issue is under study, the IRS has advised that it will not issue any private letter rulings with respect to a decanting that involves a change in beneficial interests, but it will continue to issue rulings with respect to transfers that do not change any beneficial interests and do not result in a change in the applicable rule against perpetuities period.
In response to the Notice, several Bar and professional organizations submitted comments. Many comments recommended that the IRS adopt certain safe harbors under which a trust decanting will not have any adverse tax consequences. Where a trust decanting falls outside the scope of the safe harbors, then whether any adverse tax consequences arise would require analysis on a case-by-case basis.

- Proposed safe harbors would include situations where:
  - All of the assets of the first trust are decanted to a second trust that changes only the administrative provisions of the first trust.
  - The decanting is effectuated by a disinterested trustee and does not shift beneficial interests in the first trust or delay the vesting of a beneficiary’s property interest in the first trust.
  - The decanting does not reduce or eliminate a beneficiary’s vested and mandatory rights to a distribution under the first trust.
  - Beneficiary consent to the decanting is obtained but is not required as a condition of the decanting (and in all events, a beneficiary’s failure to object should not be considered tantamount to consent).
  - The first trust and the second trust are both grantor trusts treated as owned by the same grantor.

INCOME TAX ISSUES

• As indicated by the Notice, a trust decanting raises a number of potential income tax issues including the following:
  
  – APPLICATION OF THE SUBCHAPTER J RULES:
    
    – Under the Subchapter J rules, a distribution from a complex trust carries out a share of the trust’s distributable net income (“DNI”) to the beneficiary who receives the distribution. The first trust receives a distribution deduction under IRC § 661 and the beneficiary includes in gross income an amount equal to his share of the trust’s DNI under IRC § 662.
    
    – It is not clear whether the Subchapter J rules apply to a trust decanting, but the Treas. Regs and case law indicate that a trust can be a beneficiary of another trust, with the Subchapter J rules applicable to a distribution to the second trust. See Treas. Reg. § 1.643(c)-1 (which provides that for purposes of Part I of Subchapter J, a trust can be a beneficiary of another trust). See also Duke v. Comm'r, 38 BTA 1264, 1269 (1938); Comm'r v. Bishop Trust Co., 136 F2d 390 (9th Cir. 1943), aff'g 42 BTA 1309 (1940); Harwood Estate v. Comm'r, 3 TC 1104 (1945); White Estate v. Comm'r, 41 BTA 525 (1939); Lynchburg Tr. & Sav. Bank v. Comm'r, 68 F2d 356 (4th Cir. 1934).
- Comments to the Notice suggest that the Subchapter J rules should not apply to a decanting distribution where the second trust is considered a continuation of the first trust (i.e., where all of the assets of the first trust are distributed to a second trust having substantially similar terms). In such a case, the distribution from the first trust would be tax neutral and no DNI would be carried out. See PLRs 200607015, 200723014, 200527007. This should be the case even if property encumbered with debt in excess of basis or negative capital account property is decanted.

- The first and second trusts will have substantially similar terms if the trusts have the same beneficiaries, the same standards for distribution and the same timing for payments.

- If the second trust is viewed as a continuation of the first trust, the second trust should be able to use the same EIN as the first trust (although there may be practical reasons why issuing a new EIN is preferred).

- However, if only a portion of the assets of the first trust are distributed to the second trust, comments to the Notice suggest that the Subchapter J rules should apply because the distribution is more equivalent to a discretionary trust distribution.
INCOME TAX ISSUES (Cont’d)

• CAPITAL LOSS CARRYOVERS AND CREDITS:
  – Where all of the first trust’s assets are decanted, how are the first trust’s net operating loss carryovers, capital loss carryovers and foreign tax credit carryovers affected. Does the second trust succeed to these carryovers, or are they passed out to the first trust’s beneficiaries as if the trust had terminated?
  – Under IRC § 642(h) and Treas. Reg. § 1.642(h)-3(d), in a trust’s final year (i.e., on termination), unused carryovers are passed out to the trust beneficiaries and allowed as a deduction by them.
  – There isn’t any specific authority, but if all of the assets of the first trust are distributed to a second trust with substantially similar terms, so that the second trust is viewed as a continuation of the first trust, the second trust should succeed to the first trust’s tax attributes.

• According to the comments, this should be the result even if the terms of the trusts are not substantially similar and is consistent with other areas of the law, including the private foundation rules and the rules for corporate reorganizations.

• If the decanting is to multiple receiving trusts, then the tax attributes of the first trust should be distributed proportionately among the receiving trusts.
INCOME TAX ISSUES (Cont’d)

• **GAIN RECOGNITION**: Is the transfer of assets from the first trust to the second trust a recognition event for either the first trust’s beneficiaries or the trust itself?

• Gain Recognition by Trust Beneficiaries
  – IRC §1001(a) and Treas. Reg. §1001-(a) generally provide an exchange of property is a disposition of property and results in the recognition of gain or loss only if the exchanged properties are “materially different” in either kind or extent. In *Cottage Savings v. Comm’r*, 499 U.S. 554 (1991), the Supreme Court adopted a test for determining when property received in an exchange is considered to be materially different from the property transferred. Under *Cottage Savings*, two properties are materially different if their respective possessors enjoy legal entitlements that are different in kind or extent.
  – Several PLRs issued after *Cottage Savings* suggest that a distribution of assets from one trust to another could result in gain to the beneficiary if the interests of the beneficiaries under the second trust differ materially from their interests under the first trust. See PLRs 2012207001, 201136014, 199951028. In such a case, there would be an exchange of property by the beneficiary that results in gain under IRC § 1001. In the PLRs, the interests of the beneficiaries were not materially different, so no gain resulted, but they suggest that if the beneficiaries’ interests were materially different, gain could have resulted.
– Unlike the taxpayer in *Cottage Savings*, which voluntarily exchanged its assets, a trust beneficiary rarely participates in a decanting (and is prohibited from participating under most state decanting statutes). Since any changes in the beneficiary’s interests under the trusts result from the trustee’s decision to decant, not the beneficiary’s actions, the comments to the Notice suggest that even if the beneficiary’s interests under the two trusts differ materially, no gain should result. Several IRS private letter rulings are consistent with this view. Under these rulings, a beneficiary does not recognize gain where the distribution to another trust is authorized by the trust instrument or local law. See PLRs 201204001, 201133007, 201134017.

– These PLRs are also consistent with Treas. Reg. § 1.1001-1(h), which provides that a non-pro rata severance of a trust does not constitute an exchange of property for other property differing materially in either kind or extent if applicable state law or the trust instrument authorize the severance and non-pro rata funding.

– However, under Rev. Rul. 69-486, gain may be recognized by a beneficiary on a distribution between trusts where the distribution is not authorized by applicable law or the terms of the governing instrument and occurs by agreement of the beneficiaries. Thus, if beneficiary consent is an express condition of the decanting, gain might be recognized if the beneficiary’s interests in the first trust and the second trust are materially different.
– Moreover, where beneficiary consent is not required under the terms of the trust instrument, applicable state law or as a condition of the decanting, Rev. Rul. 69-486 should not apply. This should be the case even if the beneficial interests in the first trust and the second trust are materially different and/or the beneficiary actually does consent even though not required to do so. (Note that most state decanting statutes do not require beneficiary consent, and where consent is required under a decanting statute, it is only in very limited circumstances.)

– **PLANNING POINTER:** Where possible, beneficiary consent or court approval should not be made a requirement of the decanting (whether under the trust instrument, state law or otherwise) as this could result in unintended income tax (and potential gift tax) consequences to the beneficiary.
INCOME TAX ISSUES (Cont’d)

• Gain Recognition by the First Trust.
  – Does a decanting distribution of appreciated assets from the first trust to the second trust cause the first trust to recognize gain?
  – If both the first trust and the second trust are grantor trusts deemed owned by the same person, then no gain should be recognized under Rev. Rul. 85-13, which disregards transactions between two grantor trusts that are deemed to have the same owner.
  – Even if the first and second trusts are not both grantor trusts deemed owned by the same person, in most cases gain should not be recognized. When a domestic non-grantor trust is funded with appreciated property, the grantor does not recognize any gain on the transfer to the trust (since the grantor does not receive anything in exchange for the contribution). Instead, the receiving trust takes the grantor’s basis in the transferred property.
  – In addition, a 2008 IRS Chief Counsel Memorandum concludes that the conversion of a non-grantor trust to a grantor trust is not a transfer of property that requires gain recognition. See CCA 200923024 (December 31, 2008).
– One exception is where appreciated assets from a domestic trust are transferred to another trust that is a foreign non-grantor trust. In such a case, the transfer will be treated as a sale or exchange of the property for its then fair market value under IRC § 684 and gain will be recognized.

– Another possible exception arises where the transferred property includes negative basis assets, such as property with debt in excess of basis or is a partnership or LLC interest with a negative capital account. In such a case, gain may be triggered under Crane v. Comm’r, 331 U.S. 1 (1947), which held that where a taxpayer sells or exchanges property and is discharged from liability, the taxpayer’s amount realized includes any debt that is discharged.

– Based on Crane, the IRS has concluded that the termination of grantor trust status results in gain recognition if the trust holds properties having liabilities in excess of basis or partnership interests with negative capital accounts. See Treas. Reg. § 1.1001-1(e), Example 5, TAM 200010010 (March 13, 2000), Madorin v. Comm’r, 84 T.C. 667 (1985).

– 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 and is not clear whether Crane trumps IRC § 643(e). As a result, practitioners have requested that the IRS issue guidance on this issue.
INCOME TAX ISSUES (Cont’d)

– However, even if Crane does trump IRC § 643(e), if all of the assets of a first trust are distributed to a second trust that is viewed as a continuation of the first trust, or if both the first and second trusts are grantor trusts deemed owned by the same person, no gain should be recognized on a decanting distribution.

• PLANNING POINTER: Practitioners must be aware of the nature of the assets that are held by the first trust if it is a grantor trust and determine whether any assets have negative basis.

• IDENTITY OF THE GRANTOR OF THE SECOND TRUST

– Another issue arising in a decanting 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 trusts. This result is consistent with Treas. Reg. §1.671-2(e)(5), which generally provides that if a trust transfers assets to another trust, the grantor of the first trust will be treated as the grantor of the second trust.

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

– Thus, where a beneficiary-trustee participates in a decanting that results in the beneficiary making a taxable gift, or where a beneficiary’s consent to a decanting is deemed to result in a taxable gift, the beneficiary should be treated as the grantor of the second trust. Comments to the Notice have requested that the IRS clarify the limited circumstances under which the grantor of the first trust will not be deemed to be the grantor of the second trust.
GIFT TAX ISSUES

Under Code § 2512, a gift arises when property is transferred for less than adequate and full consideration in money or money’s worth. In order for a gift tax to be imposed, there must be an intentional act of transfer (See Treas. Reg. § 25.2511-1(c)(1)).

In most cases, a trust decanting effectuated by a trustee who does not have a beneficial interest in the first or second trust should not raise any gift tax issues.

However, if beneficiary consent to the decanting is required, and if the decanting would reduce or eliminate a beneficiary’s interest in the first trust, then the beneficiary may be deemed to have made a transfer subject to gift tax. Note, however, that with some very limited exceptions, the decanting statutes do not require beneficiary consent. If a specific decanting provision is included in a trust instrument, it should not require beneficiary consent. Where possible, a trustee should consider dispensing with beneficiary consent where the decanting changes beneficial interests in the first trust.
GIFT TAX ISSUES

Many decanting statutes require notice to trust beneficiaries, but a beneficiary’s mere receipt of notice should not give rise to adverse gift tax consequences. Comments to the Notice suggest that in most cases, because a beneficiary does not have a legal right to oppose a decanting that is undertaken in accordance with state law or the trust instrument, acquiescence should not result in a taxable gift by the beneficiary.

− Where a decanting changes only the administrative provisions of the first trust, and does not alter beneficial interests, no gift tax consequences should arise regardless of whether or not beneficiary consent is required.

− Special problems can also arise where a trustee-beneficiary participates in a decanting that reduces or eliminates his beneficial interest in the first trust (a decanting to change only administrative provisions should have no adverse gift tax consequences). For example, if a trustee-beneficiary’s life income interest in a trust were eliminated by a decanting, a taxable gift equal to the actuarial value of the life income interest could occur.
GIFT TAX ISSUES (cont’d)

Some statutes prevent unintended gift tax consequences from arising by expressly prohibiting a trustee-beneficiary from participating in a decanting (i.e., New York, New Hampshire). Others allow a trustee with a beneficial interest to act only where distributions to the beneficiary are subject to a HEMS standard and the same standard is included in the second trust.

Where a decanting would result in a lapse of a general power of appointment, such as where a beneficiary’s presently exercisable right of withdrawal in excess of a 5 and 5 power could be eliminated, a gift results under Code § 2514(b). All of the state decanting statutes contain provisions that prevent such a lapse from occurring.

Or, where the first trust contains provisions that cause the grantor’s transfer to the first trust to be an incomplete gift, a decanting that eliminates those provisions will cause the grantor’s gift to be completed.
ESTATE TAX ISSUES

When a trust is decanted, the original transferor of property to the first trust is deemed to be transferor of property to the second trust (this is the case regardless of whether the second trust is created by the trustee of the first trust or by its grantor).

If the property that was held by the first trust was not included in the transferor’s gross estate for federal estate tax purposes, the property held by the second trust should not be included in the transferor’s gross estate unless the second trust contains a provision that causes estate tax inclusion. This could arise where the second trust gives the transferor a dispositive power over trust property that triggers inclusion under Code § 2038, or where the second trust holds a life insurance policy on the life of the transferor and gives the transferor an incident of ownership with respect to the property (causing estate tax inclusion under Code § 2042(2)).
GST TAX ISSUES

The GST tax implications of decanting a trust must be examined when the trust is either grandfathered from the GST tax or exempt from the GST tax because exemption was allocated to the trust (a “post-effective date trust”). The rules vary depending under which category the trust falls. In either case, caution must be taken if the decanting would extend the term of the first trust.

The GST tax is imposed when any one of the following 3 types of transfers occurs:

1. **Direct Skip** – This is a transfer made to a skip person that is subject either to gift or estate tax. A skip person is a person who is assigned to the generation of the transferor’s grandchildren or to any generation below that.

2. **Taxable Termination** – Occurs when a person’s interest in a trust terminates and there is no non-skip person who has an interest in the trust.

3. **Taxable Distribution** – Occurs when a distribution is made from a trust to a person who is a skip person.
GST TAX ISSUES

In the case of a taxable termination or a taxable distribution, whether any GST tax is payable will depend upon whether the trust is grandfathered from the GST tax, or whether any portion of the transferor’s GST tax exemption was allocated to the trust.

A taxpayer can allocate GST tax exemption to a trust in order to shelter future distributions to skip persons from the GST tax. At present, the amount of the GST tax exemption is $5,340,000.

Grandfathered Trusts

A grandfathered trust, generally, is a trust that is exempt from the GST tax because it was irrevocable on September 25, 1985. If proper caution is not taken in decanting a grandfathered trust, its exempt status could be tainted.

The regulations provide two “safe harbors” that if met, will prevent a decanting from subjecting a grandfathered trust to GST tax.
**GST TAX ISSUES**

**Safe Harbor #1.** If a trustee distributes property from a grandfathered trust to a new trust, the distribution will not cause the new trust to lose grandfathered status if 3 requirements are met:

i. Either the terms of the grandfathered trust or state law authorized the trustee’s action on the date the grandfathered trust became irrevocable;

ii. The trustee can distribute the property without beneficiary consent or court approval; and

iii. The new trust does not postpone or suspend the vesting, absolute ownership, or power of alienation of an interest in property beyond the federal perpetuities period.

**NOTE:** No state had a decanting statute in effect prior to 1992, so to meet the first prong of this test, either the trust instrument itself must have authorized the decanting or state common law in effect at the date of the trust’s creation must have permitted decanting.

GST TAX ISSUES

**Safe Harbor #2.** This safe harbor applies to any changes made to a grandfathered trust. A change made to a grandfathered trust resulting from a decanting must satisfy two requirements in order to avoid tainting grandfathered status:

i. The modification cannot shift a beneficial interest in the trust to any generation lower than that of the persons holding beneficial interests prior to the modification; and

ii. The modification cannot extend the time for vesting of any beneficial interests beyond the period provided for under the terms of the first trust.

If using Safe Harbor #2, the term of the grandfathered trust cannot be extended because an extension would violate the second prong of the safe harbor.

Safe Harbor #2 is useful when working with a grandfathered trust because no state decanting statute was in existence prior to 1992. Thus, it is unlikely that the first prong of Safe Harbor #1 will be met unless the trust itself permitted decanting or the trustee relies on state common law as having permitted a decanting at the time the trust became irrevocable. In the absence of authority under the trust and an argument that the decanting is permitted under state common law, a decanting that is effectuated under the applicable state decanting statute will need to satisfy Safe Harbor #2. Treas. Reg. § 26.2601-1(b)(4)(i)(D).
GST TAX ISSUES

If the applicable decanting statute requires beneficiary consent to the decanting, the Regulations provide that the decanting will constitute a modification of the trust because the statute will necessarily have been enacted after the date the trust was created (since no state decanting statute existed before 1992).

If, however, the modification meets both prongs of Safe Harbor #2, the GST tax will not be triggered for either the first trust or the second trust. In an example provided in the Regulations, despite the consent of the beneficiaries constituting a modification, the requirements of Safe Harbor #2 were met because the modification did not shift any beneficial interest in the trust to a beneficiary who occupied a lower generation and the modification did not extend the time for vesting beyond the period provided for in the first trust. The Regulations, therefore, provide that the consent of the beneficiaries to the decanting is a modification that falls within Safe Harbor #2. (Treas. Reg. § 26.2601-1(b)(4)(E) Example (2)).
The examples in the Regulations detail other modifications to a trust that can be accomplished by decanting without tainting the grandfathered status of the trust. These examples include the following:

- A construction proceeding brought to clarify an ambiguous term in the first trust which results in an order by a court construing the instrument a certain way does not taint grandfathered status (Treas. Reg. § 26.2601-1(b)(4)(i)(E) Example (1)).

- A merger of two trusts that are both grandfathered trusts for the benefit of the same beneficiaries does not taint grandfathered status (Treas. Reg. § 26.2601-1(b)(4)(i)(E) Example (6)).

- A trust that requires income be paid to the income beneficiary for life, remainder to the income beneficiary’s descendants, can be modified in the new trust to provide that the income beneficiary receives the greater of the income of the trust or the unitrust amount. The modification is not considered a shift in beneficial interest to a lower generation because the modification only increases the amount distributable to the income beneficiary. Further, the modification does not extend the time for vesting. (Treas. Reg. § 26.2601-1(b)(4)(i)(E) Example (8)).
GST TAX ISSUES

In addition to the above safe harbors, another mechanism is available for grandfathered trusts under the Regulations that govern the exercise of a special power of appointment. Treas. Reg. § 26.2601-1(b)(1)(v)(B) provides that the exercise of a power of appointment over the assets of a grandfathered trust will not cause the trust to lose its GST exempt status if the exercise does not extend the trust’s term in violation of the permissible perpetuities period under federal law. The federal perpetuities period will not be violated if the vesting, absolute ownership or power of alienation of an interest in property is not suspended or delayed beyond (i) a life in being at the date of the creation of the trust plus twenty-one years, or (ii) ninety years from the date of the creation of the grandfathered trust. It is not clear why the Regulations lay out two separate frameworks, one for a special power of appointment and the other for a decanting, given that under common law and the vast majority of the state decanting statutes, a decanting is considered to be the exercise by the trustee of a special power of appointment.
GST TAX ISSUES

**Post-Effective Date GST Exempt Trusts.** Post-effective date GST exempt trusts are trusts that have been allocated sufficient GST exemption so that they have a zero-inclusion ratio for GST tax purposes.

The safe harbors under the Regulations do not specifically apply to post-effective date trusts but have been extended by the IRS to post-effective date trusts under various PLRs. These PLRs have applied the second safe harbor to post-effective date trusts, and found that when there was no shift of beneficial interest and no extension of the time for vesting, the trust did not lose any of its GST exemption.

In PLR 200743028, certain assets of an existing trust were decanted under state statute to a second trust having virtually identical terms. A portion of the grantor’s GST exemption had been allocated to the trust. Prior to making the decanting distribution, the trustees of the trust changed the trust’s situs to another state. The taxpayer sought a ruling from the IRS that neither the prior decantings, nor any future appointments to the second trust, would cause the trust’s inclusion ratio to change. The IRS noted that no guidance exists concerning the changes that may affect the status of trusts that are exempt from GST tax because sufficient GST exemption was allocated to them. However, it acknowledged that at a minimum, a change that should not adversely affect the GST status of a grandfathered trust should similarly not affect the exempt status of a trust to which exemption was previously allocated.
What if a particular state does not have a decanting statute and the trust instrument does not contain a decanting provision? A common law basis for decanting is recognized under court decisions in Florida, New Jersey, Iowa and Massachusetts, and is also supported under the Second and Third Restatements of Property.

A. CASES

1. **Phipps v. Palm Beach Trust Co. (Florida Supreme Court) (1940):** Phipps is the first American case recognizing the ability of a trustee authorized to make discretionary trust distributions to exercise that power to distribute trust assets to a second trust for the benefit of the beneficiaries of the first trust. Wife (“W”) created a discretionary trust for her children and descendants and named Husband (“H”) and Trust Co. as trustees, giving H the absolute discretion to distribute trust assets among the beneficiaries. H distributed the assets of the first trust to a second trust for the benefit of the same persons, but the second trust granted one of W’s children a testamentary power of appointment exercisable in favor of his wife, who was not a beneficiary under the first trust. The corporate trustee brought a construction proceeding to determine whether H’s actions were within the scope of his powers as trustee. The Florida Supreme Court upheld H’s actions. First, it determined that H’s distribution power was a special power of appointment, which included not only the ability to appoint the trust property outright to a beneficiary, but also to create a lesser interest, such as an interest in further trust. Second, the Court noted that the class of beneficiaries under the second trust was identical to those under the first trust.

**Note** – *Phipps* is often cited as common law authority for a trustee’s ability to appoint trust property in further trust. However, H’s distribution power was more similar to a beneficiary power of appointment and less like the type of discretionary distribution power that a trustee exercising a decanting power normally has.
A. **CASES**


Wiedenmayer involved a trust held for the benefit of an heir to the Johnson & Johnson family fortune. The trust gave the trustees absolute discretion to distribute trust principal to the beneficiary for his best interests. The trustees distributed the trust assets to another trust established by the beneficiary. The beneficiary had been married and divorced and the trustees determined that the distribution in further trust was for the financial benefit of the beneficiary since it would protect the trust assets from the claims of another spouse. The guardian ad litem for the beneficiary’s minor children opposed the distribution, claiming that it would defeat the children’s contingent remainder interest under the first trust. The court held for the trustees, finding that the appointment in further trust was consistent with the settlor’s intent since it was in the best interest of the beneficiary to protect the trust assets from future creditor claims. It also reasoned that an outright distribution of trust assets to the beneficiary, which was within the scope of the trustees’ powers, would similarly defeat the interests of the trust’s remainder beneficiaries.

**Note** – The trustees’ willingness to make distributions from the trust to the grantor’s son was expressly conditioned on the son’s agreeing to establish a second trust to receive the distribution.
A. CASES

3. *In Re: Estate of Spencer (Iowa Supreme Court) (1975)*

Wife (“W”) created a testamentary trust for her children and gave Husband (“H”), who was a trustee, a testamentary power to grant life estates to the children, with the remainder to pass to W’s grandchildren. H exercised his power of appointment by creating a trust for his children, to last for the maximum period allowed by the Rule Against Perpetuities. The court examined whether H had the right to appoint the trust property in further trust for his children, as opposed to granting them life estates. The court determined that H’s appointment in further trust for the children during their lives was consistent with W’s intention that the trust assets remain within her family line and that they pass as a single unit. However, the court determined that the assets could not be held in further trust beyond the lives of W’s children as it was clear that W intended that the assets pass outright to her grandchildren upon the death of her children.

*Note* – The power held by H was exercisable in his individual capacity, not in his capacity as a trustee of the trust. Thus, the court did not analyze the exercise of the power from a fiduciary standpoint.
DECANTING UNDER COMMON LAW (Cont‘d)

A. CASES


Morse involved an inter vivos trust created for the benefit of the grantor’s sons and their issue. The trust consisted of four subtrusts, each of which gave the trustees full discretion to distribute trust income and principal “for the benefit of” the grantor’s sons. Morse, the independent trustee, brought an action for declaratory relief to clarify that the terms of the trust authorized him to transfer all of the assets of the subtrusts to new subtrusts (created under a new master trust) for the benefit of the same beneficiaries without beneficiary consent or court approval. The new trust authorized the grantor’s sons to serve as co-trustees of their subtrusts. Since the trust did not specifically allow an appointment of trust assets in further trust (and Massachusetts does not have a decanting statute), the ruling was necessary in order to avoid losing the GST grandfathered status of the trust.

The issue was whether the distribution language of the trust, which authorized the trustee to distribute trust principal “for the benefit of” each child, authorized a distribution in further trust. Relying primarily on *Wiedenmayer* and *Phipps*, the court held that the trustee could transfer the assets of the subtrusts to new subtrusts without beneficiary consent or court approval. In finding that the trustees held a decanting power, the court relied on the specific language of the trust instrument, which gave the trustees the power to distribute trust principal “for the benefit of” the beneficiary. The court found that the trust language created a “broad grant of almost unlimited discretion” which was “evidence of the settlor’s intent that the disinterested trustee have the authority to distribute assets in further trust for the beneficiaries’ benefit.”
Note – The language in the trust instrument that the Morse court relied on is important because the court did not recognize an inherent power of the trustees of all discretionary trusts to exercise their distribution authority to distribute assets in further trust. The Boston Bar Association, in its amicus brief, had requested that the court recognize a decanting power in any discretionary trust where the trustee has the power to distribute trust assets “to” the beneficiary. The court declined to adopt this request and limited its finding of an inherent decanting power only to trusts where the trustee has the power to distribute “for the benefit of” the beneficiaries.
B. RESTATEMENTS OF PROPERTY

Under the Second Restatement, a trustee’s discretionary power to distribute trust assets gives the trustee the power to designate beneficial interests in the trust property and is considered a power of appointment. The trustee’s power to appoint trust property allows the trustee to vest interests in the property in the appointees of the property and to divest the interests of persons who would receive the property in default of the exercise of the power. Unless the donor has manifested a contrary intention, the holder of a special power of appointment has the same rights to dispose of the property among the objects of the power that he would have had he owned the property directly – i.e., by making either an outright disposition of the property or disposing of it in further trust. Thus, unless a trust instrument specifically limits the trustee’s distribution power to making outright distributions, the trustee’s distribution power includes the power to appoint the trust property in further trust for the beneficiaries.

The Third Restatement distinguishes between beneficiary powers of appointment and fiduciary distributive powers. Fiduciary distributive powers include a trustee’s power to distribute trust income and principal to one or more designated trust beneficiaries. A fiduciary distributive power is not considered a discretionary power of appointment under the Third Restatement because the exercise of the power is subject to the trustee’s fiduciary obligations. Under the Third Restatement, subject to fiduciary standards and the terms of the power as set forth in the trust instrument, a trustee can exercise a fiduciary distributive power such as a power of invasion to create another trust. In addition, a trustee exercising a distribution power in further trust is expressly subject to the same rules that apply to the exercise of a beneficiary power of appointment, including the persons for whose benefit the power can be exercised, under the same rules that apply where a trust is created by a beneficiary’s exercise of a special power of appointment.
ADDITIONAL FEDERAL TAX CONSEQUENCES

• There are two reasons why the modification procedures discussed above may not have the desired federal tax result – the Bosch rule and the completed transaction rule.

• **Bosch Rule**
  – The IRS is not necessarily bound by a state court decision regarding property rights – even though property rights are usually determined at the state level.
  – Bosch case – Supreme Court decided that the IRS is allowed to have the Tax Court or another federal court determine the proper result under state law, unless a decision as to that result has been made by the highest court of the state.
ADDITIONAL FEDERAL TAX CONSEQUENCES (Cont’d)

• **Completed Transaction Rule**
  – Here we are dealing with a situation where a taxable event has occurred (i.e., the death of a testator or completed gift to an irrevocable trust), and a modification is subsequently made - after that taxable event.
  – This rule operates as a timing rule:
    – If the completed transaction rule applies, the modification will not pre-date the taxable event, and thus will not change the tax consequence. (This is the result even if the reformation is consistent with state law.)
    – However, if there is a state court decision prior to the taxable event, then the IRS is bound by that decision.
  – Does not apply to:
    – Construction proceedings; or
    – Reformation that allows a settlor to undo the transfer (and take back the property) because of a mistake made in connection with the transfer.

• **Other Federal transfer tax consequences**
  – As discussed throughout the presentation, potential for gift and GST tax consequences.
OTHER MODIFICATION TECHNIQUES

• **Loans**
  – If no principal distributions are allowed under the trust instrument.
  – Re-classifying a gift as a loan.

• **Merger Doctrine**
  – Assign current interest to remaindermen to merge interests.
  – Concerns about spendthrift provisions.

• **Sale to Grantor Trust**
  – Sell assets from trust with “incorrect” terms to new trust with “fixed” terms.
  – Some assets will still be trapped in original trust, but future appreciation can pass to new trust.
Uniform Trust Code Jurisdictions (as of April 2014)

<table>
<thead>
<tr>
<th>Alabama</th>
<th>North Carolina</th>
</tr>
</thead>
<tbody>
<tr>
<td>Arizona</td>
<td>North Dakota</td>
</tr>
<tr>
<td>Arkansas</td>
<td>Ohio</td>
</tr>
<tr>
<td>D.C.</td>
<td>Oregon</td>
</tr>
<tr>
<td>Florida</td>
<td>Pennsylvania</td>
</tr>
<tr>
<td>Kansas</td>
<td>South Carolina</td>
</tr>
<tr>
<td>Maine</td>
<td>Tennessee</td>
</tr>
<tr>
<td>Massachusetts</td>
<td>Utah</td>
</tr>
<tr>
<td>Michigan</td>
<td>Vermont</td>
</tr>
<tr>
<td>Missouri</td>
<td>Virginia</td>
</tr>
<tr>
<td>Montana</td>
<td>West Virginia</td>
</tr>
<tr>
<td>Nebraska</td>
<td>Wisconsin</td>
</tr>
<tr>
<td>New Hampshire</td>
<td>Wyoming</td>
</tr>
<tr>
<td>New Mexico</td>
<td></td>
</tr>
</tbody>
</table>
Meryl G. Finkelstein

Senior Counsel
Fulbright & Jaworski LLP
meryl.finkelstein@nortonrosefulbright.com
(212) 318-3301

Meryl is senior counsel in the New York office, where she focuses on trusts and estates matters, with an emphasis on estate and wealth planning for individuals and their families. Her clients include a wide variety of business professionals, owners of closely-held businesses and private investors.

She has over two decades of experience in the development and implementation of sophisticated estate and wealth transfer plans. Her expertise extends not only to advising U.S. citizens, but also includes advising resident and non-resident aliens.

Jaclyn G. Feffer

Senior Vice President & Fiduciary Counsel, Bessemer Trust, New York, NY
feffer@bessemer.com
(212) 708-9385

Ms. Feffer assists high net worth individuals and families in developing and implementing generational wealth transfer planning strategies. She has extensive experience in estate and gift tax matters, family succession planning, and charitable planning. In her role as Fiduciary Counsel, she helps administer various types of trusts.

Prior to joining Bessemer in 2013, Ms. Feffer was an attorney at Fulbright & Jaworski, LLP, practicing in its Trusts and Estates department.